Tax Considerations in Corporate Deal Structures

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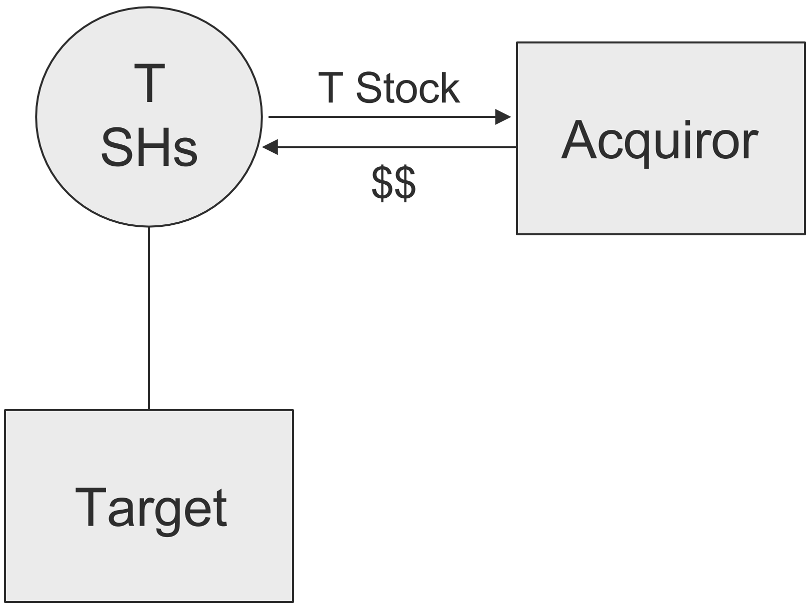
Tax Considerations – Fundamental Issues

- Levels of Tax Imposed
  - Is a separate tax imposed on the entity as well as the owners?
- Timing Considerations
  - Taxable versus “tax-free” (*i.e.*, pay me now or pay me later, to the extent equity is received)
- Character Issues
  - For noncorporate taxpayers - capital gains tax rate (20%) versus ordinary income tax rate (39.6%)
  - For corporate taxpayers - no distinction between capital gains tax rate and ordinary income tax rate (35%); possible dividends received deduction for corporate taxpayers
  - Special 20% tax rate on dividends for individual taxpayers

Taxable vs. Tax-Free

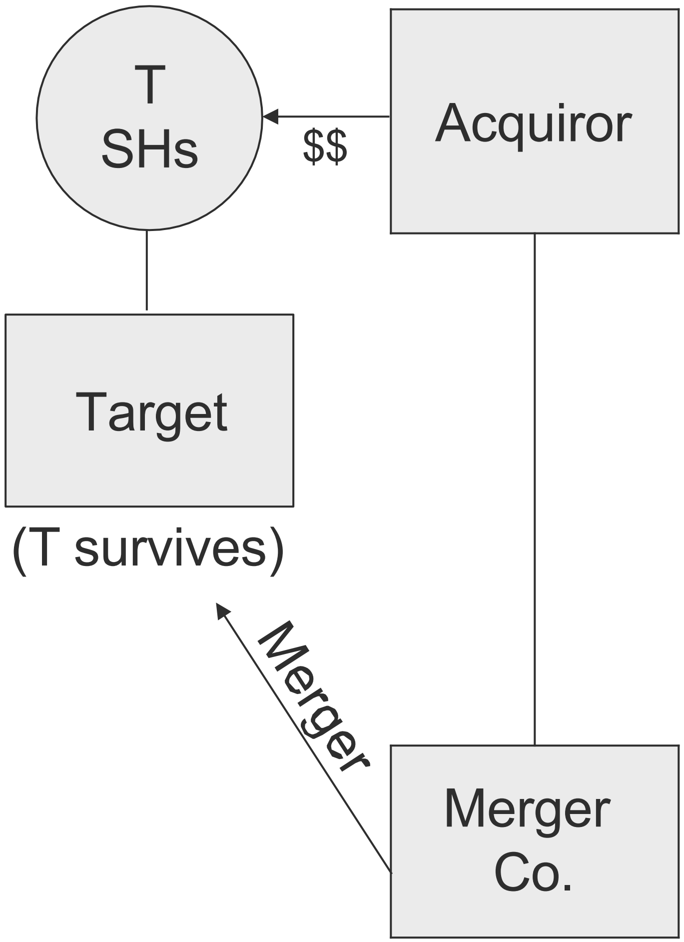
- Key Factor – Nature of Consideration
  - If consideration is mostly or all cash, then transaction will generally be taxable
  - If consideration is at least 40% stock, then tax-free transaction may be possible
- If taxable, should transaction be structured as an acquisition of stock or assets?
  - May be possible to achieve the best of both worlds with a 338(h)(10) or 336(e) election

Taxable Acquisitions – Stock Purchase



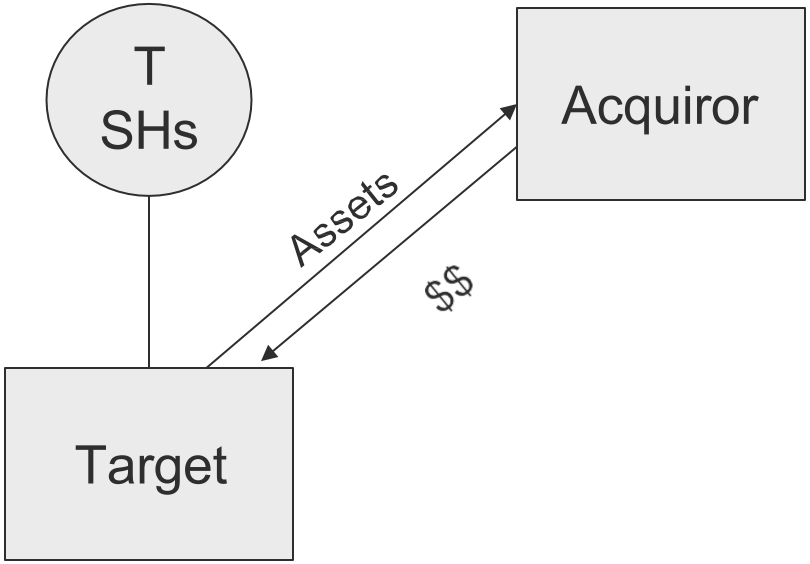
- Advantages
  - Cash directly to shareholders.
  - Easier to transfer stock than assets (*e.g.*, entity-level agreements often unaffected)
- Disadvantage
  - Generally, no step-up in tax basis of assets (but see 338(h)(10) and 336(e) elections below)

