

Taxation of Mergers and Acquisitions

Buying and Selling a Business – Mastering the Basics July 31, 2008

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Goals

- 1. Identify buyers' and sellers' tax considerations**
- 2. Identify common deal structures**
- 3. Identify how deal structures may achieve buyers' and sellers' tax preferences**
- 4. Identify tax-planning opportunities**
- 5. Identify other important tax considerations**

General Tax Considerations

- **Sellers' Tax Considerations**
 - Capital gain treatment
 - Liquidation of the target corporation
 - Installment sale treatment

- **Buyers' Tax Considerations**
 - Tax attributes after acquisition
 - Step-up in basis
 - Net operating losses

Seller's Tax Considerations

■ **Installment Sale Treatment**

– Transaction Type

- Stock Sale – Shareholder holds note.
- Asset Sale – Target Corp. holds note unless Target Corp. is liquidated.

– Earn-Out / Contingent Sales Price

- Where there is a Maximum Earn-Out
- No Maximum Earn-Out, but Maximum Time
- No Maximum Earn-Out or Time

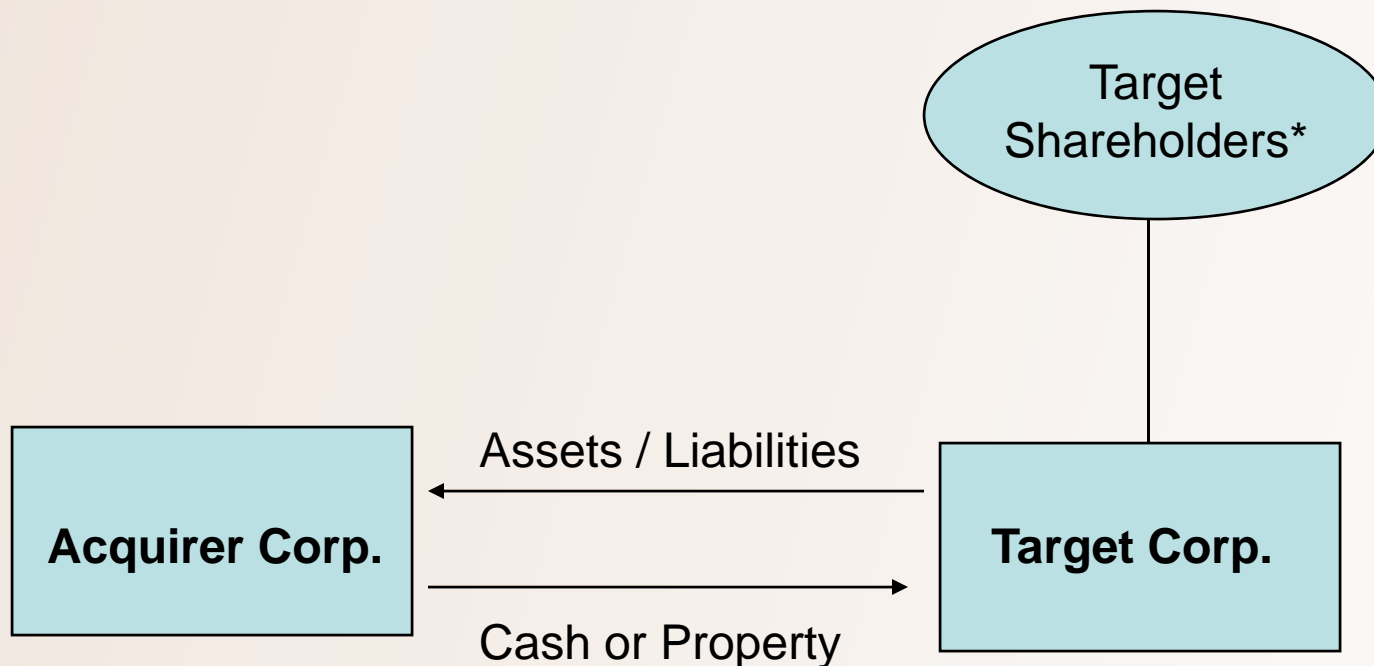
Buyer's Tax Considerations

- **Net Operating Losses**
 - Section 382
 - Section 269

Taxable Acquisitions of C-Corps

Taxable Acquisitions of C-Corps

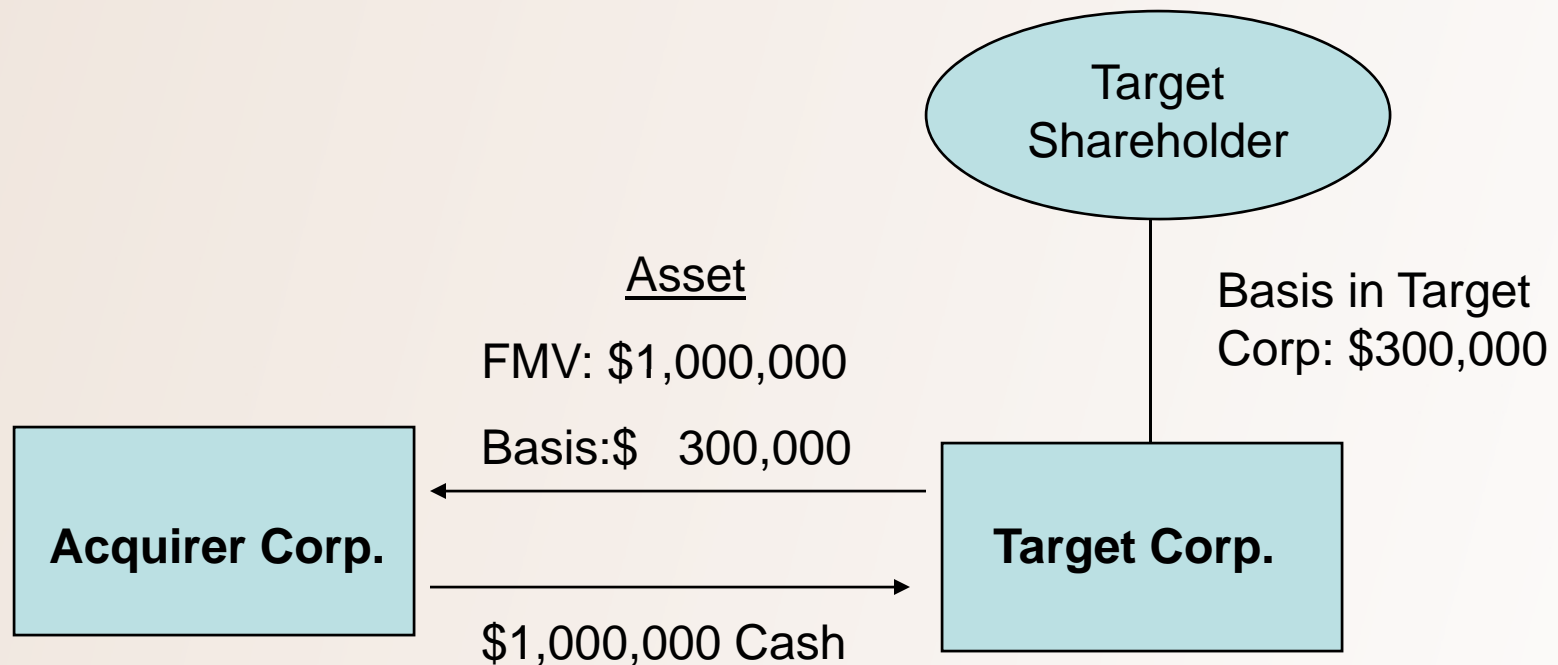
- Taxable Asset Sale



* Continue to hold stock in Target Corp. unless Target Corp. is liquidated.

Taxable Acquisitions of C-Corps

- Taxable Asset Sale - Example



Taxable Acquisitions of C-Corps

■ Taxable Asset Sale – Example

– Consequences to Target Corp.:

■ Recognize gain immediately:

» Purchase Price	\$1,000,000
» Less: Basis in Asset	<u>300,000</u>
