



The Basics of Tax-Free Business Acquisitions: What You Don't Know Could Hurt You

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Tax attorney Peter J. Guy specializes in federal income tax law. Mr. Guy has extensive experience providing federal income tax advice to public and private companies with a particular emphasis on mergers, acquisitions, securities offerings and divestitures. He advises real estate funds, private equity funds, hedge funds, limited liability companies, partnerships, S corporations and similar entities on tax issues relevant to the formation and operation of such entities. He has experience advising real estate investors and developers on tax issues arising out of the ownership and operation of real estate, including certain tax credit advice. His experience includes advising domestic and international clients regarding cross border tax issues and certain New York state and local tax issues. Mr. Guy also has experience advising clients that have special tax considerations such as real estate investment trusts and tax-exempt entities. Prior to joining Ellenoff Grossman & Schole LLP, Mr. Guy was associated with the law firms of Paul, Weiss, Rifkind, Wharton & Garrison, LLP and Bryan Cave, LLP. Mr. Guy is admitted to practice in the state of New York and is a member of the American Bar Association's Section of Taxation. Mr. Guy received his Juris Doctorate from Harvard Law School where he graduated *cum laude* and his Bachelor of Science degree from Northeastern University where he graduated *summa cum laude*.

Why do a “Tax Free” Deal?

- Sellers prefer not to pay tax when they sell their businesses (don't we all?)
- Example: private start-up software company is being acquired by big public software company
- Private company stockholders can receive public company stock and decide when they want to pay tax on gains by selling stock in the future

Why tax free deals may hurt buyers

- A buyer may prefer a taxable deal to get a step-up in basis
- Tax-free deals require the buyer to take the seller's old, lower tax basis
- Example: Seller owns a corporation ("Target") with business assets having a tax basis of \$30 and a value of \$100
- Buyer agrees to acquire Target for \$100 worth of Buyer stock in a tax free deal. Following that transaction, Buyer will own assets with a tax basis of \$30.
- If Buyer had instead purchased Target's assets for \$100 in cash, it would receive a \$100 tax basis in those assets. The additional \$70 could generate tax value to Buyer in the form of increased depreciation deductions.

Tax Free Corporate Acquisitions

- This presentation deals primarily with corporate acquisitions
- Tax-free acquisitions involving partnerships or entities taxed as partnerships (such as limited liability companies) are much easier to accomplish because the partnership acquisition rules are much more flexible
- This should influence the choice of entities for start-up companies more than it currently does
- Corporate acquisitions are very form-driven -- it is VERY important to pay attention to details

Tax-Free Corporate Acquisitions Discussed in This Presentation

- The “Alphabet” Reorganizations
- Merger of two corporations (“Type A” Merger)
- “Triangular” mergers involving three corporations (Acquiring corporation, a “merger subsidiary” controlled by Acquiror, and Target corporation)
- Stock-for-Stock exchanges (“Type B” reorganizations)
- Asset acquisitions (“Type C” reorganizations)
- Acquisitions using Section 351 or Section 721

Requirements Common to the “Alphabet” Reorganizations

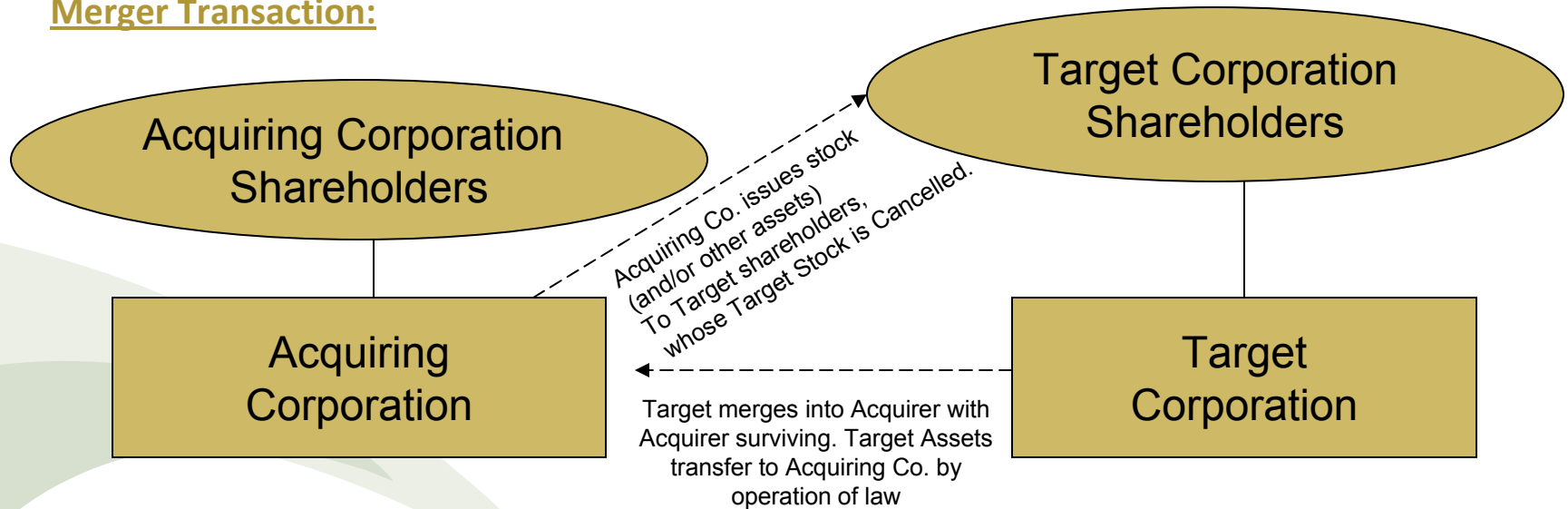
- The Alphabet Reorganizations are all found under Code Section 368
- To qualify, all Alphabet Reorganizations must meet certain common requirements:
- Pursuant to Plan of Reorganization
- Must meet “continuity of interest,” “continuity of business enterprise” and “business purpose” tests
- Continuity of Interest requires that Target stockholders receive a minimum amount of stock – IRS regulations require that at least 40% of the property received by Target stockholders must be Acquiring company stock
- Continuity of Business Enterprise requires continuation of some portion of the Target’s pre-acquisition business
- Must not be part of a “step transaction” that results in the overall transaction being taxable. Step transactions are two or more transactions that are linked together, either because they are part of a plan or are deemed part of a plan based on the facts.