Taxable Acquisitions – Reverse Subsidiary Merger



- Treated as a stock purchase for tax purposes
- Acquiror's subsidiary merges into Target, with Target surviving
- Target becomes a subsidiary of Acquiror

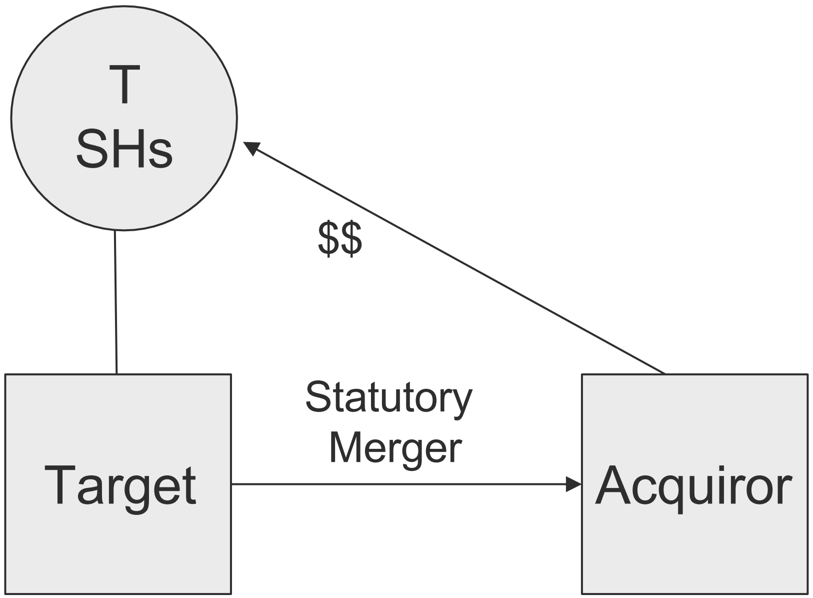
Taxable Acquisitions – Asset Purchase



- Advantages
  - Step-up in tax basis of assets
  - Generally, liabilities may be left with Target

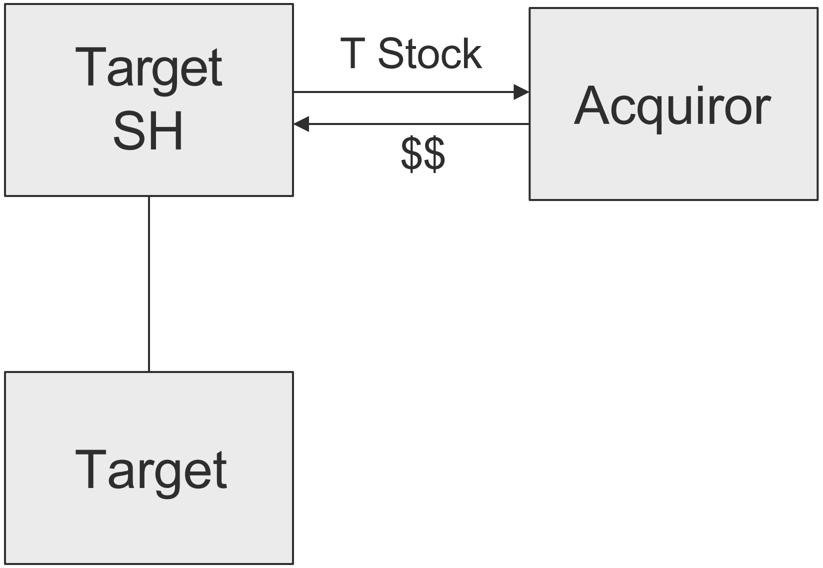
- Disadvantages
  - "Double tax" to get cash to shareholders (*i.e.*, corporate level tax and SH level tax)
  - May be difficult to transfer assets
  - Agreements to which assets are subject may need to be renegotiated

Taxable Acquisitions – Forward Merger



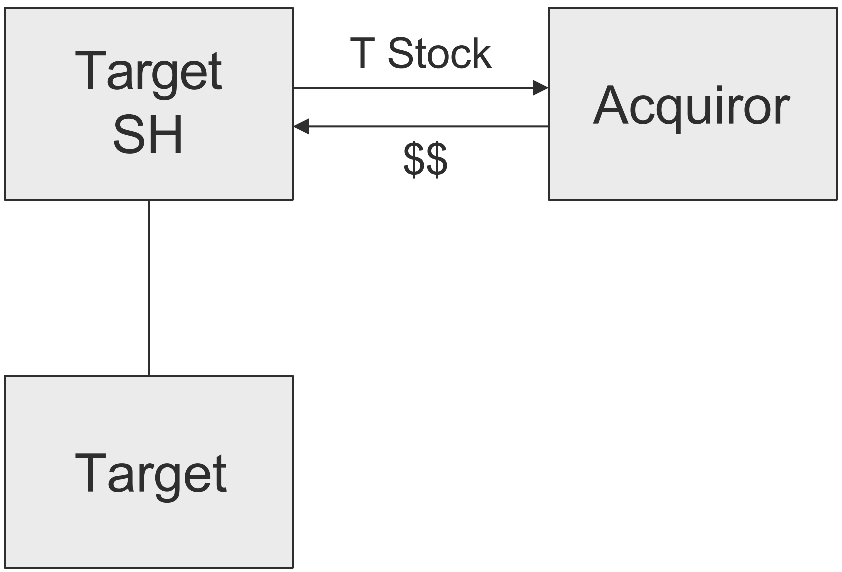
- Target merges directly into Acquiror, with Acquiror surviving
- Target shareholders get cash for Target stock
- Treated as a taxable asset sale by Target, followed by a taxable liquidation of Target
- This structure is rarely employed because it results in "double tax" (*i.e.*, corporate level tax and SH level tax)

Taxable Acquisitions – Section 338(h)(10) Election



- Allows stock purchase to be treated as asset purchase for tax purposes. Thus, Target SH receives cash and Acquiror receives tax basis step-up in Target's assets
- Generally available if either (a) Target SH and Target are members of a consolidated group or (b) Target is an "S" corporation
- Acquiror must purchase at least 80% of Target stock (by vote and value) and Acquiror must be a corporation.
- Election must be jointly made by Acquiror and Target SH