» Gain on Sale of Asset	700,000
» Tax on Gain on Sale at 30%:	210,000
» Gross Proceeds:	\$1,000,000
» Less: Corporate Level Tax	<u>210,000</u>
» Net Proceeds to Target Corp	790,000

Taxable Acquisitions of C-Corps

■ Taxable Asset Sale – Example

– Consequences to Shareholder (A) upon Liquidation of Target Corp.:

■ Recognize gain on liquidation:

» Proceeds	\$ 790,000
» Less: Basis in Stock	<u>300,000</u>
» Gain on Liquidation	490,000
» Tax on Gain on Sale at 20% (capital gains rate)	98,000
» Gross Proceeds to A	790,000
» Less: Capital Gains Tax	<u>98,000</u>
» Total Proceeds to A	692,000

Taxable Acquisitions of C-Corps

- **Taxable Asset Sale – Example**
 - Consequences to Acquirer Corp. (P):
 - Takes asset with basis of \$1,000,000.

Taxable Acquisitions of C-Corps

- **Allocation of Purchase Price**
 - Contractual Agreement
 - Residual Method

Taxable Acquisitions of C-Corps

- **Allocation of Purchase Price – Residual Method**
 - Class I: Cash and cash equivalents
 - Class II: Actively traded personal property
 - Class III: Accounts receivable, certain debt instruments and mark-to-market assets
 - Class IV: Inventory
 - Class V: All other assets (buildings, land, machinery)
 - Class VI: Section 197 Intangibles except goodwill and going-concern value
 - Class VII: Goodwill and going-concern value

Taxable Acquisitions of C-Corps

- **Allocation of Purchase Price**
 - Intangible Assets
 - Personal Goodwill
 - IRS Form 8594

Taxable Acquisitions of C-Corps

■ Taxable Asset Sale - Evaluation

– For Seller:

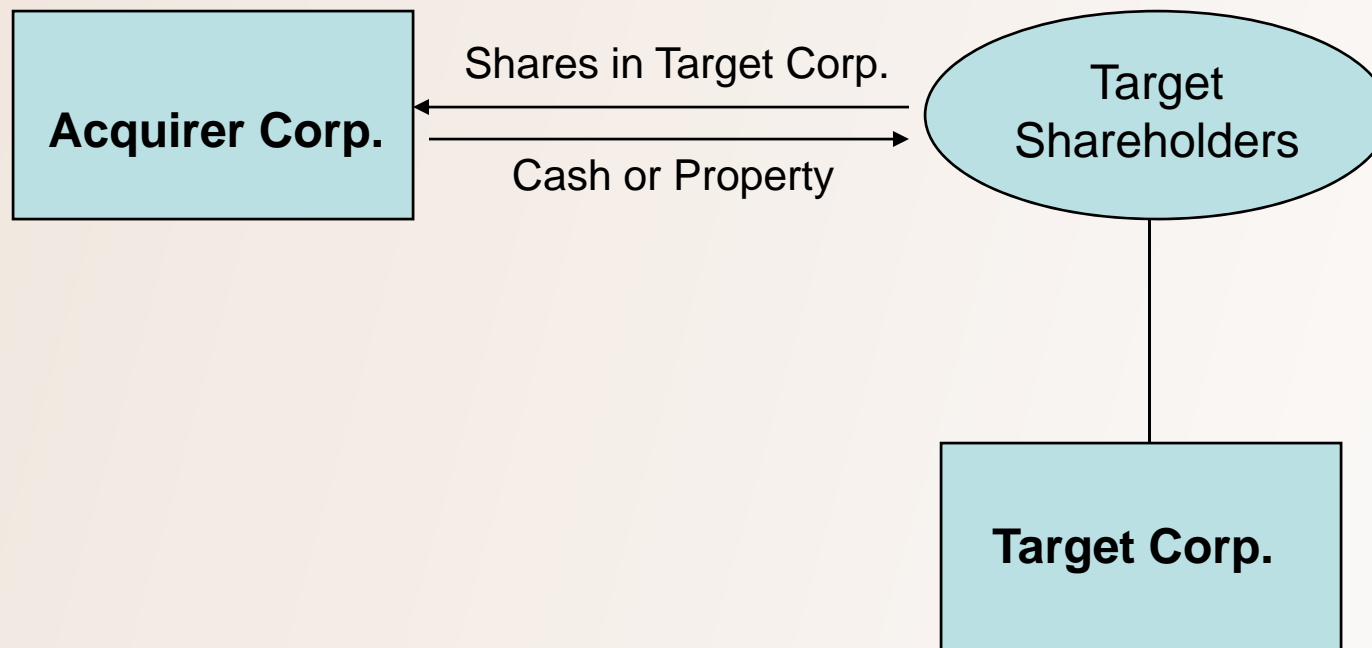
- Capital gain treatment?
- Value to shareholders without liquidation?
- Installment sale treatment?