Benefits of Tax-Free Reorganizations

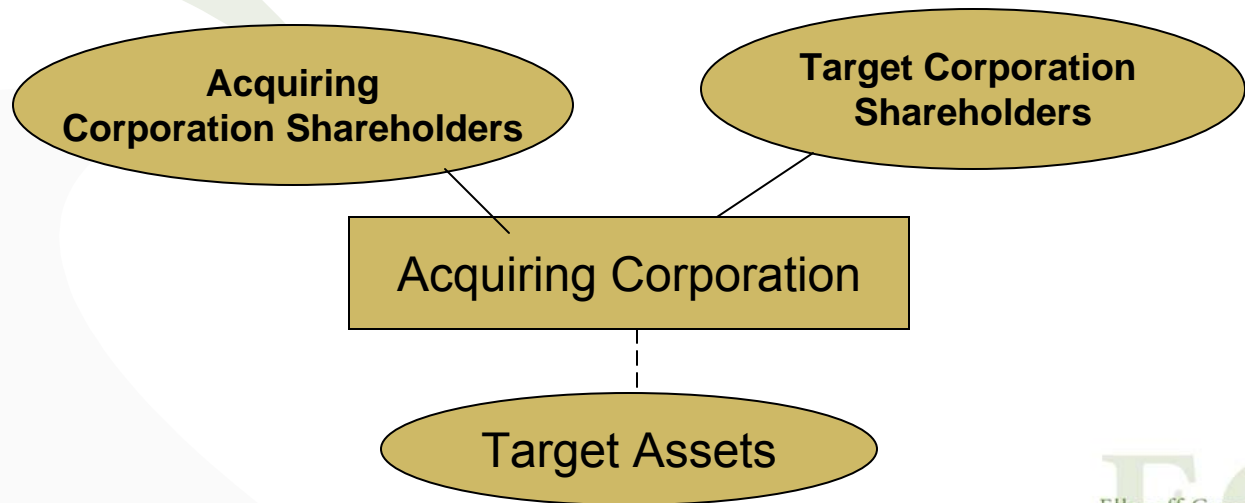
- Neither Target nor Acquiring corporation recognizes gain or loss in the reorganization
- Target Shareholders do not pay tax if they receive all stock
- Target Shareholders who receive a blend of stock and other taxable property such as cash recognize gain to the extent of such cash
- Example: Target shareholders have a basis of \$20 in their stock with a fair market value of \$100 (so \$80 of unrealized gain). The shareholders receive \$70 worth of Acquiror stock in a valid reorganization plus \$30 of cash. Under the reorganization rules, the Target shareholders will pay tax on \$30 of gain. The remaining \$50 of gain remains untaxed until Acquiror stock is sold.

“Type A” Merger Reorganization

- Merger Transaction:



- Post-Merger:



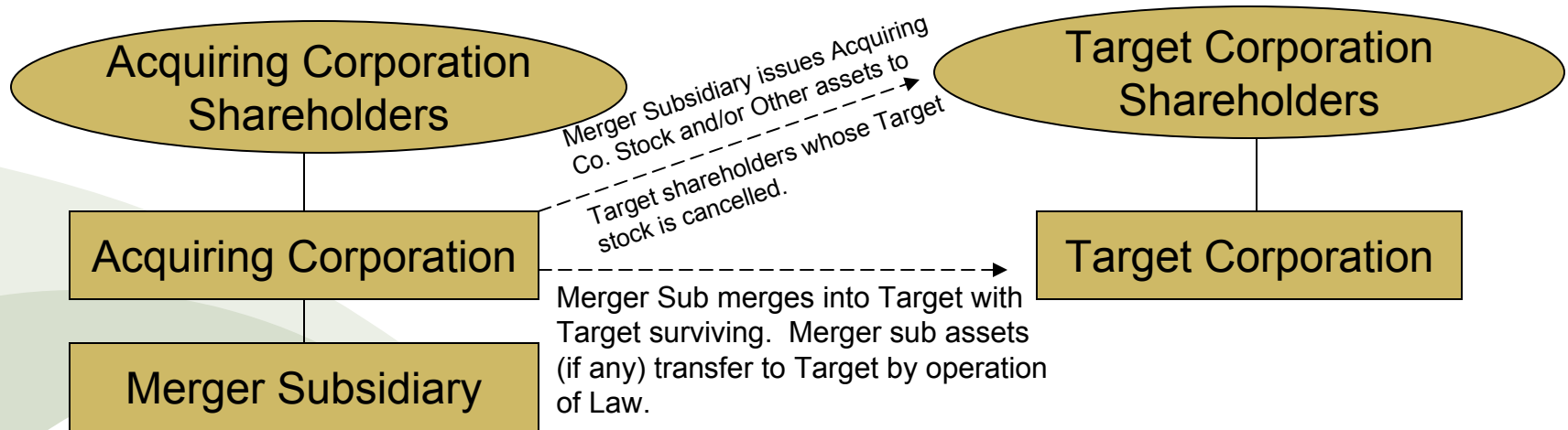
Highlights of Type A Merger

- Typically the most flexible of all the reorganizations in terms of the type and form of transaction
- Not often done because for non-tax reasons you may not want to commingle the assets and liabilities of one entity with the assets and liabilities of another
- To solve the liability problem, can use the triangular mergers detailed on next two slides
- RISK -- if you fail to satisfy any of the requirements for a Type A reorg, the Target will be deemed to have a taxable asset sale. This risk can be solved by doing a Reverse Subsidiary Merger instead, or by using a “disregarded entity” limited liability company as a merger subsidiary in a Forward Subsidiary Merger.