Taxable Acquisitions – Section 336(e) Election



- Allows stock purchase to be treated as asset purchase for tax purposes. Thus, Target SH receives cash and Acquiror receives tax basis step-up in Target's assets
- Generally available if either (a) Target SH and Target are members of a consolidated group or (b) Target is an "S" corporation
- Applies to a combination of sales, exchanges or distributions aggregating to at least 80% of Target stock (by vote and value) during a 12-month period
- Election is made by Target and Target SH

Tax-Free Acquisitions – Threshold Considerations

- Consideration must consist of at least 40% stock in the Acquiror
- Consider various forms of tax-free “reorganizations” that may be used:
  - Target merges directly into Acquiror (“A”)
    - Target merges into Acquiror’s Subsidiary, with Subsidiary surviving (forward triangular)
    - Acquiror’s Subsidiary merges into Target, with Target surviving (reverse triangular)
  - Acquiror acquires Target’s stock (“B”)
  - Acquiror acquires Target’s assets (“C”)

Tax-Free Acquisitions – Threshold Considerations (cont’d)

- Continuity of Business
    - The business of the acquired entity must continue after the transaction
    - Transfers of Target assets or stock after transaction can cause tax-free treatment to fail
- Continuity of Interest
    - A substantial number of Target stockholders must continue to be stockholders of the surviving entity after the deal
    - Measured in the aggregate (*i.e.*, cash election mergers are OK)
- Business Purpose and Plan of Reorganization
- Boot
    - Basically, non-stock consideration (usually cash)
    - Will be taxed at fair market value

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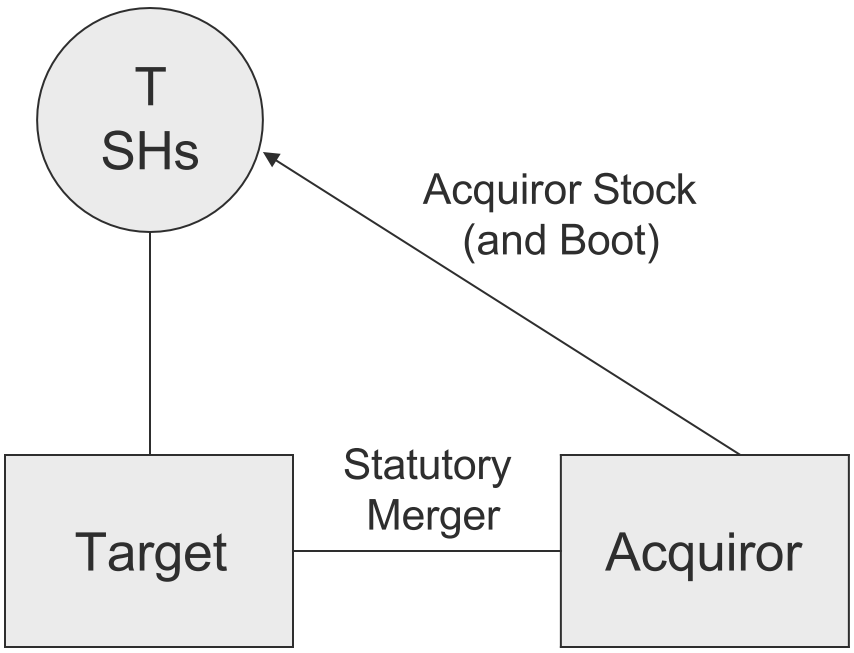
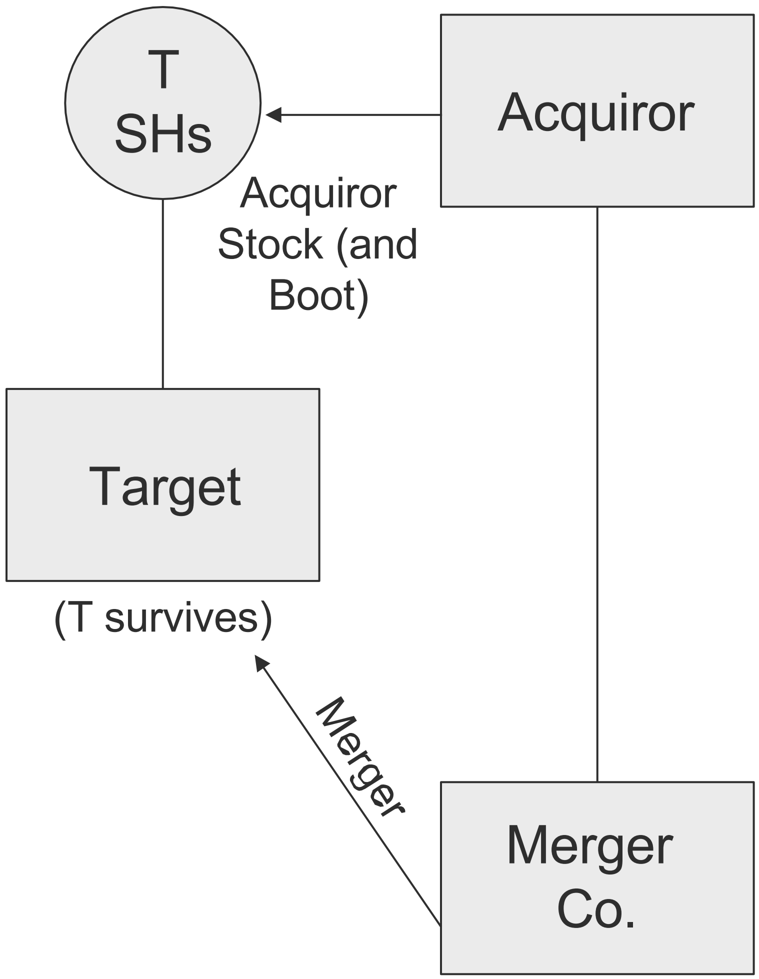
Type "A" Reorganization – Direct Forward Merger