– For Buyer:

- Tax attributes after ownership?
- Step-up in basis?
- Net operating losses?

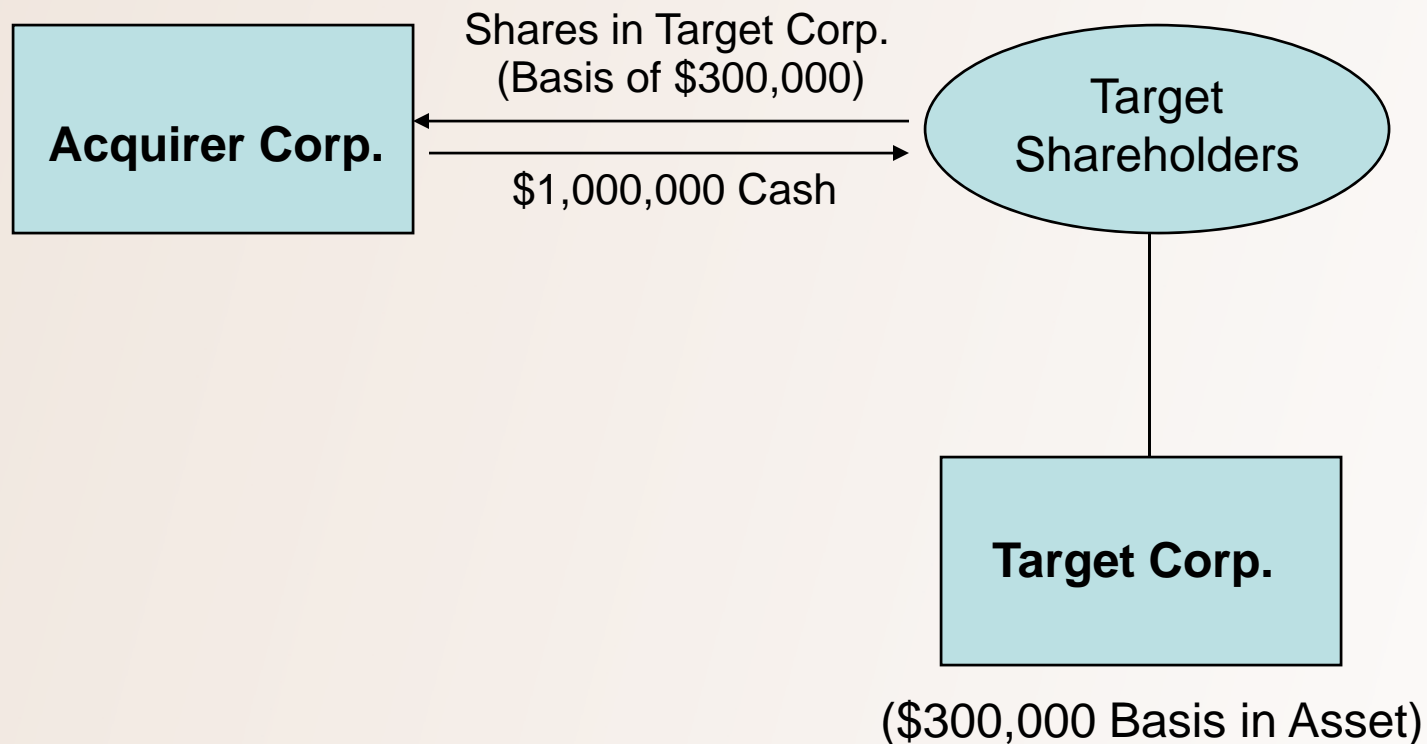
Taxable Acquisitions of C-Corps

- Taxable Stock Sale



Taxable Acquisitions of C-Corps

- Taxable Stock Sale - Example



Taxable Acquisitions of C-Corps

■ Taxable Stock Sale - Example

– Tax Consequences to Shareholder (A):

■ Amount Realized	\$1,000,000
■ Less: Stock Basis	<u>300,000</u>
■ Capital Gain	700,000
■ Tax at Capital Gain Rate	140,000
■ Gross Proceeds to A	\$1,000,000
■ Less: Capital Gain Tax	<u>140,000</u>
■ Net Proceeds to A	860,000

Taxable Acquisitions of C-Corps

■ Taxable Stock Sale - Example

- Tax Consequences to Acquirer Corp. (P):
 - Target Corp. is now a subsidiary of Acquirer Corp.
 - Target Corp. retains basis of \$300,000 in the asset.

Taxable Acquisitions of C-Corps

■ Taxable Stock Sale - Evaluation

– For Seller:

- Capital gain treatment?
- Value to shareholders without liquidation?
- Installment sale treatment?

– For Buyer:

- Tax attributes after ownership?
- Step-up in basis?
- Net operating losses?

Taxable Acquisitions of C-Corps

- **Stock Sale with 338 Election - Description**
 - Target Corp. is deemed to sell all of its assets, subject to its liabilities, to a newly formed corporation, and then to liquidate.