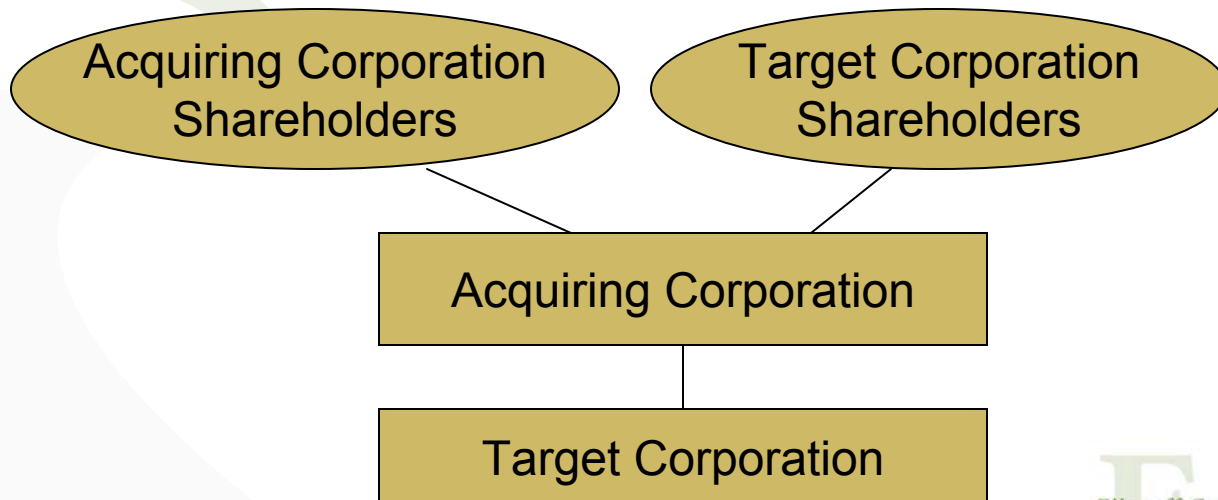
Variations on the “Type A” Merger-Subsidiary Mergers

Reverse Subsidiary Merger

- Merger Transaction:**



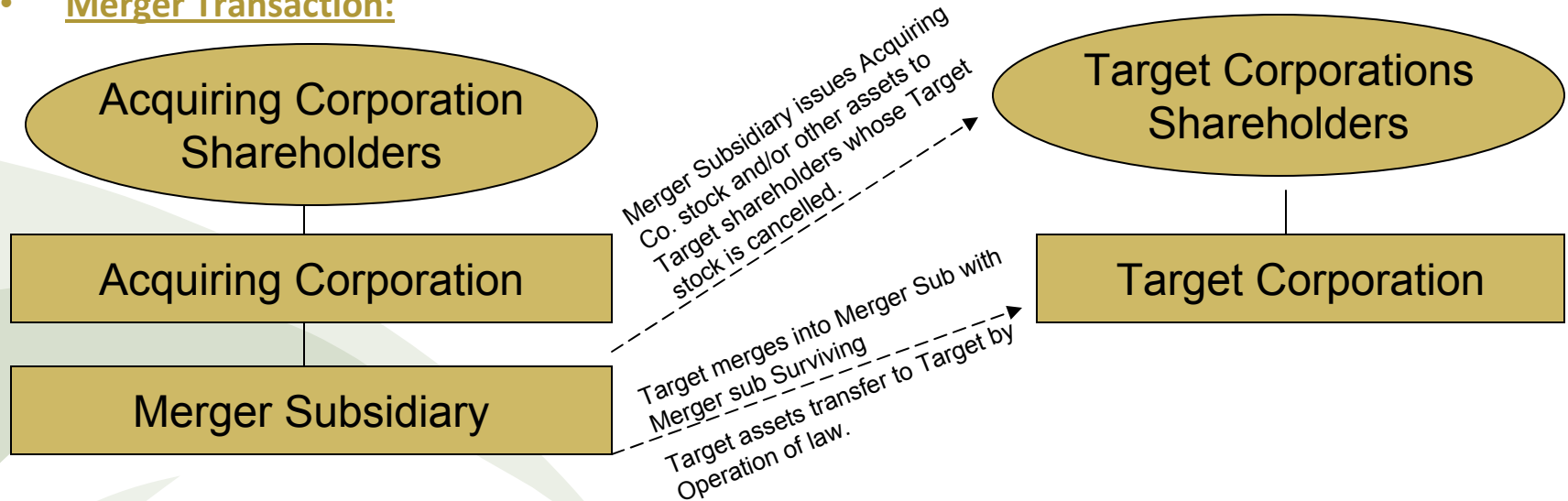
- Post Merger**



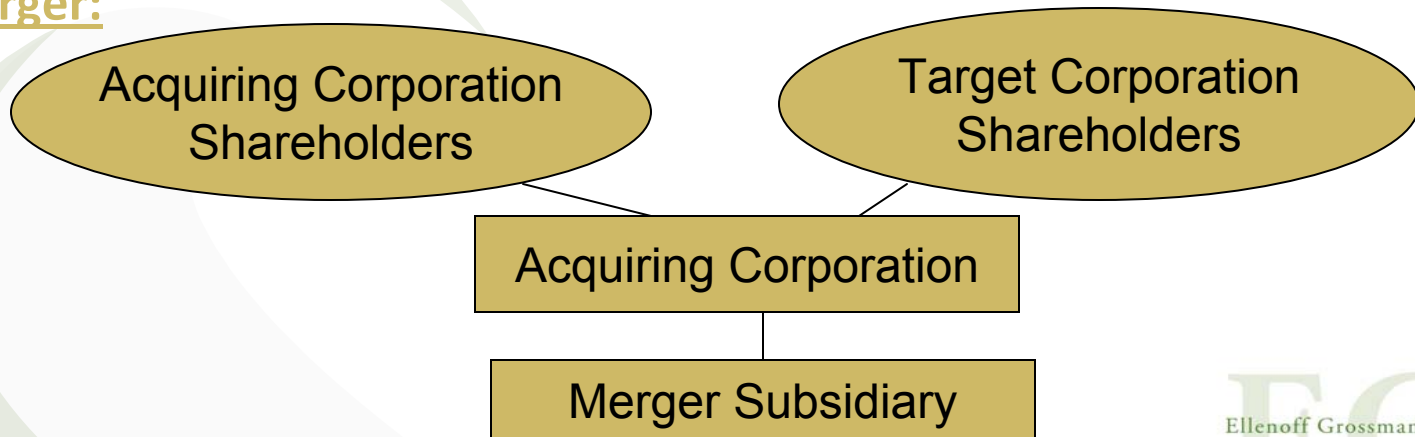
Variations on the “Type A” Merger- Subsidiary Mergers