Classic Reorganization



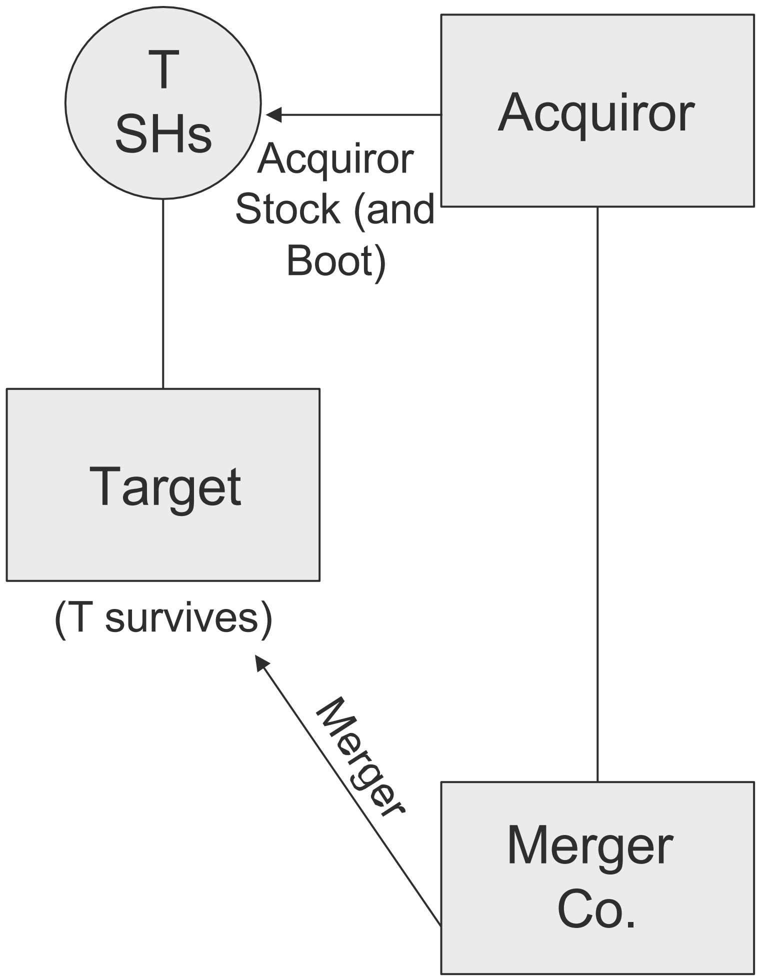
1. Statutory merger or consolidation
2. Assets and Liabilities of Target transferred to Acquiror by operation of law
3. Generally, most flexible and easy to satisfy of reorganizations
4. Can involve related or unrelated parties

Type “A” Reorganization – Reverse Triangular Merger



1. Merger Co. merges into Target
2. Target stockholders receive stock of Acquiror (and boot)
3. This is commonly referred to as a “reverse triangular merger.” Most public company tax-free deals use this form of reorganization

Type "A" Reorganization – Reverse Triangular Merger (cont'd)



4. General Requirements:
   - 80% control obtained in transaction. Control for these purposes is defined as 80% of the total combined voting power and 80% of the number of shares of each class of nonvoting stock
     - In the transaction, former Target stockholders exchange Target stock constituting control of Target for Public Co. Acquiror voting stock
   - "Substantially All" – After the transaction, Target holds substantially all of its properties and substantially all of Merger Co. properties. Substantially all" is generally met if Target retains 90% of net assets and 70% of gross assets

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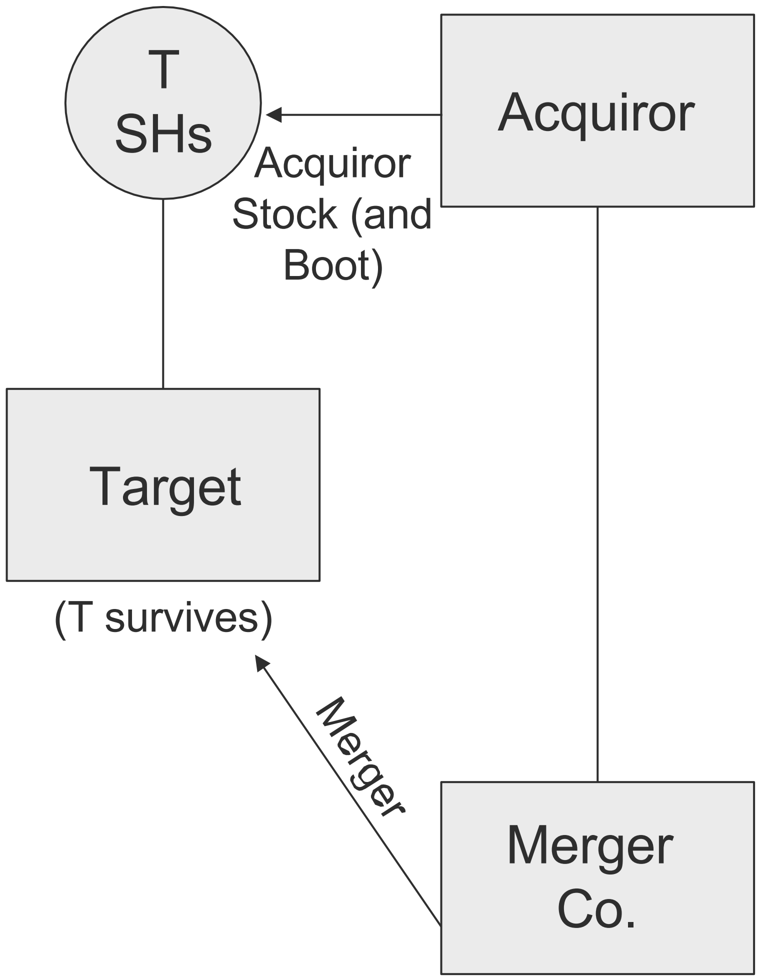
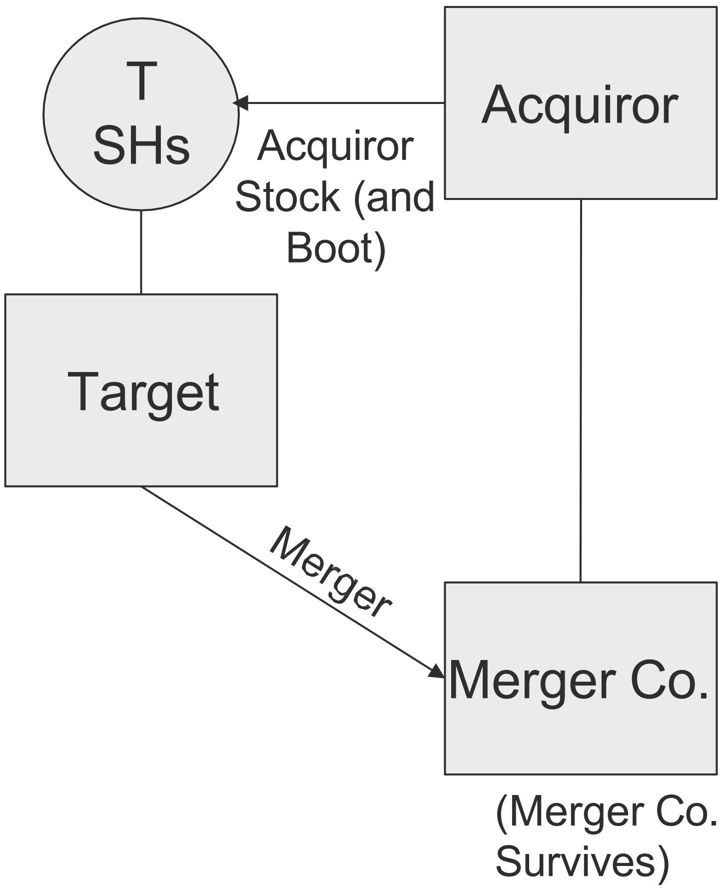
Type “A” Reorganization – Reverse Triangular Merger (cont’d)