Taxable Acquisitions of C-Corps

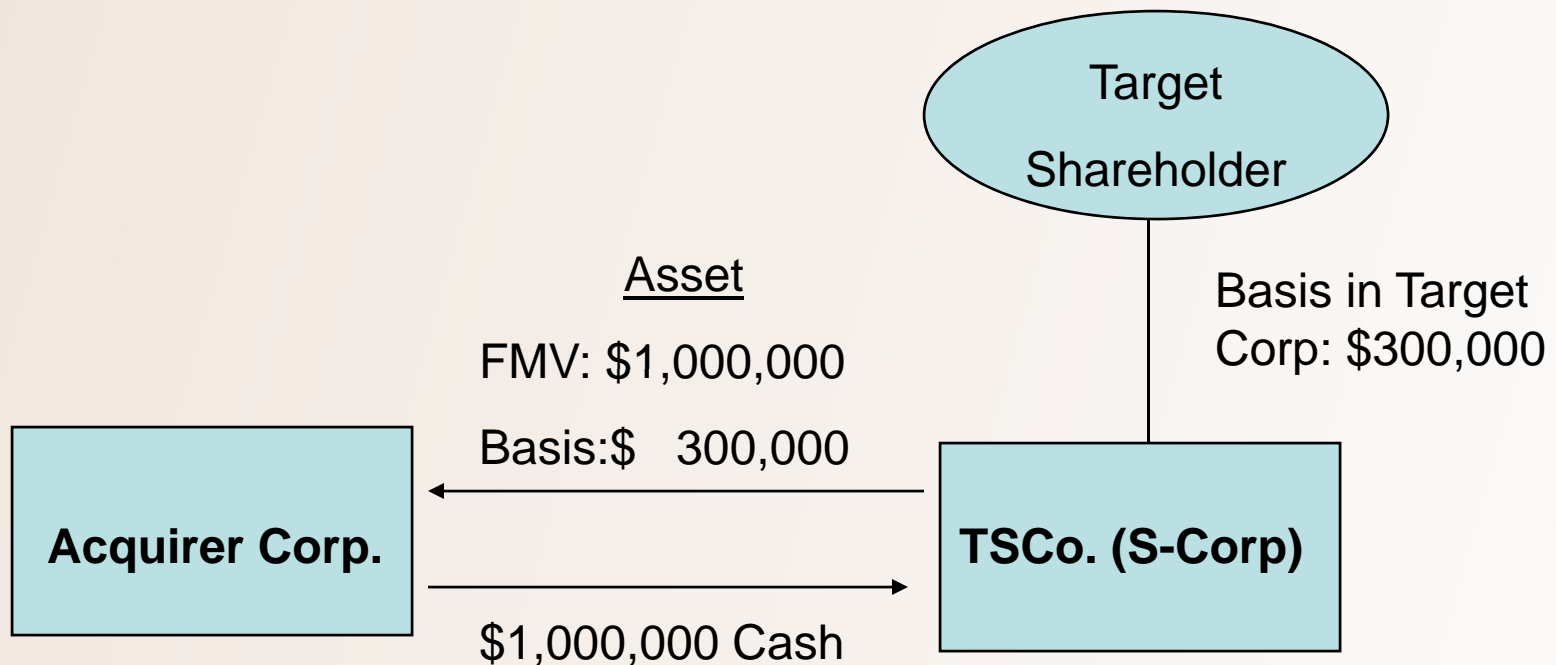
- **Stock Sale with 338 Election - Evaluation**
 - For Seller:
 - Capital gain treatment?
 - Value to shareholders without liquidation?
 - Installment sale treatment?

 - For Buyer:
 - Tax attributes after ownership?
 - Step-up in basis?
 - Net operating losses?

Taxable Acquisitions of S-Corps

Taxable Acquisitions of S-Corps

- Taxable Asset Sale - Example



Taxable Acquisitions of S-Corps

■ Asset Sale - Example

– Consequences to TSCo.:

■ Recognize gain immediately:

» Purchase Price	\$1,000,000
» Less: Basis in Asset	<u>300,000</u>
» Gain on Sale of Asset	700,000

» TSCo. is not taxed on the gain, but rather the gain flows through to TSCo's Shareholder (A).

Taxable Acquisitions of S-Corps

■ Asset Sale - Example

– Tax Consequences to A:

– Tax on the flow-through gain

» Flow-Through Gain	\$ 700,000
» A's Tax on Gain (at 20%)	140,000

– A's Basis increases by the flow-through income

» A's Beginning Basis	300,000
» Flow-through income	<u>700,000</u>
» A's Ending Basis	1,000,000

– Liquidation of TSCo.

» Distribution	\$1,000,000
» Less: A's Ending Basis	<u>\$1,000,000</u>
» Gain	-0-

– Net Proceeds to A: $\$1,000,000 - \$140,000 = \$860,000$.

Taxable Acquisitions of S-Corps

- **Asset Sale - Example**

- Consequences to Acquirer Corp. (P):

- Basis of \$1,000,000 in the asset.

Taxable Acquisitions of S-Corps

■ Asset Sale - Evaluation

– For Seller:

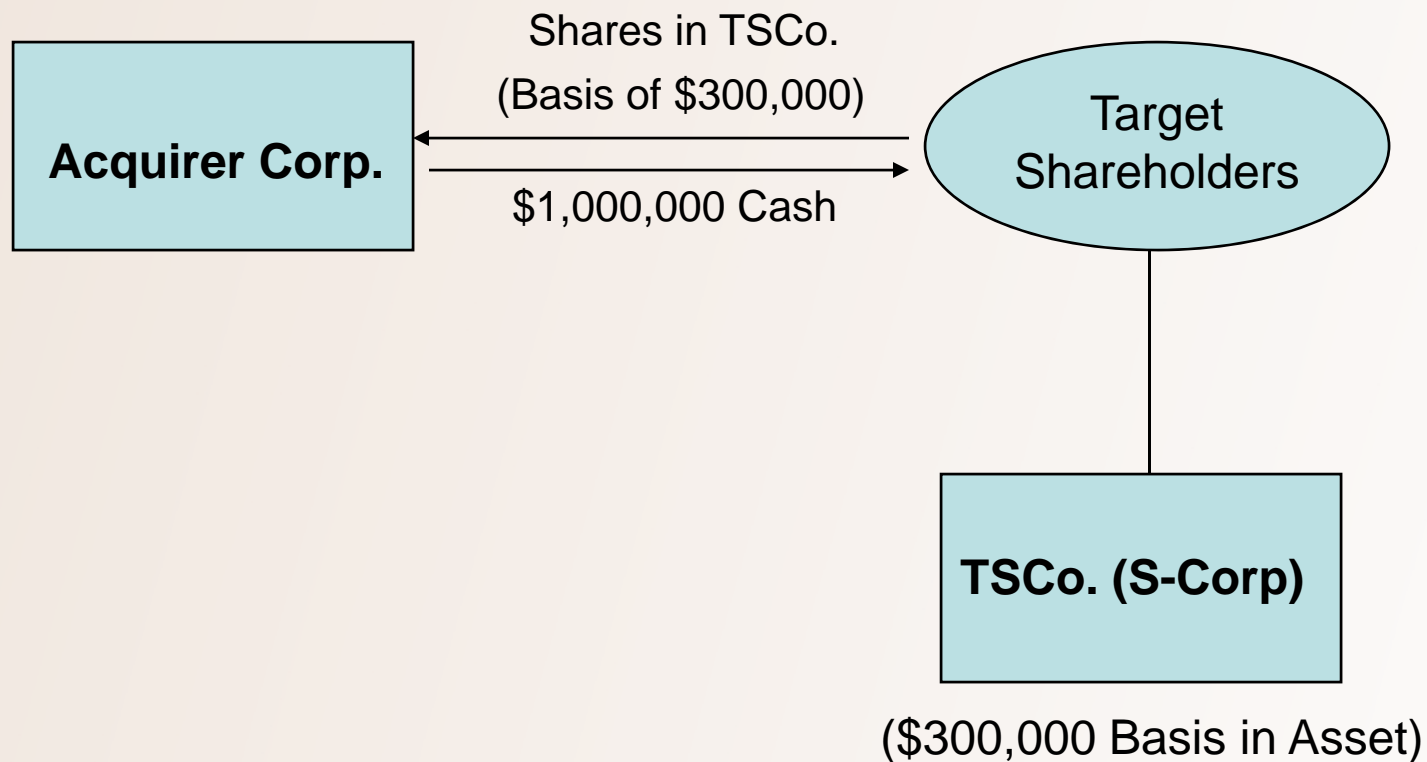
- Capital gain treatment?
- Value to shareholders without liquidation?
- Installment sale treatment?