Forward Subsidiary Merger

- Merger Transaction:



- Post Merger:

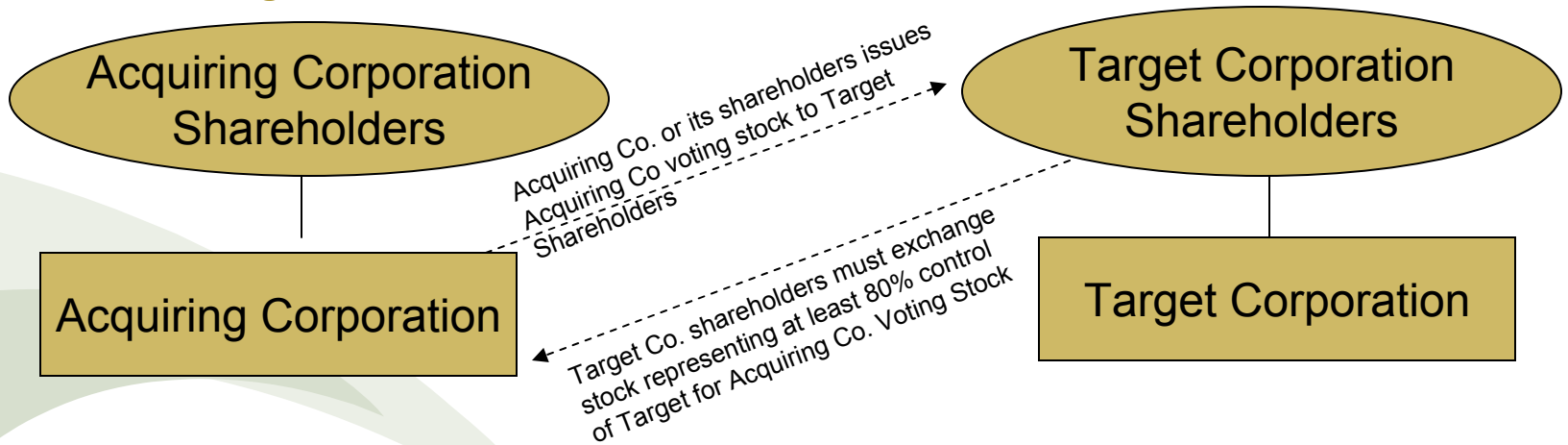


Risks/other issues with Forward and Reverse Subsidiary Mergers

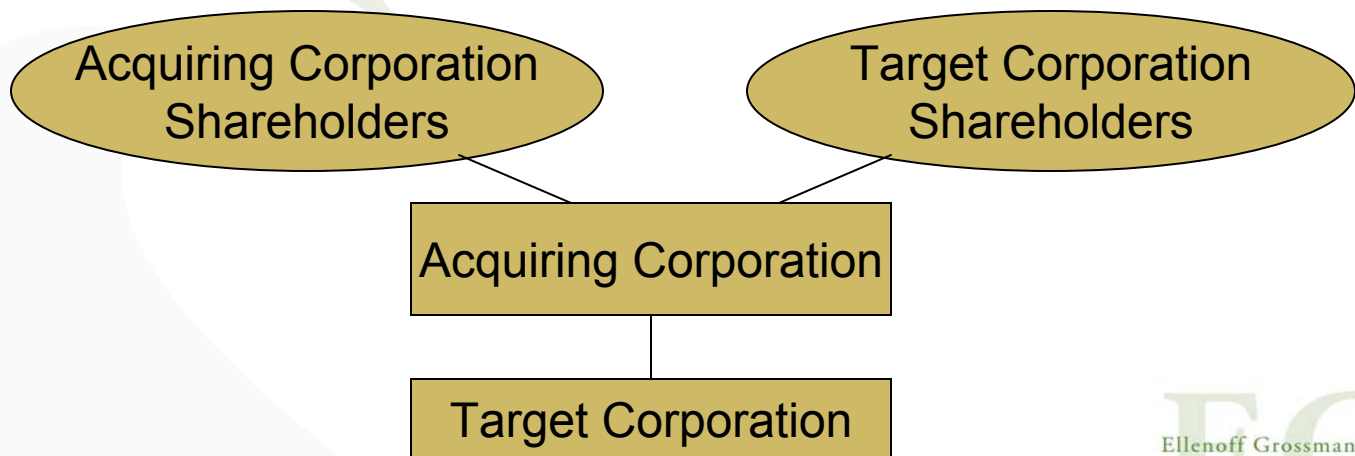
- Forward Subsidiary Mergers carry the same risk of asset taxation as a Type A Merger if fail to meet requirements
- For Reverse Subsidiary Mergers, cash (or similar non-stock assets) is limited to no more than 20% of the transaction value.
- In each of the subsidiary merger structures, dispositions of unwanted assets may present a problem – each has a “substantially all assets” requirement

Type B Reorganization-Stock Exchanged for Stock

- Stock "Exchange"



- Post Exchange

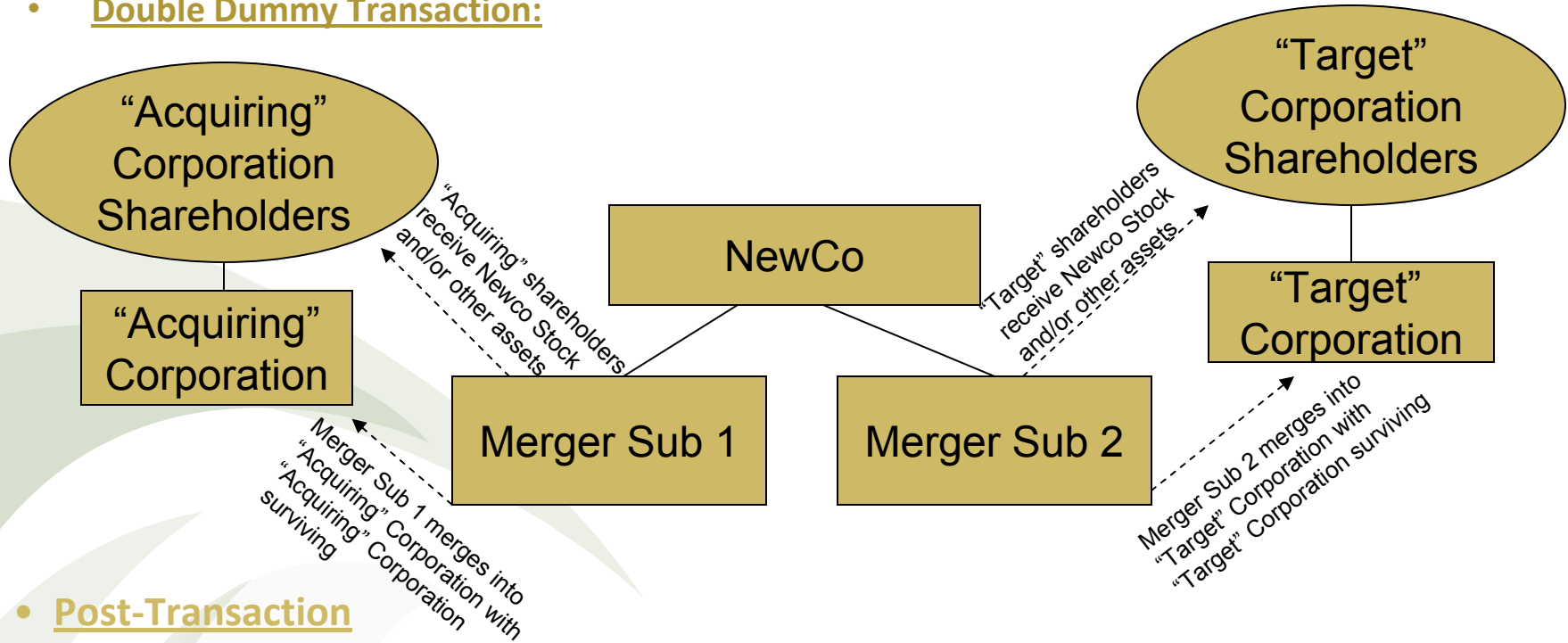


Highlights of Type B Reorganizations

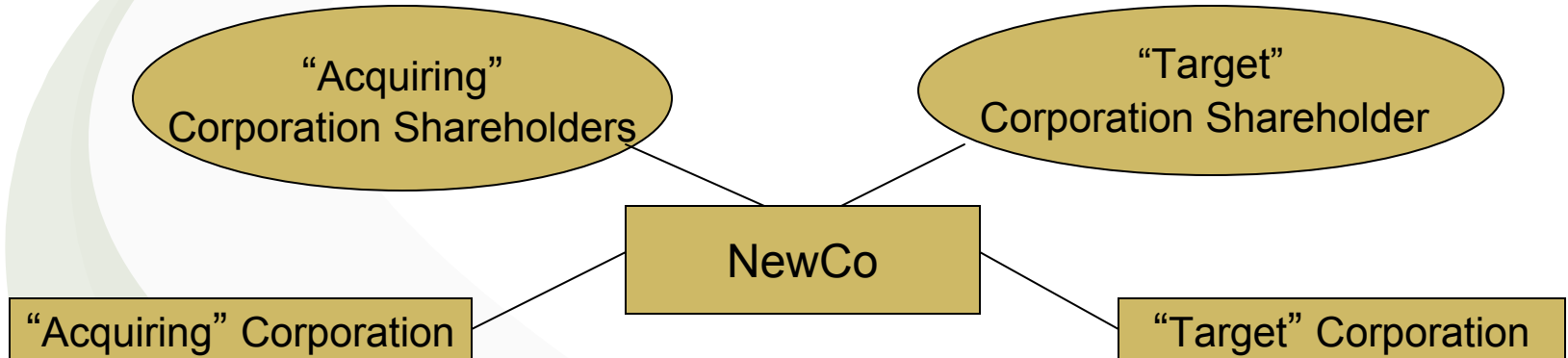
- Can ONLY be for Acquiror voting stock – no cash, no other property can be issued to Target shareholders
- Target shareholders have to surrender “control” of Target – generally 80% stock ownership
- Be careful about pre-transaction purchases of Target stock by Acquiror

“Double Dummy” Acquisition/Holding Company Structures

- Double Dummy Transaction:**



- Post-Transaction**

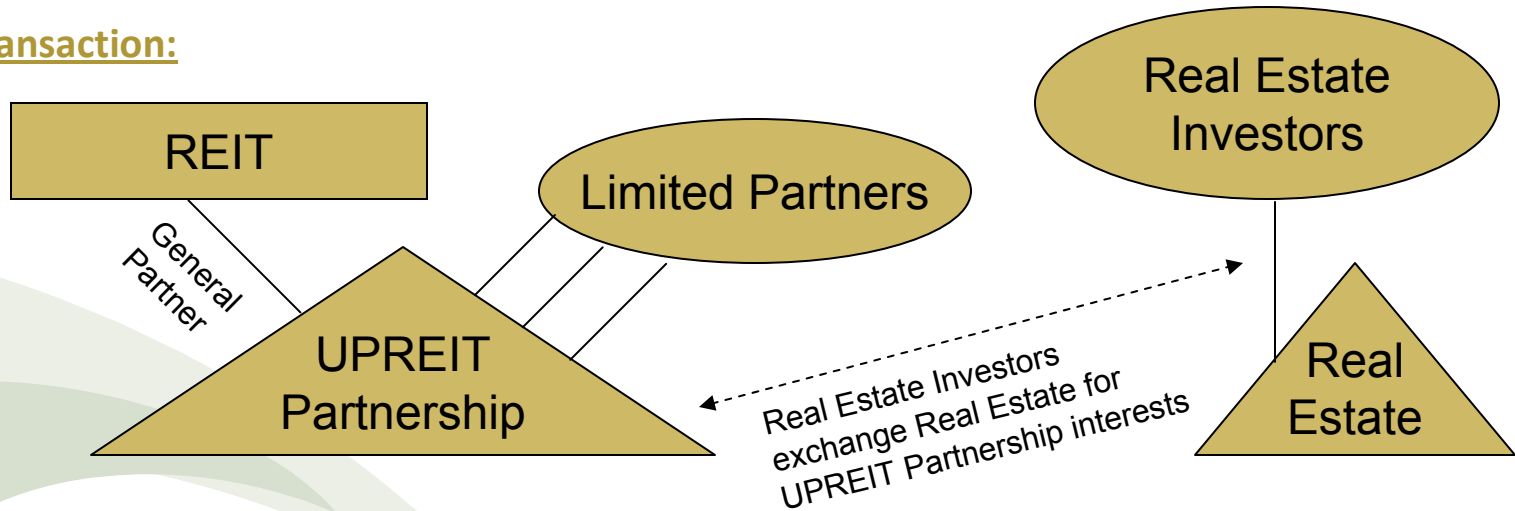


Highlights of Double Dummy Structure

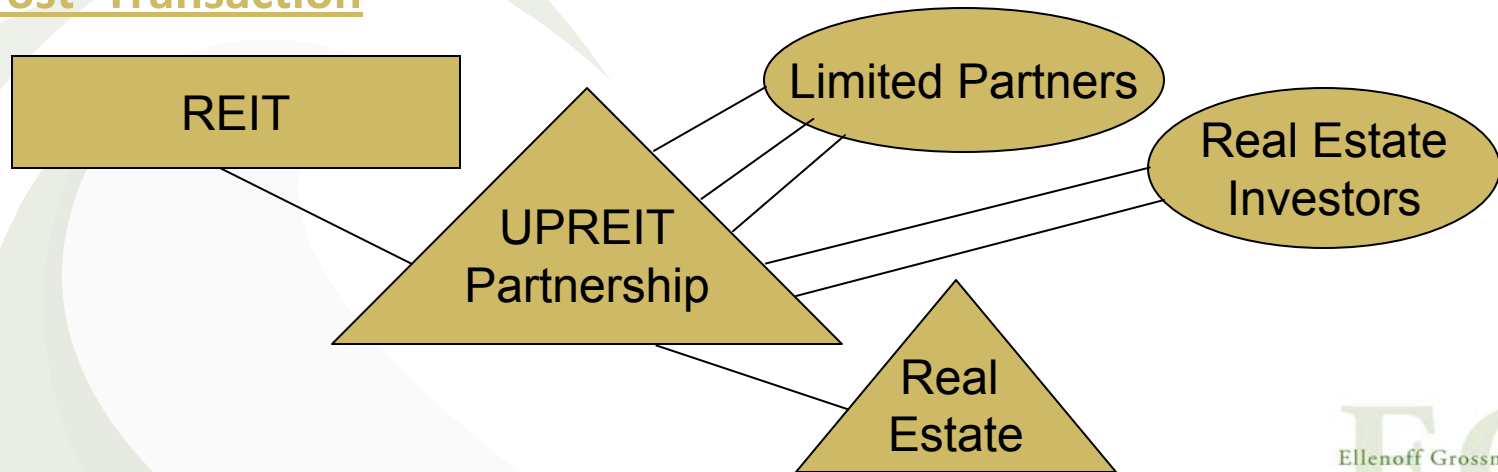
- This is NOT a Section 368 “Alphabet” reorganization
- Because it’s not a reorganization, there is much more flexibility to structure the transaction.
- Do not have to meet the Continuity of Interest business enterprise test that generally requires 40% or more stock

Tax Free Rollups

- Transaction:

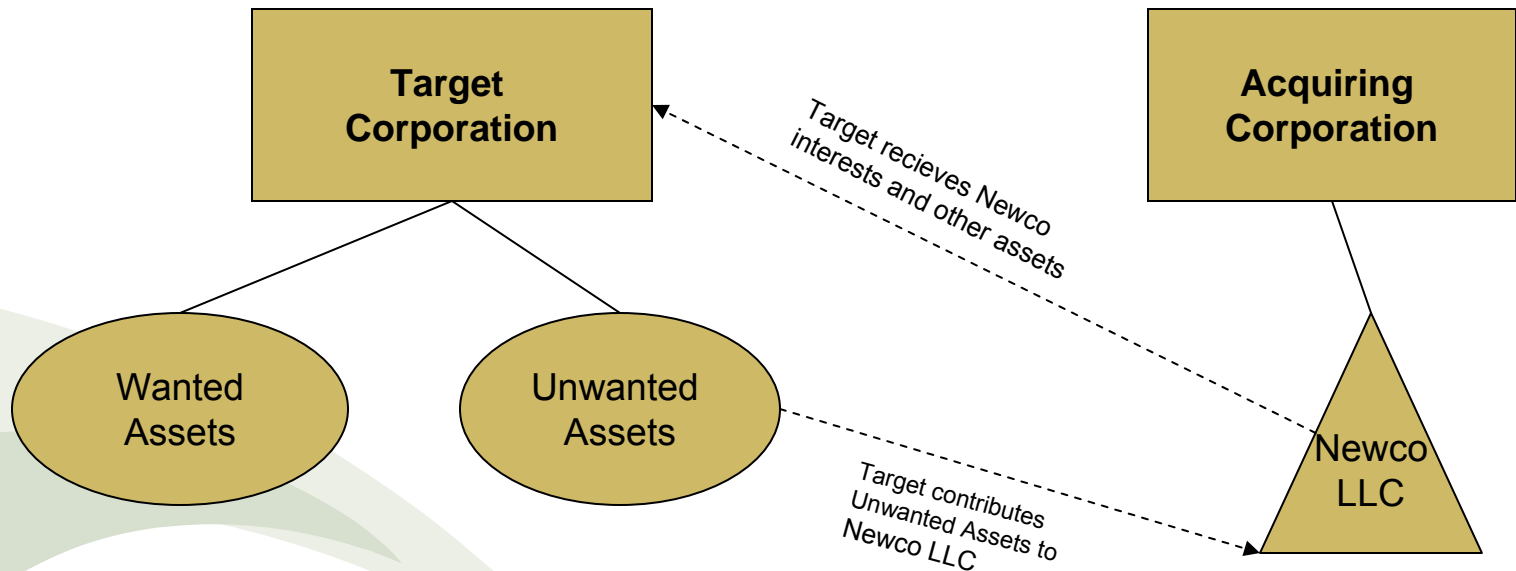


- Post-Transaction

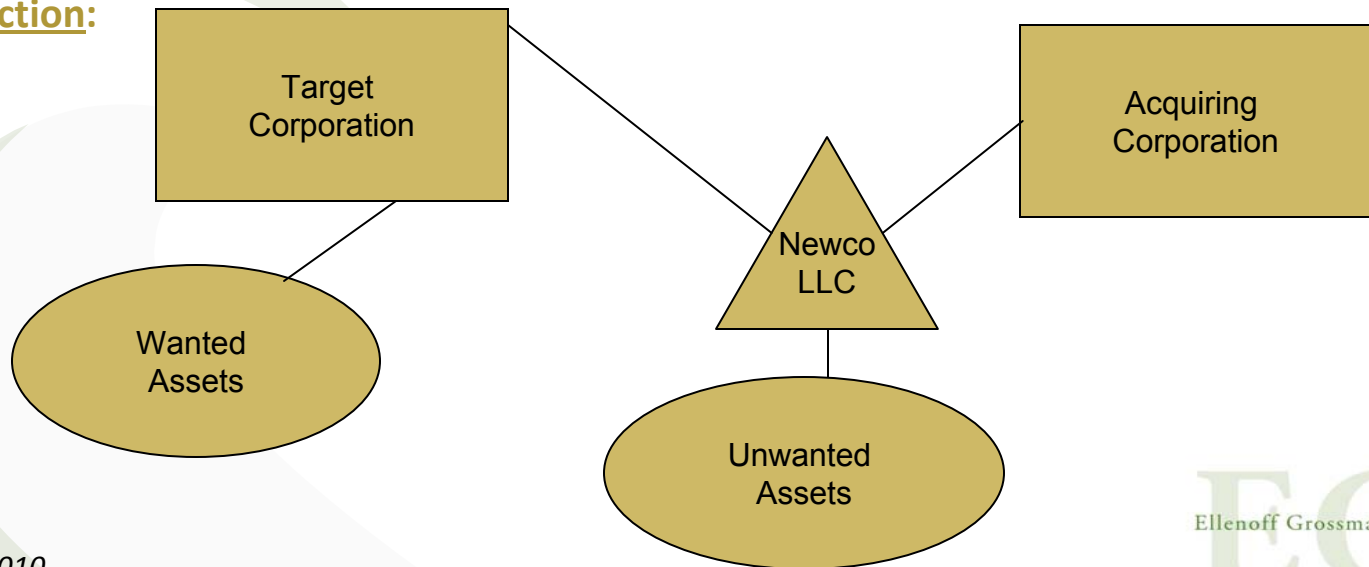


Using Joint Ventures to Mimic Tax-Free Acquisitions

Typical Transaction:

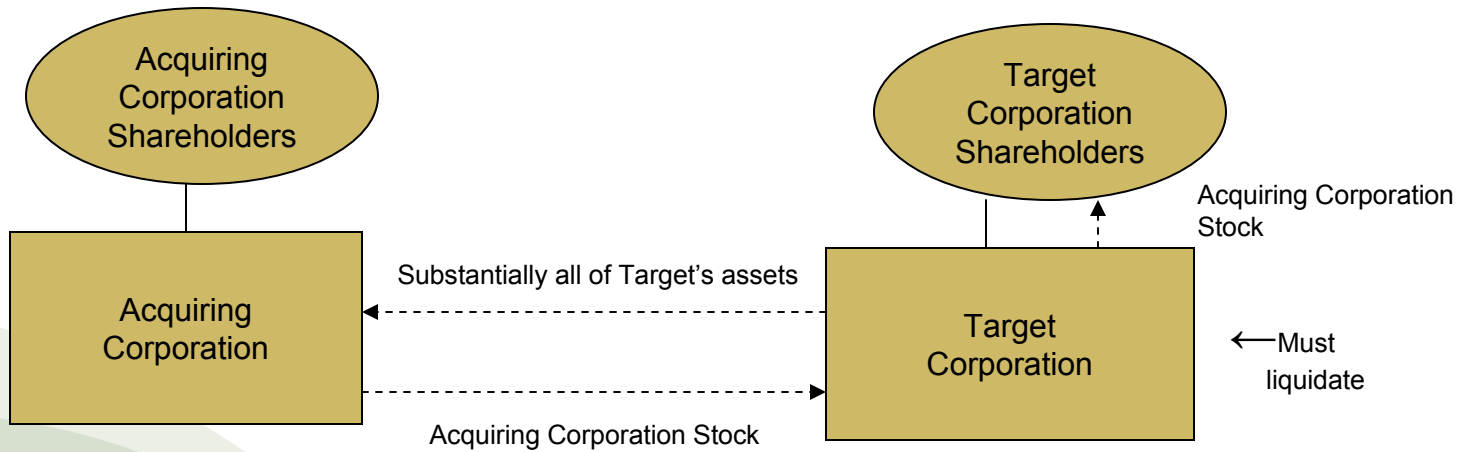


Post Transaction:

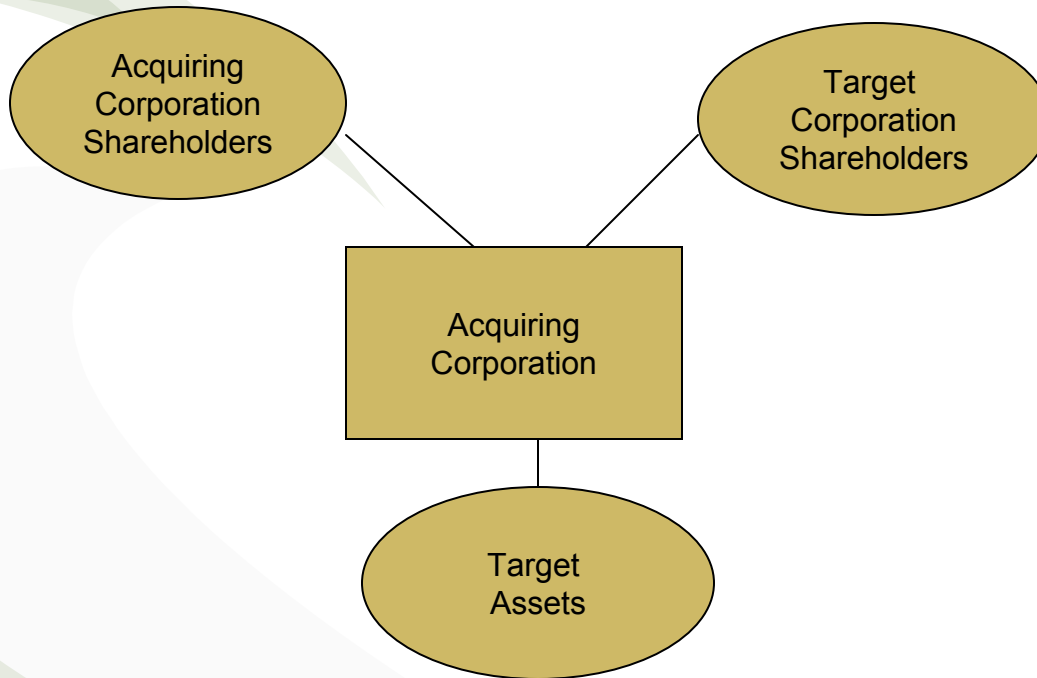


Tax-Free Asset Acquisitions

Asset Acquisition:



Post-Asset Acquisition:



Highlights of Type C Reorganization

- Must acquire “substantially all” of Target assets
- If giving cash or other taxable assets in addition to stock, such cash/other assets limited to 20% by value, and for these purposes any liabilities that are assumed are treated as cash
- Thus if Target liabilities being assumed in transaction exceed 20% of the value of the assets, only voting stock of Acquiror may be issued

Using Net Operating Losses to Make a Taxable Deal Tax-Free

- If Target has a significant amount of Net Operating Losses (“NOLs”), it may be possible to structure a deal that is “taxable” from Buyer’s side but not taxed to Seller
- Example – Seller owns fully-depreciated assets worth \$50 and NOLs of \$80. Buyer agrees to buy assets for \$50 and thus gets a fully stepped-up basis equal to \$50 (instead of \$0 in the hands of the Seller). Seller pays no regular income tax
- Risks: Seller may owe Alternative Minimum Tax regardless
- Buyer may be tempted to buy stock of Seller to get hands on full amount of NOLs, but anti-NOL-trafficking rules limit use of NOLs in the hands of a Buyer who “buys” such NOLs. No step up in basis in stock deal.

Single-Entity Restructuring (“Type E” Reorganizations)

- Not used for “acquisitions” in a traditional sense
- Typically done to transfer control of a corporation from one generation to the next without income tax consequences (there may be gift/estate tax consequences)
- Defined simply as “recapitalizations”
- Classic example – a closely-held corporation has only common stock outstanding. Husband and wife founded the corporation and have previously gifted shares of common stock to their daughter, who is taking over the business. To transfer wealth to the next generation and to incentivize the daughter to grow the business, the parents agree to recapitalize the company into preferred and common stock. The parents retain the preferred, which has a limited upside in corporate growth but is entitled to a fixed liquidation preference plus a modest cumulative dividend. The daughter retains the common stock representing most of the upside. The exchange of the parents’ common for the new preferred is a tax-free E reorganization.
- Can also be done as a “reverse stock split” to freeze-out minority investors. Example: A corporation has 100 shares of outstanding stock. Of those 100 shares, 60 are owned by A, 36 by B and 4 by four other shareholders who each own one share. A and B vote for a recapitalization whereby each shareholder receives one new share for every six owned (a “6-for-1” reverse split). Any fractional shares that result will be cashed out. Following the reverse split, A will own 10 shares, B will own 6 and the four single share owners are cashed out (since they would each otherwise receive 1/6 of a share, and fractional shares are cashed out). As a result, A and B cashed out the minority shareholders without being taxed on the reverse stock split.
- Must have a business purpose.

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