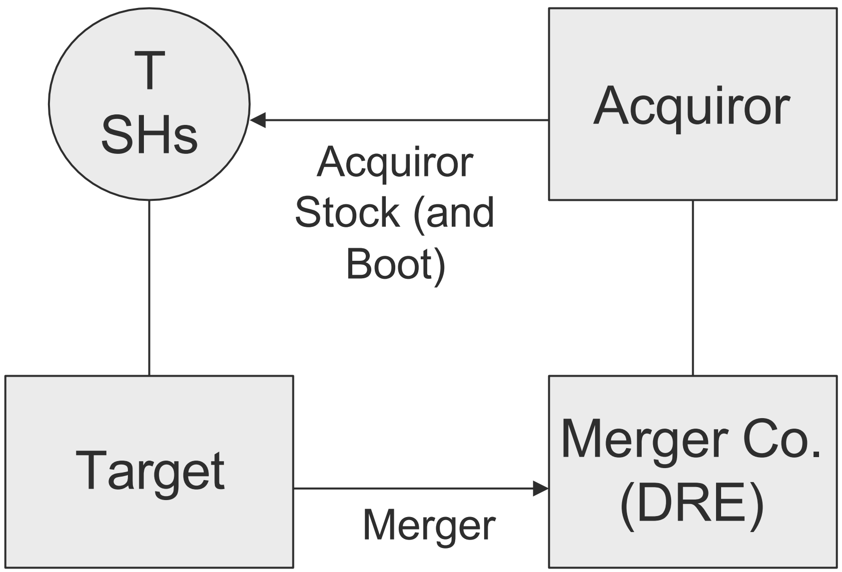
5. If transaction is determined to be taxable, it is a stock purchase by Acquiror of Target stock (see prior discussion)

Type "A" Reorganization – Forward Triangular Merger



1. Target merges into Merger Co
2. Target shareholders receive stock of Acquiror (and boot) (no Merger Co. stock permitted as consideration)
3. Merger Co. must acquire substantially all of Target's assets
4. This is commonly referred to as a "forward triangular merger." This form of reorganization is slightly more flexible than a reverse triangular merger. However, Target does not survive; consider 3rd party consents
5. If transaction is determined to be taxable, it is an asset sale by Target followed by a liquidation of Target (see prior discussion)

Type "A" Reorganization – Disregarded Entity ("DRE") Structure



1. Target merges into Merger Co., a disregarded entity, with Merger Co. surviving and Target Stockholders receiving Acquiror stock (and boot)
2. Treated as a direct forward merger of Target into Acquiror. No additional requirements
3. If transaction is determined to be taxable, then an asset sale by Target to Acquiror followed by a liquidation of Target (see prior discussion)