– For Buyer:

- Tax attributes after ownership?
- Step-up in basis?
- Net operating losses?

Taxable Acquisitions of C-Corps

- Taxable Stock Sale - Example



Taxable Acquisitions of S-Corps

■ Stock Sale - Example

– Tax Consequences to Shareholder (A):

■ Amount Realized	\$1,000,000
■ Less: Basis in Stock	<u>300,000</u>
■ Gain	700,000
■ Tax on Gain (20%)	140,000
■ Gross Proceeds to A	\$1,000,000
■ Less: Tax on Gain	<u>140,000</u>
■ Net Proceeds to A	860,000

Taxable Acquisitions of S-Corps

- **Stock Sale - Example**

- Tax Consequences to Acquirer Corp. (P):
 - Takes carryover basis in the asset.
 - TSCo's Subchapter "S" election terminates.

Taxable Acquisitions of S-Corps

■ Stock Sale - Evaluation

– For Seller:

- Capital gain treatment?
- Value to shareholders without liquidation?
- Installment sale treatment?

– For Buyer:

- Tax attributes after ownership?
- Step-up in basis?
- Net operating losses?

Taxable Acquisitions of S-Corps

- **Stock Sale with 338(h)(10) Election**
 - Description
 - TSCo.'s shareholder (A) sells all of his stock in TSCo. to Acquirer Corp. (P), but for tax purposes TSCo. is deemed to have sold all of its assets to Acquirer Corp. (P) while TSCo. was still an S-Corp.
 - Requirements
 - Among other requirements, the election must be made jointly by TSCo.'s shareholders and by Acquirer Corp.

Taxable Acquisitions of S-Corps

- **Stock Sale with 338(h)(10) Election - Example**
 - A is the sole shareholder of TSCo., which owns one asset with a basis of \$300,000 and a fair market value of \$1,000,000.
 - A's stock basis is \$300,000.
 - A sells to its stock in TSCo. to Acquirer Corp. (P) for \$1,000,000 and A and TSCo. make a joint Section 338(h)(10) election.

Taxable Acquisitions of S-Corps

- **Stock Sale with 338(h)(10) Election - Example**

- Tax Consequences to TSCo.

■ Amount Realized	\$1,000,000
■ Less: Basis in Asset	<u>300,000</u>
■ Gain on Sale of Assets	700,000

Taxable Acquisitions of S-Corps

■ Stock Sale with 338(h)(10) Election - Example

– Tax Consequences to A:

– Tax on the flow-through gain

» Flow-Through Gain	\$ 700,000
» A's Tax on Gain (at 20%)	140,000

– A's Basis increases by the flow-through income

» A's Beginning Basis	300,000
» Flow through income	<u>700,000</u>
» A's Ending Basis	1,000,000

– Liquidation of TSCo.

» Distribution	\$1,000,000
» Less: A's Ending Basis	<u>\$1,000,000</u>
» Gain	-0-

– Net Proceeds to A: $\$1,000,000 - \$140,000 = \$860,000$.

Taxable Acquisitions of S-Corps

- **Stock Sale with 338(h)(10) Election - Example**
 - Tax Consequences to Acquirer Corp. (P):
 - Takes a basis of \$1,000,000 in asset.

Taxable Acquisitions of S-Corps

- **Stock Sale with 338(h)(10) Election - Evaluation**
 - For Seller:
 - Capital gain treatment?
 - Value to shareholders without liquidation?
 - Installment sale treatment?

 - For Buyer:
 - Tax attributes after ownership?
 - Step-up in basis?
 - Net operating losses?

Pervasive Judicial Doctrines

- 1. Step Transaction Doctrine**
- 2. Business Purpose Test**

Tax-Free Reorganizations

Tax-Free Reorganizations

- Eligibility
- Not Tax-Free, But Tax-Deferred
- Effects on Parties to the Reorganization
- Plan of Reorganization
- I.R.C. § 368(a)(1)(A), (B), (C)
- Special Considerations

Tax-Free Reorganizations

- **General Principles**
 - Continuity of Interest
 - Continuity of Business Enterprise
 - Business Purpose
- **Parties to a Reorganization**
- **Plan of Reorganization**

Tax-Free Reorganizations

- **“A” Reorganizations**

- Description

- A “statutory merger or consolidation”

- Requirements

- A statutory merger or consolidation
- Continuity of Interest
- Business Purpose
- Continuity of Business Enterprise

- Tax Consequences

Tax-Free Reorganizations

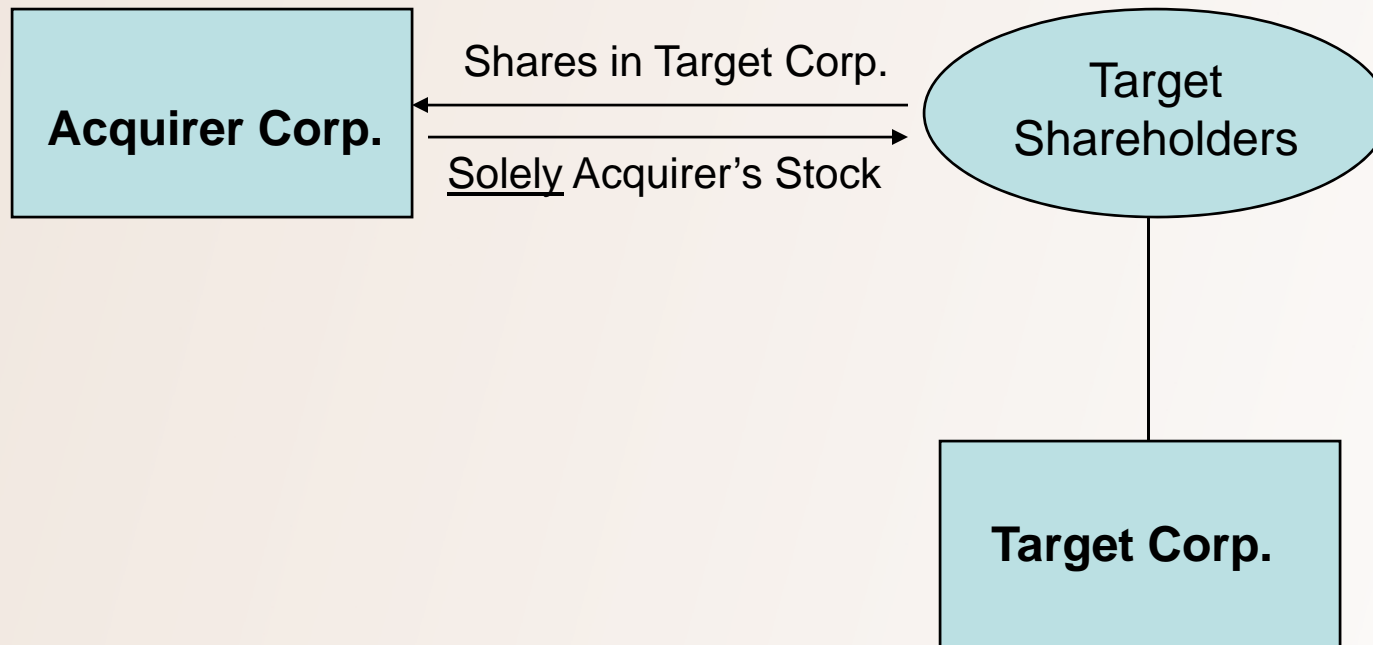
- **“B” Reorganizations**

- Description

- An acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

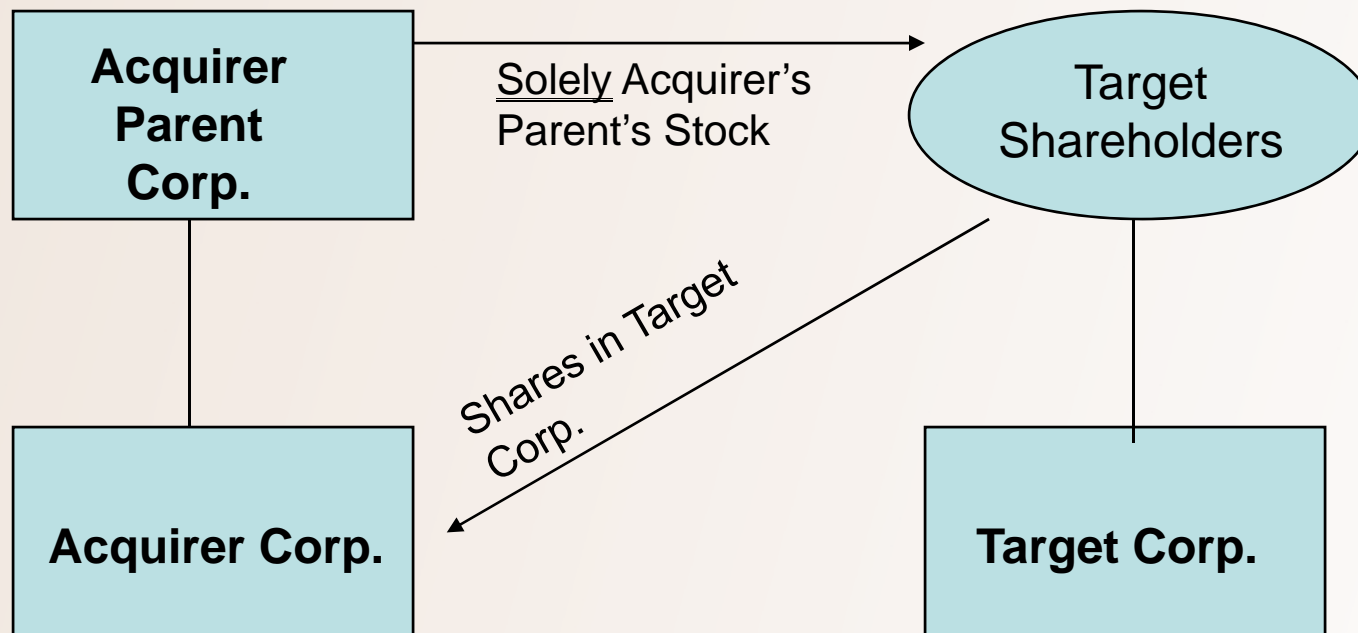
Tax-Free Reorganizations

- “B” Reorganizations



Tax-Free Reorganizations

- **“B” Reorganizations**
 - Additional Example



Tax-Free Reorganizations

- **"B" Reorganizations**

- Requirements

- Solely for Acquirer's or Acquirer's Parent's voting stock.
 - Consider prior cash purchases of target stock and dangers of "integration"
- Control
 - 80% of the voting power of all classes of stock; and
 - 80% of the total number of shares or all non-voting stock.
- Continuity of Interest, Business Purpose, Continuity of Business Enterprise

- Tax Consequences

Tax-Free Reorganizations

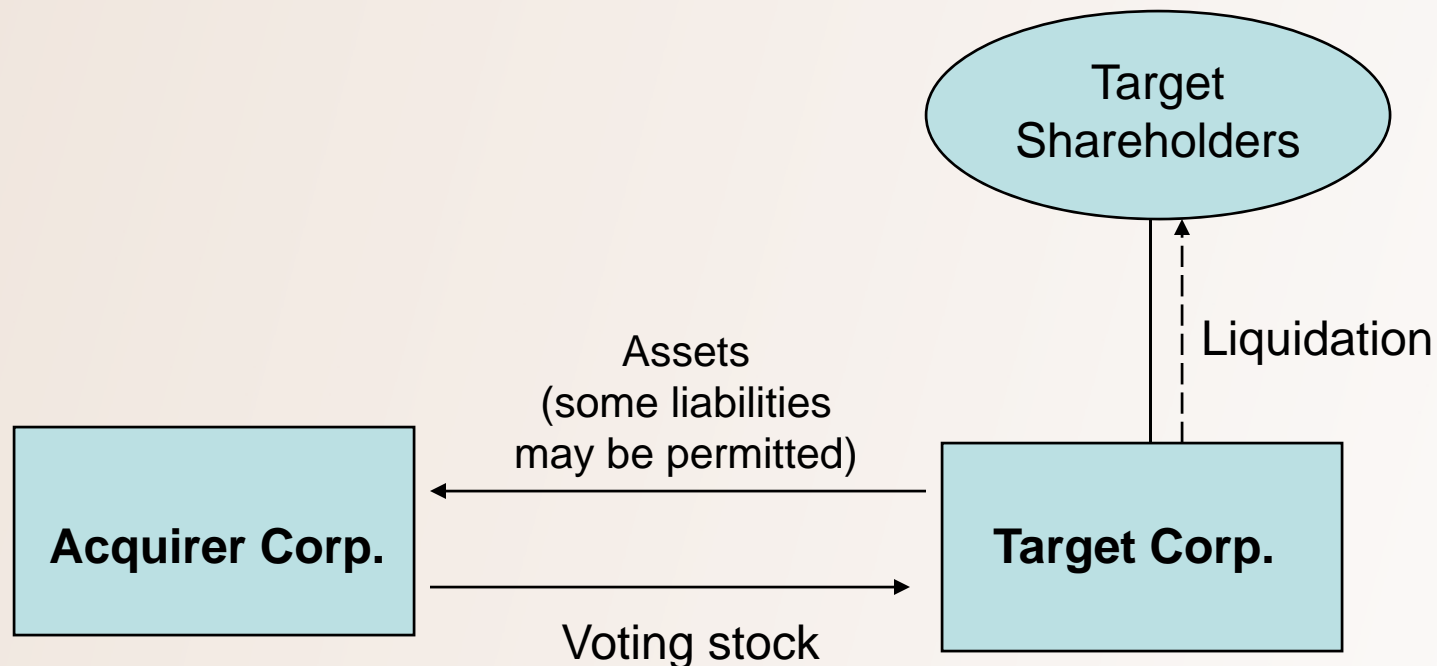
- **“C” Reorganizations**

- Description

- An acquisition by one corporation, in exchange for solely all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all the properties of another corporation.

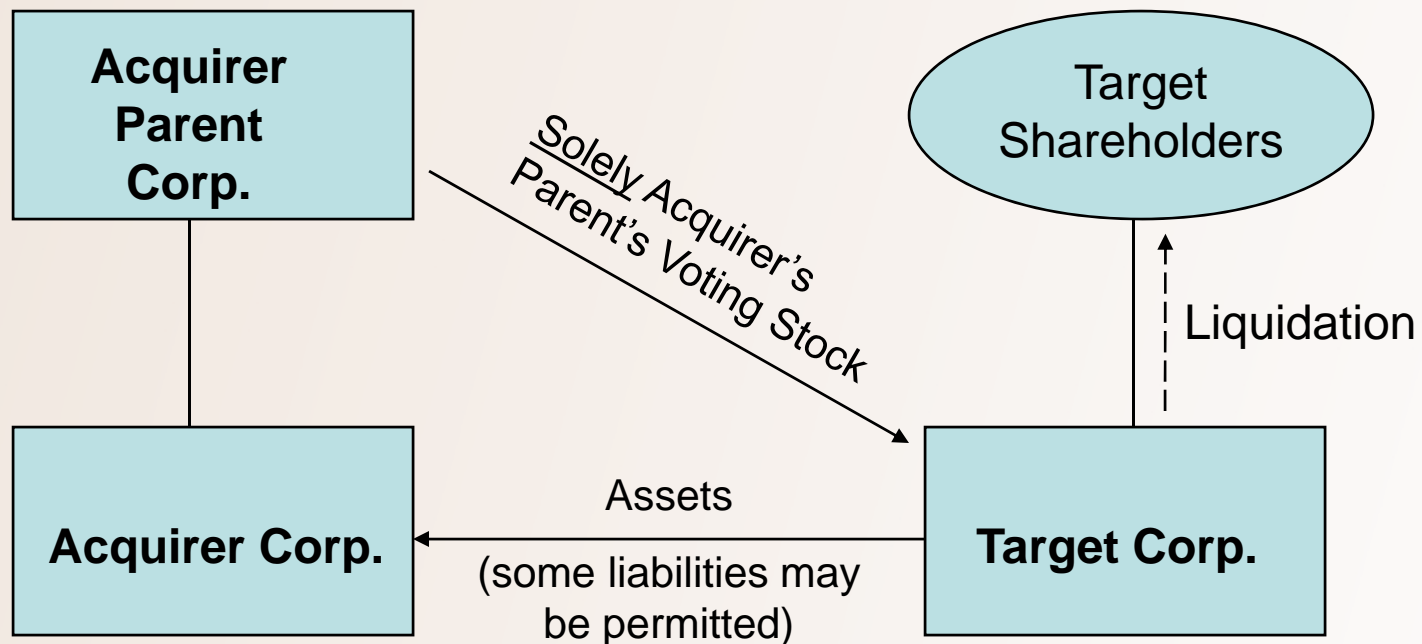
Tax-Free Reorganizations

- “C” Reorganizations



Tax-Free Reorganizations

- “C” Reorganizations
 - Additional Example



Tax-Free Reorganizations

- **"C" Reorganizations**

- Requirements

- Solely Acquirer's (or Acquirer's Parent's) voting stock.
- "Substantially all" of Target 's assets.
- Acquirer may assume some, but not all, types of liabilities.
- Target must distribute the voting stock and any permitted boot to its shareholders.
- Target must liquidate.
- Continuity of Interest, Continuity of Business Enterprise, Business Purpose.

- Tax Consequences

Tax-Free Reorganizations

- **Comparison of “B” and “C” Reorganizations**
 - Who is the seller?
 - What is sold?
 - Does Target Corp. survive?
 - Is “boot” permitted?

Tax-Free Reorganizations

- **Special Considerations in Reorganizations**
 - What is “Boot”?
 - Contingent Earn-Outs
 - Escrows
 - Indemnification by Acquirer

Tax-Free Reorganizations

- **Special Considerations in Reorganizations**
 - Employment Agreements
 - Covenants Not To Compete
 - Pre-Reorganization Transactions
 - Post-Reorganization Transactions

Goal IV: Identify Tax Planning Opportunities

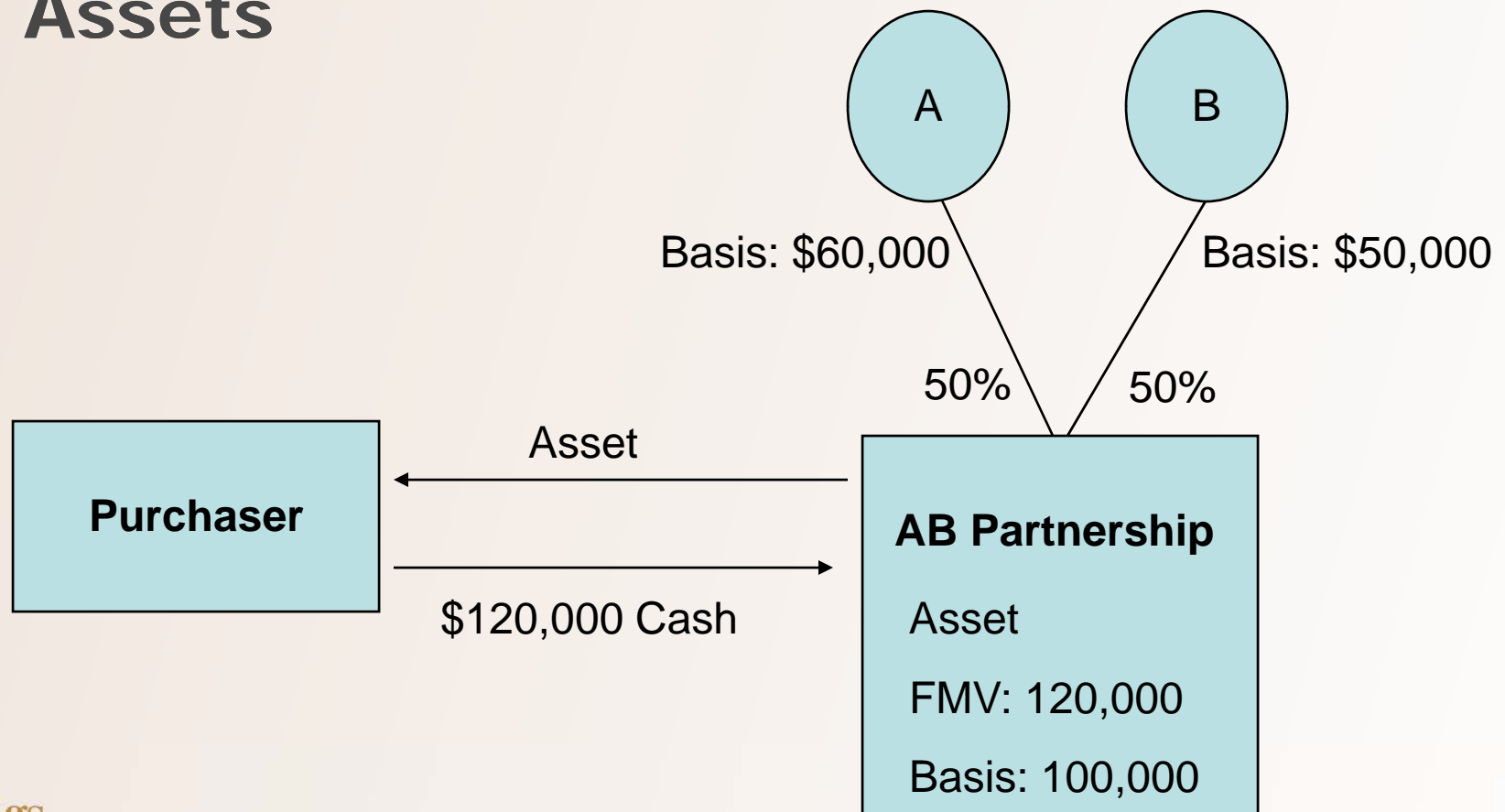
Tax Planning Opportunity

- **Choice of Entity**

- What is the firm's exit strategy?
 - Initial Public Offering
 - Merger, Acquisition or Reorganization
- Consider client's preferences
- Consider the likely acquirer's preferences

Limited Liability Companies / Partnerships

- Example – Sale of LLC/Partnership Assets



Limited Liability Companies / Partnerships

■ Example – Sale of LLC/Partnership Assets

– Consequences to AB:

■ Proceeds of Asset Sale	\$120,000
■ Less: Basis in Asset	<u>100,000</u>
■ Gain on Asset Sale (flows through)	20,000

– Consequences to Owners:

	<u>A</u>	<u>B</u>
■ Recognize gain on sale (retains character)	10,000	10,000
■ Initial Outside Basis	60,000	50,000
■ Allocation of Gain on Sale	<u>10,000</u>	<u>10,000</u>
■ Ending Outside Basis	70,000	60,000

Limited Liability Companies / Partnerships

- **Example – Sale of LLC/Partnership Assets**

- Consequences to Owners (continued):

	<u>A</u>	<u>B</u>
■ Distribution	60,000	60,000
■ Less: Ending Outside Basis	<u>60,000</u>	<u>70,000</u>
■ Gain / Loss on Distribution	-0-	<10,000>

Limited Liability Companies / Partnerships

- **Opportunity: Roll-up**
 - Merger under state law
 - Contribution of interests to corporation (Section 351)
 - Liquidate LLC
 - Don't liquidate LLC

Goal V: Identify other important tax considerations

Other Considerations

- **Qualified Plans**
- **Tax Clearance Letters**
- **Consolidated Returns**
- **Short Periods**
- **Liquidations of C-Corps**
- **Liquidations of S-Corps**

Questions?

Please contact:

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