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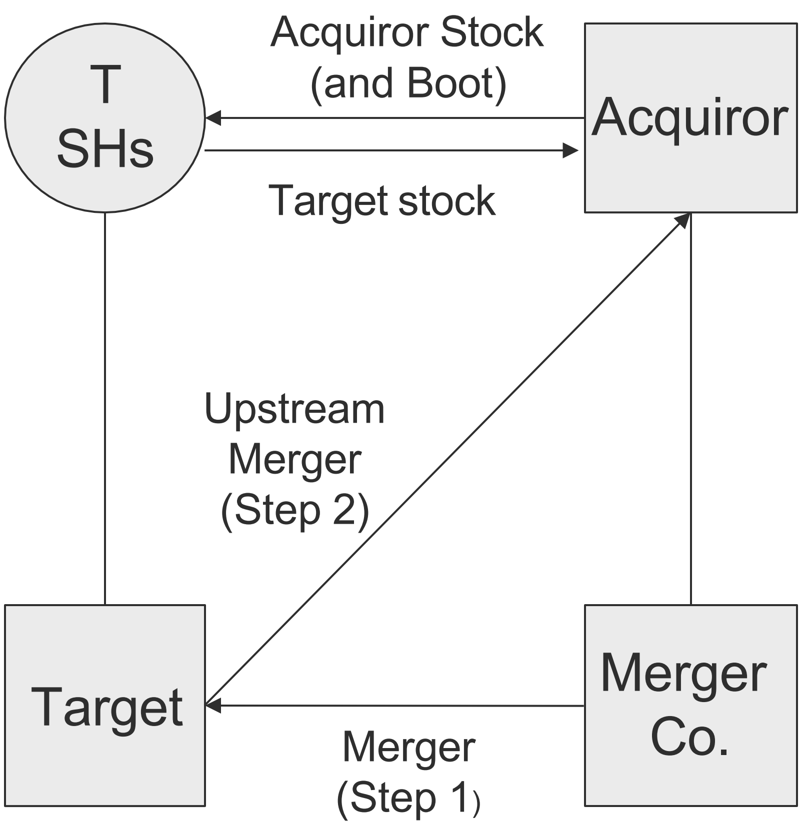
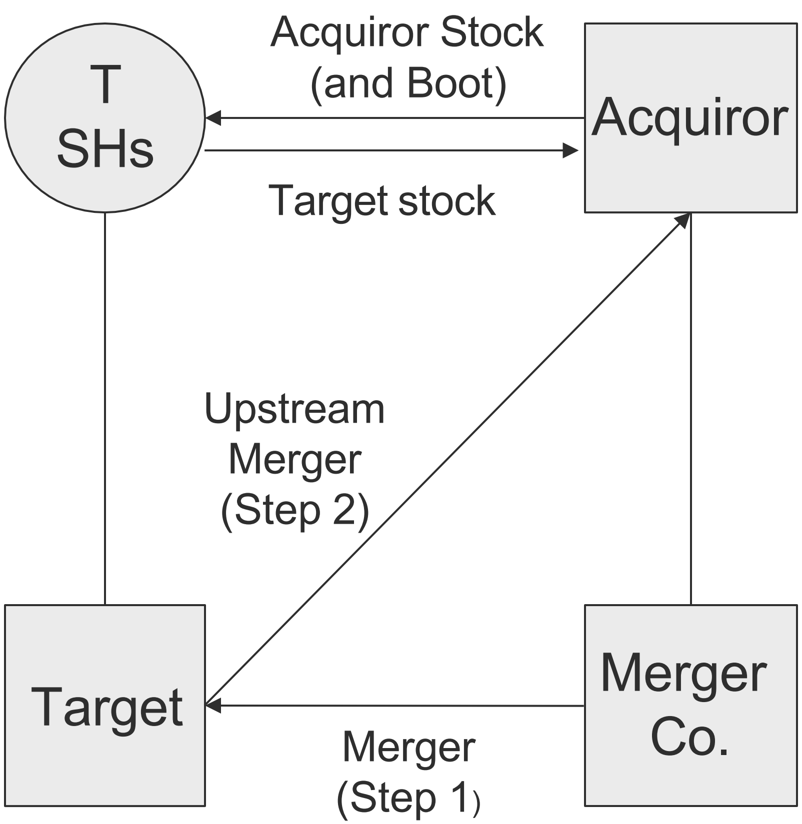
Type "A" Reorganization – Two-Step
(Rev Sub Merger + Upstream Merger)



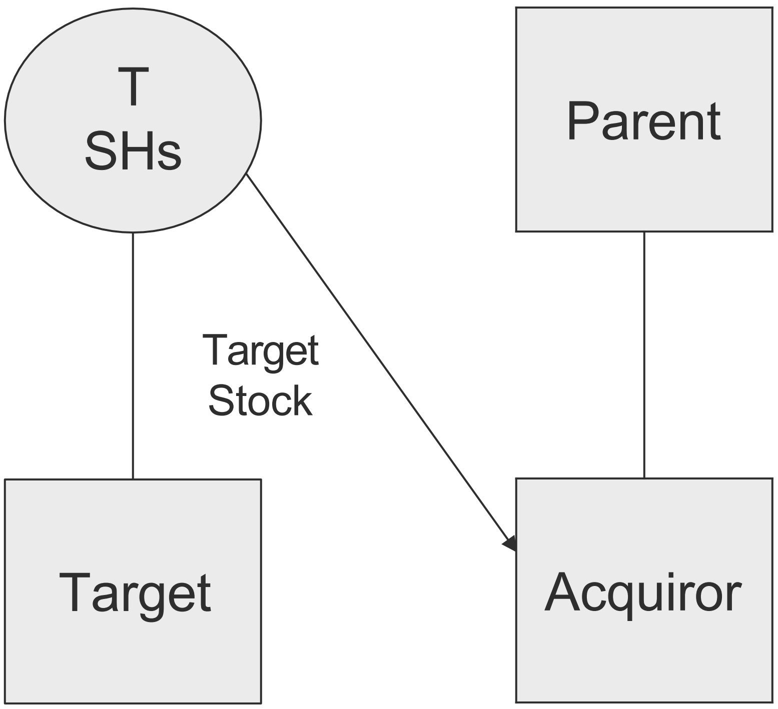
- "Double tax" if a direct forward or forward triangular merger fails to qualify as a tax-free reorganization (see prior discussion)
  - To avoid this result, consider structuring as two-step integrated reorganization transaction
- Structure
  - **Step 1** – Reverse subsidiary merger where Merger Co. merges into Target with Target surviving and T SHs receive Acquiror stock (and boot). Target becomes a subsidiary of Acquiror
  - **Step 2** – Target merges upstream into Acquiror (or its DRE subsidiary) with Acquiror surviving

Type "A" Reorganization – Two-Step
(Rev Sub Merger + Upstream Merger) (cont'd)



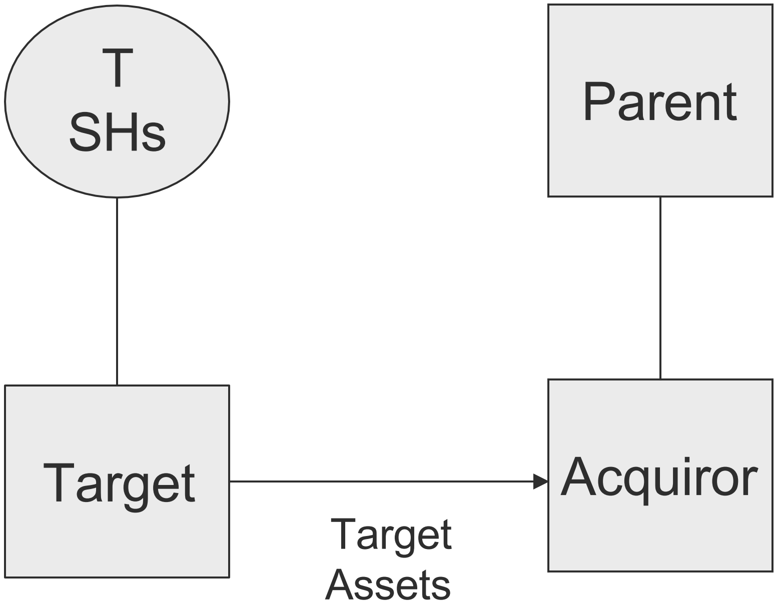
- Treatment
  - Two steps get integrated and treated as a direct forward merger of Target into Acquiror
  - If two-step transaction fails as an A reorganization (for example, too much boot), steps will be separated. Step 1 treated as a taxable acquisition of Target stock by Acquiror. Step 2 treated as tax-free liquidation or merger of Target into Acquiror. The result is one level of tax, not two (*i.e.*, only SH level tax and not corporate level tax)

Type "B" Reorganization



1. Transfer of Target stock to Acquiror
2. **Solely** in exchange for **voting stock** of:
   - Acquiror, or
   - Parent
   - **Not** of both
3. **Solely** means **solely**
4. Acquiror must obtain "control" of Target, which for these purposes is 80% of voting power and 80% of the "total number of shares of all other classes"

Type "C" Reorganization



1. Transfer of Target Assets to Acquiror
2. **Solely** in exchange for **voting stock** of:
   - Acquiror, or
   - Parent
   - **Not** of both
3. **Solely** means **solely** (kind of)

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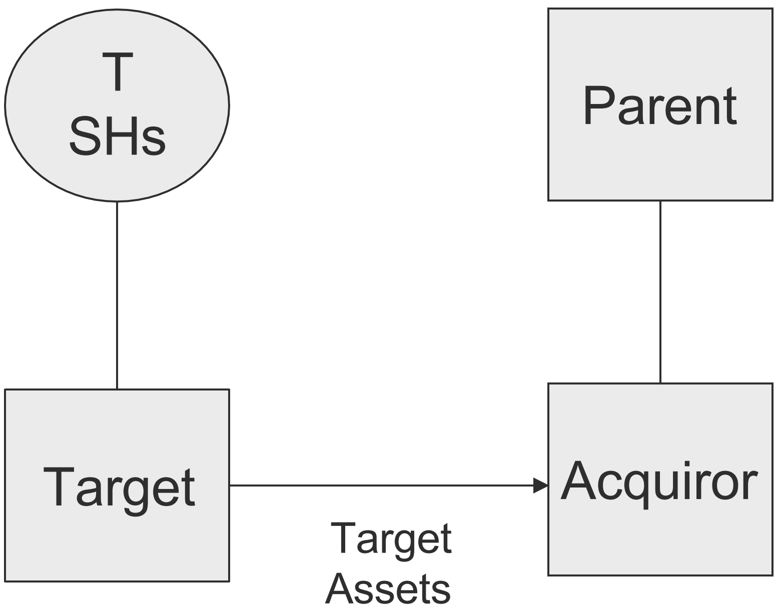
Type "C" Reorganization (cont'd)



4. "Boot relaxation" rule allows up to 20% boot, but if other property is used as consideration, assumed liabilities are counted as boot
5. No statutory merger requirement
6. A "C" reorganization requires substantially all of Target's assets be held by Acquiror (or an entity controlled by Acquiror), taking into account step transaction doctrine
7. Target must distribute stock received and its other property to its stockholders (liquidation requirement)

Section 351 Transactions

- **Section 351(a)**: Generally no gain or loss recognized if:
  - property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation; **and**
  - immediately after the exchange, such person or persons are in control of the corporation. “Control” for these purposes is defined as 80% of the total combined voting power, and 80% of the number of shares of each class of nonvoting stock
- **Boot**: Generally, if a transferor receives boot in addition to stock, the transferor recognizes gain in the same manner as when boot is received in a reorganization transaction

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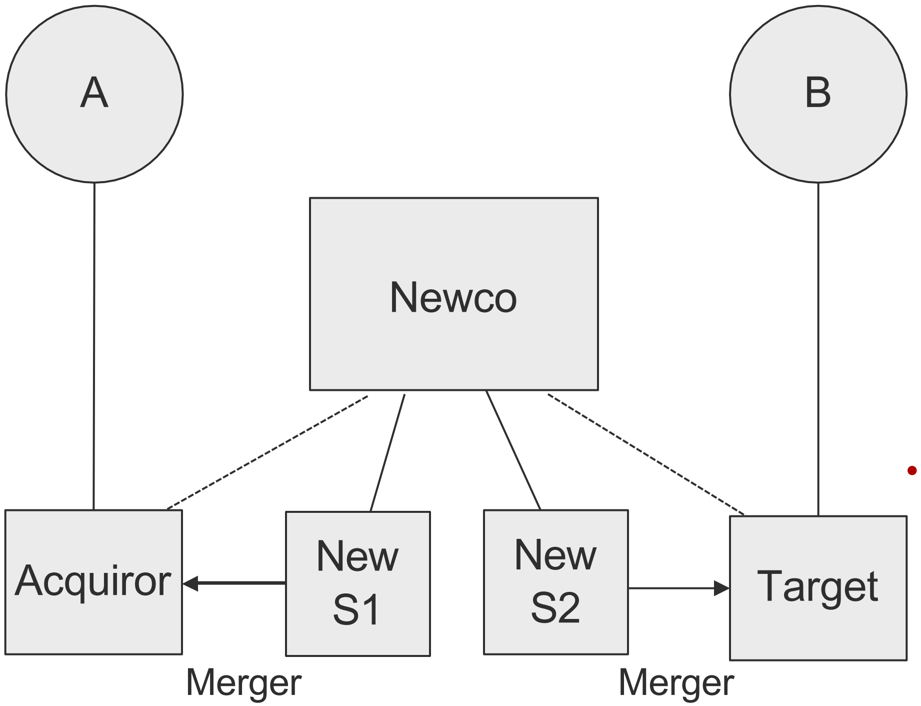
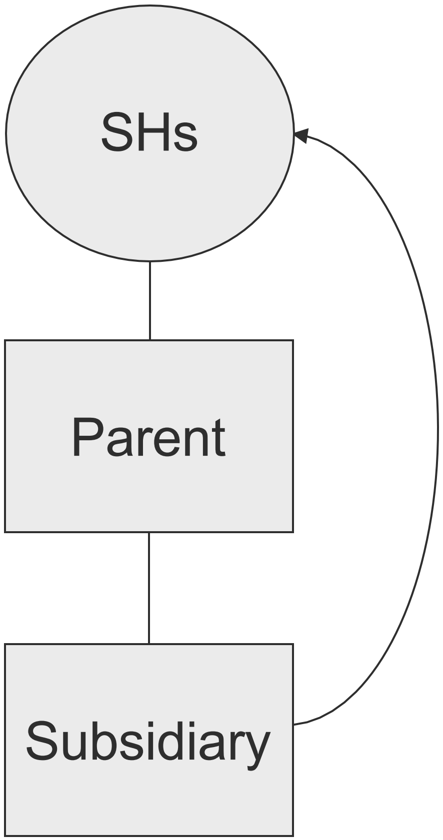
Acquisitive Section 351 Transactions – Butterfly or Double-Dummy Transaction



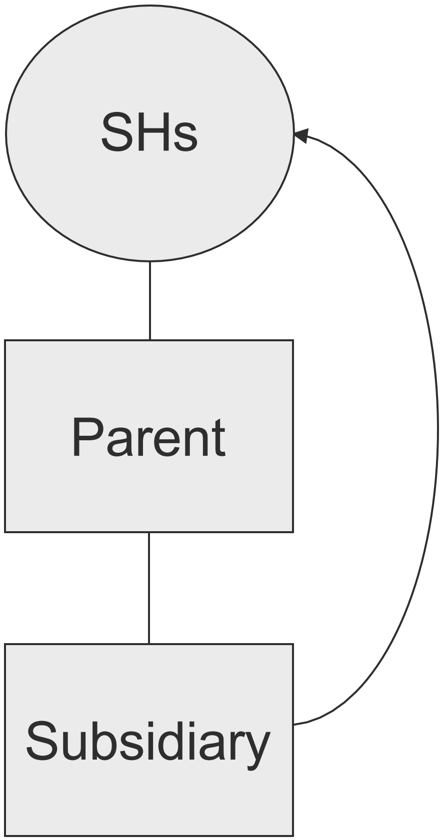
- Structure
  - New S1 merges into Acquiror with Acquiror surviving and A receives Newco stock
  - New S2 merges into Target with Target surviving and B receives Newco stock and boot (which may represent more than 60% of the consideration)
- Key Considerations
  - Qualifies as a contribution under Section 351(a) (no continuity of interest requirement; no limit on amount of boot)
  - Requires formation of new holding company

Spin-Offs



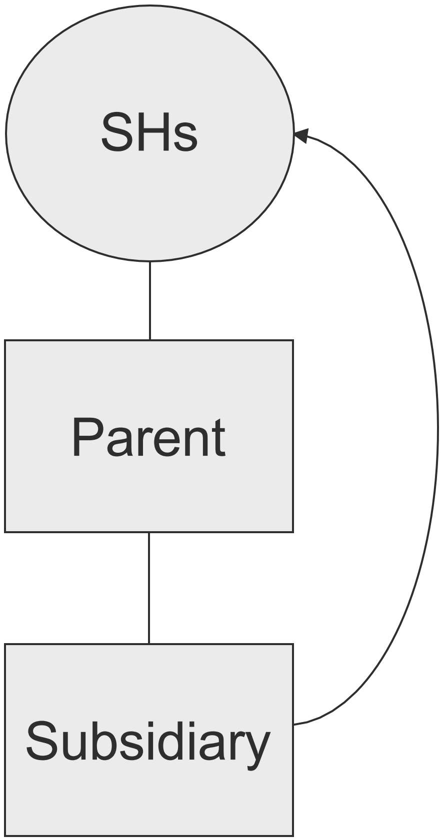
- A "Spin-Off" is a distribution of the stock of a controlled Subsidiary by Parent to some or all of its Shareholders
- Downside of not qualifying for tax-free status is generally two levels of tax: (i) Parent recognizes any built-in gain on the distribution of Subsidiary, and (ii) Parent's shareholders have a dividend (to extent of Parent's current and accumulated earnings and profits) equal to the fair market value of the Subsidiary stock they receive

Spin-Offs (cont'd)



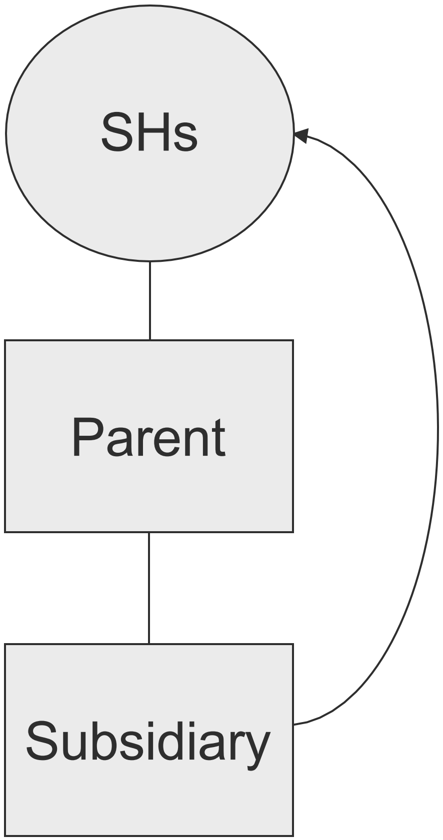
- Parent will often try to structure the spin as tax-free, which requires neither Parent nor Parent's SHs to recognize income or gain. Generally, a tax-free spin requires:
    - Business Purpose: a "real and substantial non-Federal tax purpose germane to the business of" Parent, Subsidiary or the Parent group, that cannot be achieved through any other nontaxable transaction "which is neither impractical nor unduly expensive;" and

Spin-Offs (cont'd)



- Active Business: Parent and Subsidiary (or each Subsidiary if Parent is a holding company) must each conduct an active trade or business that has not been acquired in a taxable acquisition within the past 5 years
- Additional Technical Requirements:
  - Parent must distribute "control," which is defined as 80% of the total combined voting power, and 80% of the number of shares of each class of nonvoting stock
  - Continuity of Interest is effectively required

Spin-Offs (cont'd)



- Additional Technical Requirements (cont'd):
  - Continuity of Business is required
  - The transaction must not be a "device" for the distribution of earnings and profits
- A tax-free Spin-Off will generally be subject to detailed restrictions (through a Tax Matters Agreement) regarding future corporate transactions (including, both asset and subsidiary sales and transactions involving the equity of either Parent or Subsidiary) to ensure that the Spin-Off does not violate various technical requirements imposed by the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder