



Strasburger
ATTORNEYS AT LAW

**TAX ASPECTS OF BUYING OR
SELLING A BUSINESS**

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SP Transactional Academy
February 16, 2010

Topics

- **Transaction considerations**
- **Taxable asset acquisition**
- **Taxable stock acquisition**
- **Tax-free reorganizations**
- **Acquisitions using disregarded entities**

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 - Taxable asset acquisition
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Transaction Considerations

- **Form of transaction**
 - Asset purchase: specified assets/liabilities
 - Hybrid – divisive merger (TBOC §10.003)
 - Stock purchase: all assets/liabilities
 - Merger: all assets/liabilities

Transaction Considerations

- **Form and timing of consideration**
 - Buyer equity versus cash or other property
 - Deferred, contingent, or escrowed payments
 - Assumption of liabilities
 - Like-kind exchange

Transaction Considerations

- **Form of transaction and consideration will impact tax consequences**
 - Taxable, tax-free, or combination to Seller
 - Timing of Seller gain recognition
 - Amount and timing of Buyer stepped-up tax basis
 - Transfer taxes

Transaction Considerations

- **Shareholder assets, including goodwill**
- **Employment/consulting agreements and covenants not to compete**
- **Purchase price allocation**

Transaction Considerations

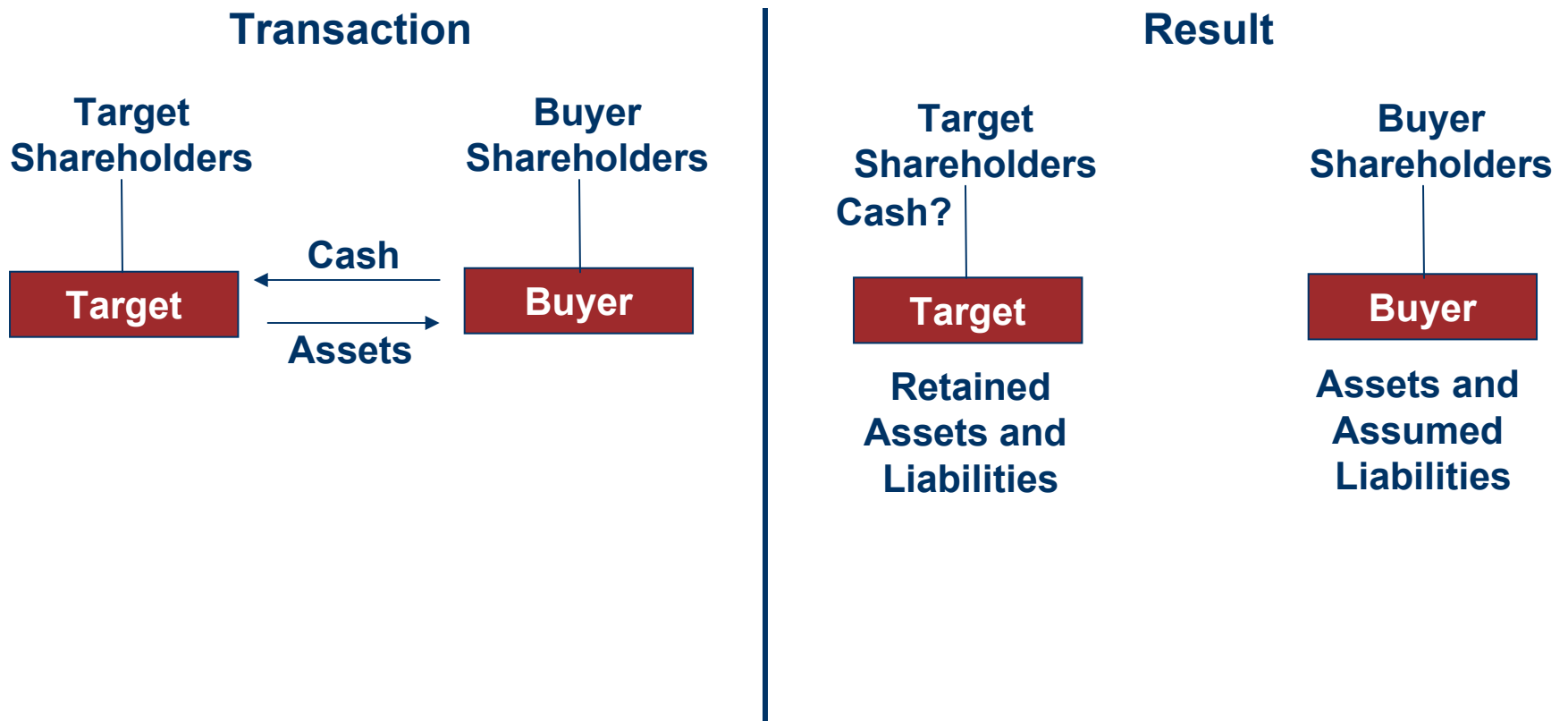
- **Book versus tax accounting**
 - Contingent consideration
 - Transaction costs
- **Tax accruals and tax indemnity**
- **Termination/transition of compensation plans**
- **Transition services (tax compliance)**
- **Transfer taxes**
- **Tax withholding certificates**

Topics

- Transaction considerations
- **Taxable asset acquisition**
- Taxable stock acquisition
- Tax-free reorganizations
- Acquisitions using disregarded entities

Taxable Asset Acquisition

- Purchase of assets



Taxable Asset Acquisition

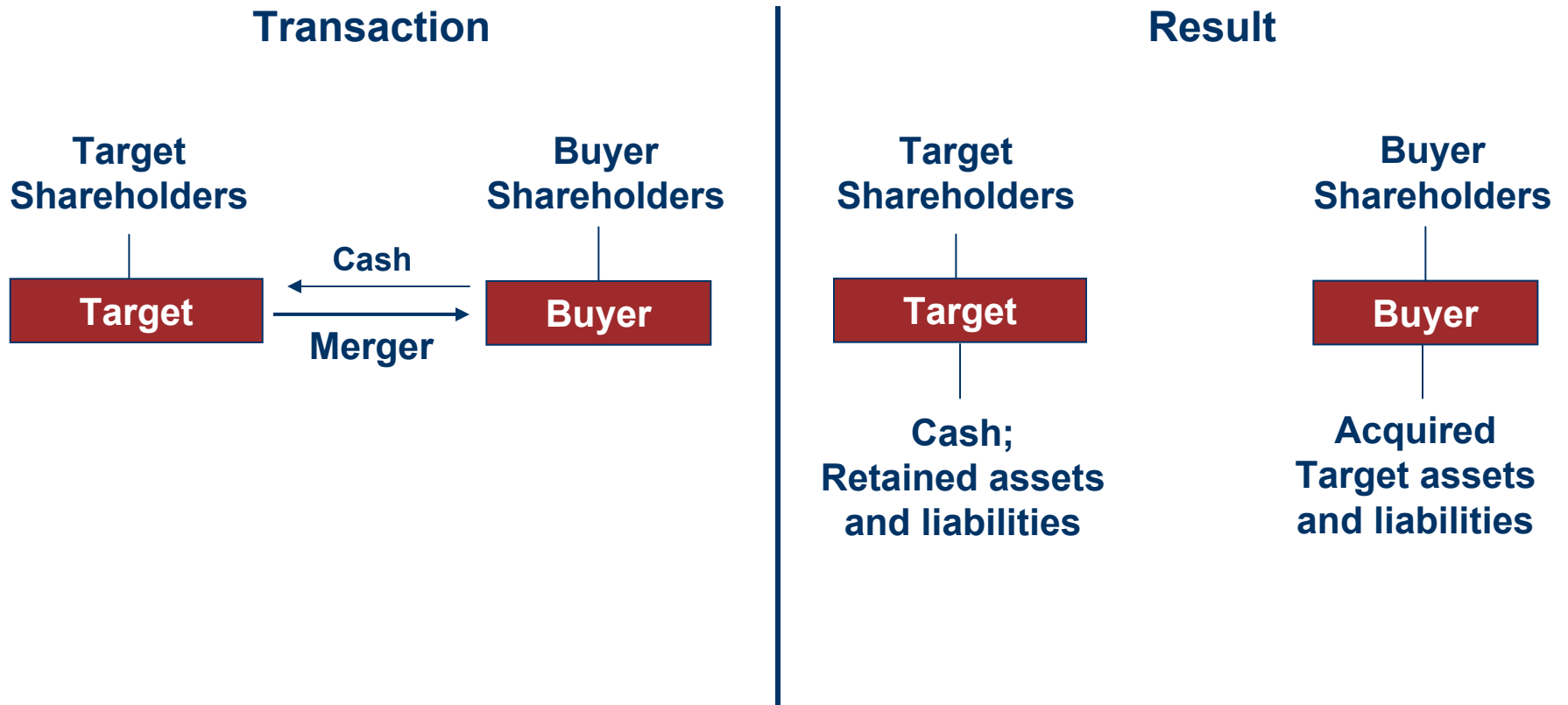
- **Target = C corporation**
 - Target recognizes gain or loss on asset sales
 - Ordinary income to extent of ordinary assets
 - Can use NOLs and other tax attributes to mitigate
 - Target Shareholders recognize gain on distribution of sale proceeds by Target
 - Buyer has FMV basis in assets acquired

Taxable Asset Acquisition

- **Target = S corporation**
 - Target recognizes gain or loss on asset sales, but passed through to Target Shareholders
 - Target Shareholders increase basis in their Target stock by gain passed through.
 - Distributed cash taxable only if $>$ stock basis
 - Buyer has FMV basis in assets acquired
- **Target = LLC/Psp**
 - Same as S corporation

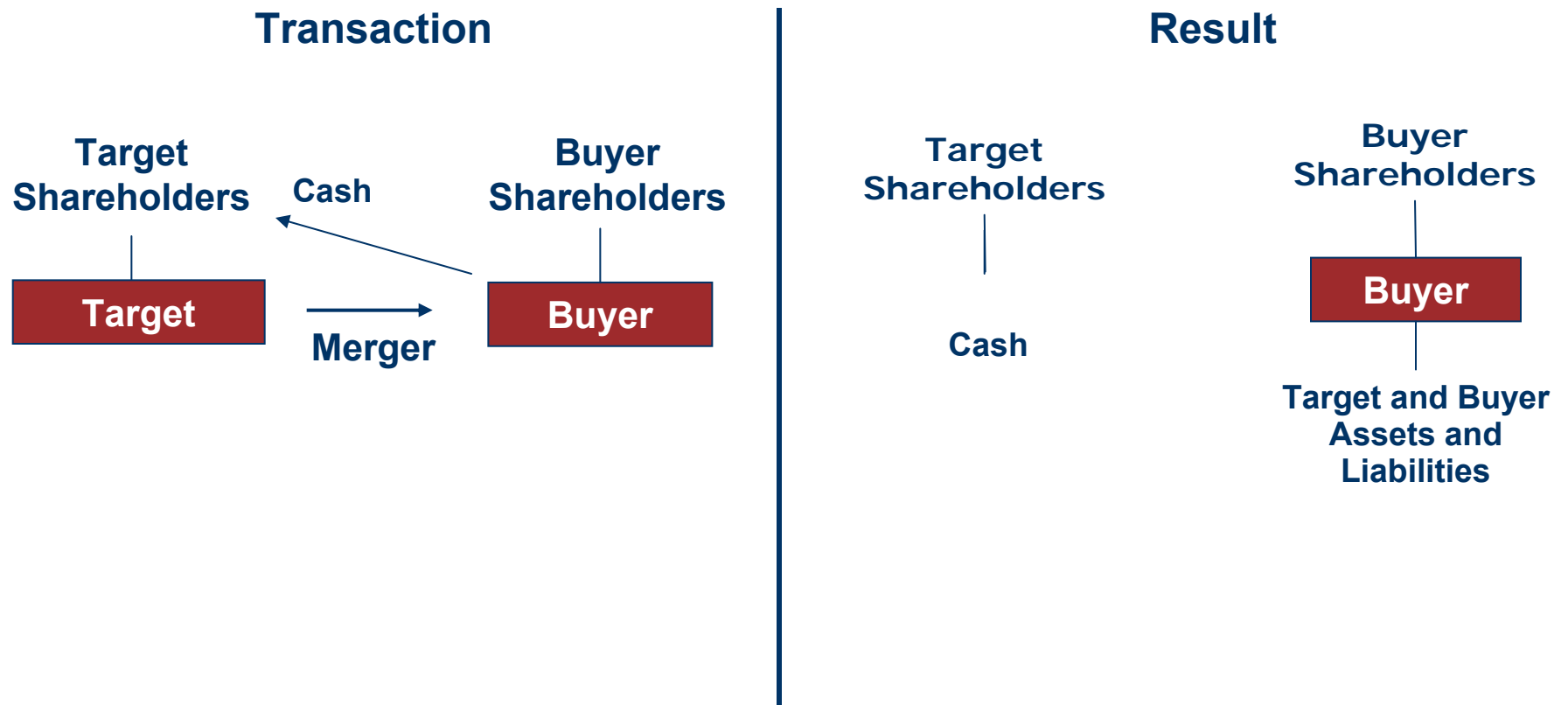
Taxable Asset Acquisition

- Divisive Merger



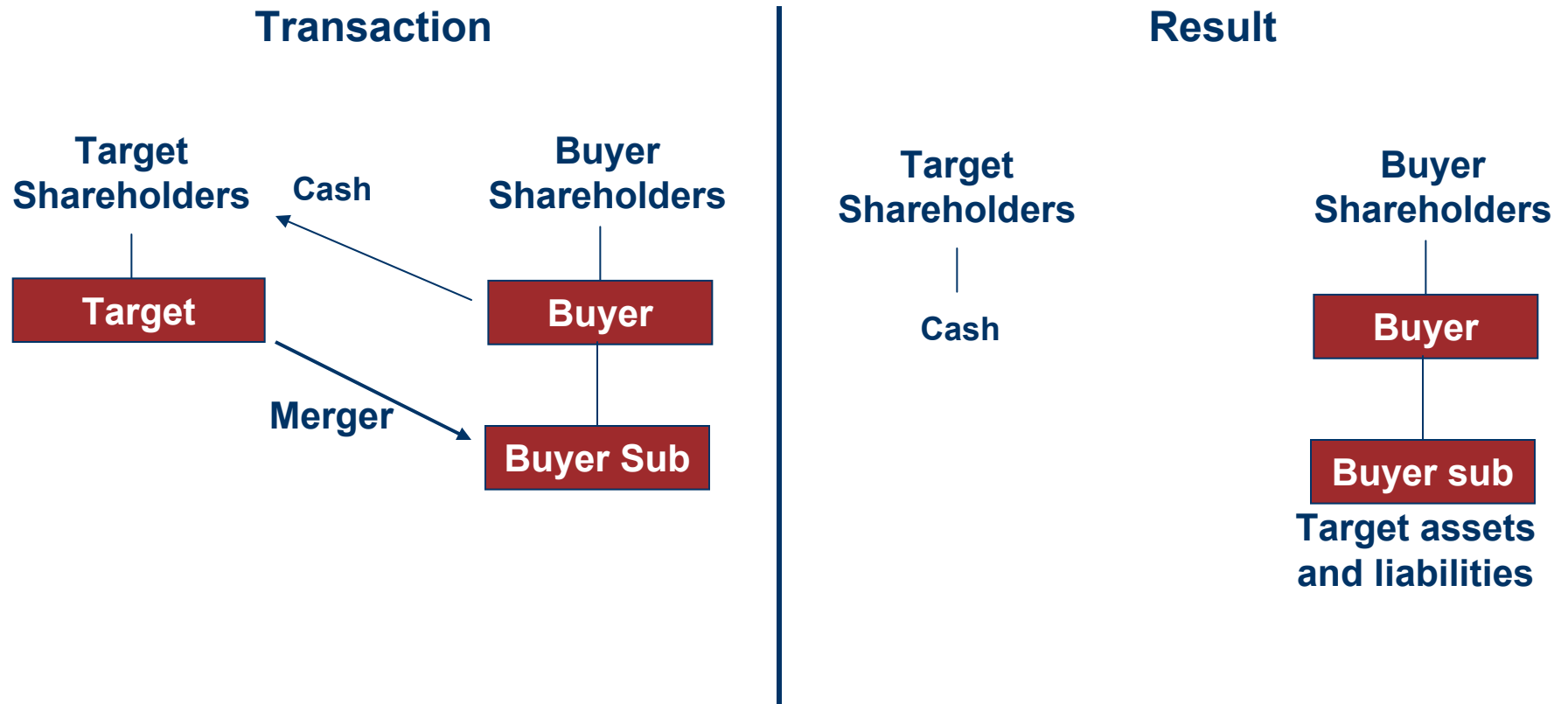
Taxable Asset Acquisition

- Forward merger



Taxable Asset Acquisition

- Forward subsidiary merger



Taxable Asset Acquisition

- **Divisive Merger**
 - Same tax consequences as asset acquisition
 - Selected assets/liabilities transfer by operation of law
 - Target survives and retains unwanted assets/liabilities
- **Forward merger**
 - Same as divisive merger, except all assets/liabilities transfer and Target terminates
- **Forward subsidiary merger**
 - Similar to forward merger, but Buyer treated as dropping Target's assets/liabilities into Buyer sub

Topics

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- **Taxable stock acquisition**
- Tax-free reorganizations
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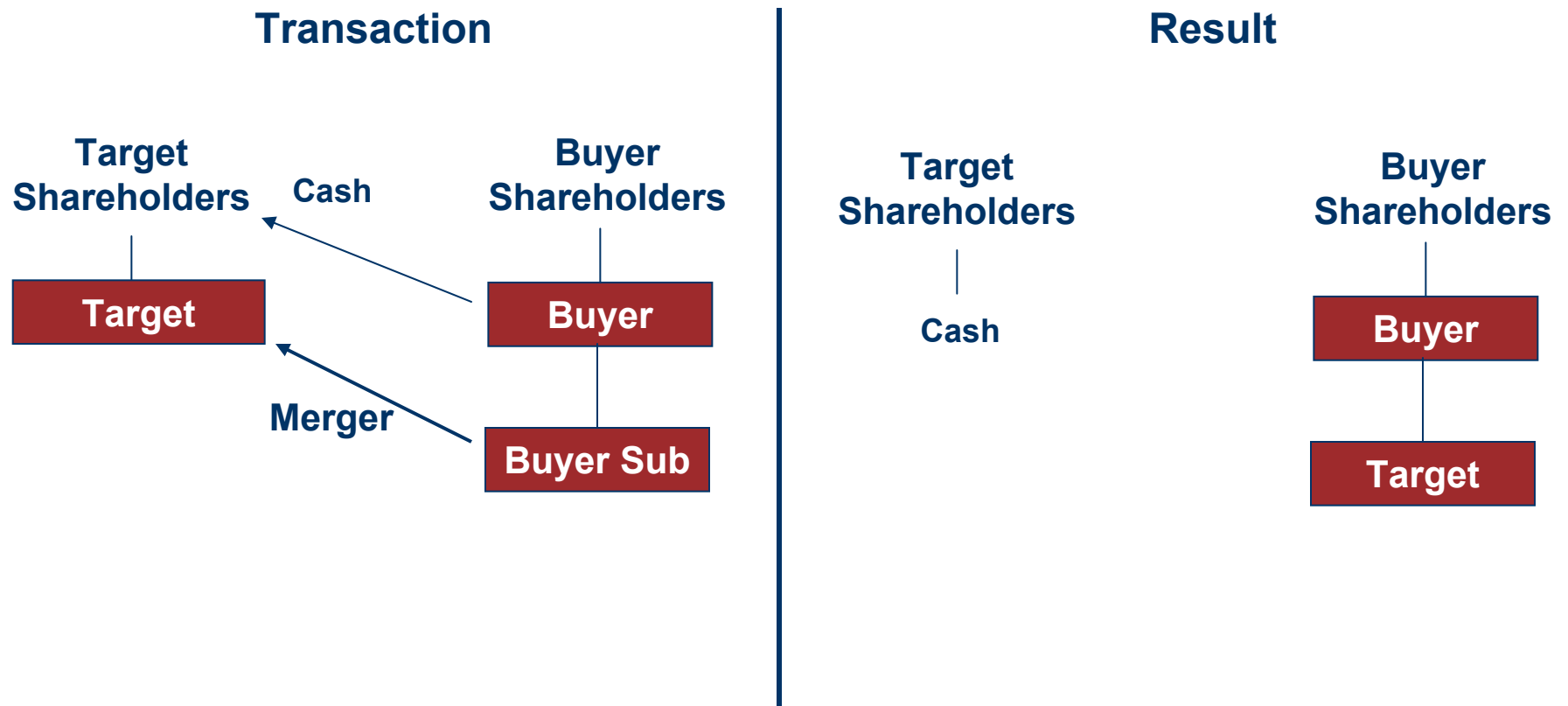
Taxable Stock Acquisition

- Purchase of stock



Taxable Stock Acquisition

- Reverse subsidiary merger



Taxable Stock Acquisition

- **Reverse subsidiary merger**
 - Treated same as stock purchase
 - Used to “squeeze out” minority shareholders
 - Most common form for acquiring the business of a publicly traded company

Taxable Stock Acquisition

- Purchase of stock



Taxable Stock Acquisition

- **Target = C corporation**
 - Target has no gain or loss
 - Target shareholders recognize gain on receipt of sale proceeds from Buyer
 - Gain generally all capital gain
 - Buyer has FMV basis in Target stock, but Target has carryover basis in assets
 - Target tax attributes (NOLs) generally eliminated

Taxable Stock Acquisition

- **Target = S corporation (SC)**
 - Generally: same tax consequences as C corp.
 - Exception: recapture of IDCs and depletion (§1254)
- **Target = LLC/Psp**
 - Target shareholders have capital gain except to extent of Target's "hot assets," which generate ordinary income
 - Target has stepped up tax basis if Section 754 election is made by Target

Taxable Stock Acquisition

- **Section 338(g) election**
 - Available if Buyer = corporation and meets other requirements (e.g., 80% stock purchase)
 - Rarely advisable due to double tax
 - Seller has stock sale gain
 - Target has deemed asset sale gain
 - Consider only if Target has large NOL carryforward

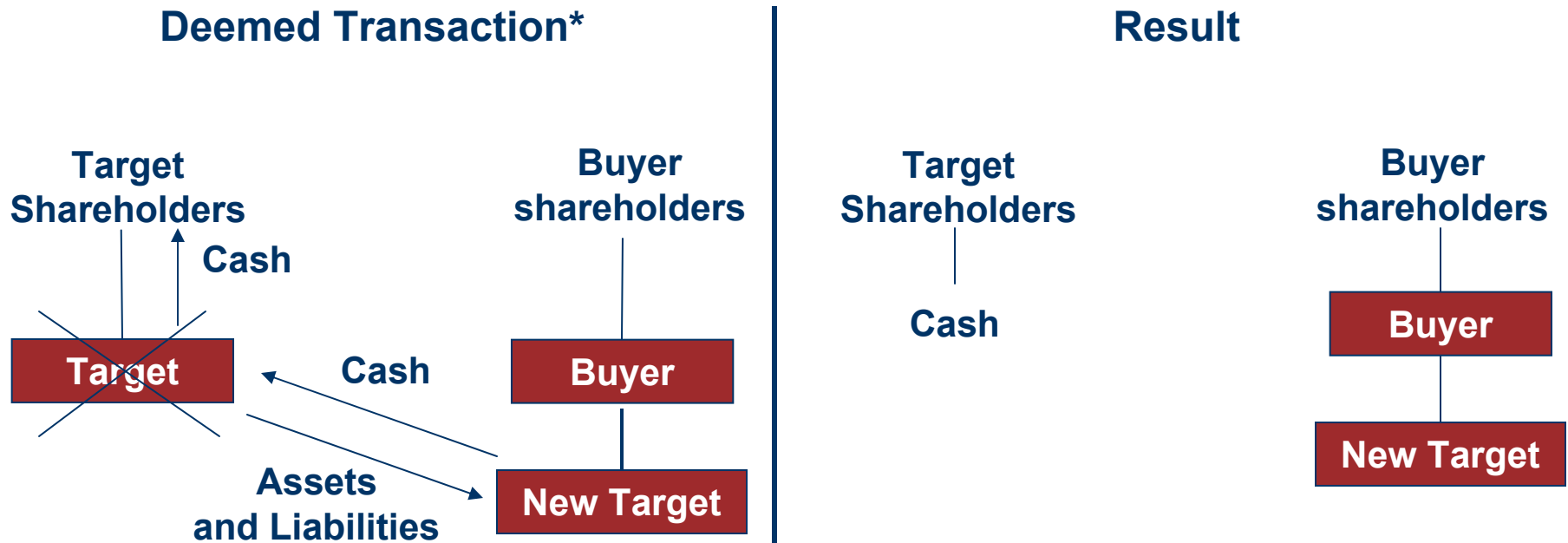
Taxable Stock Acquisition

- **Section 338(h)(10) election**

- Available if Seller and Target file a consolidated federal return, are affiliated corporations, or Target is an S corporation
- No double tax
 - Seller recognizes asset sale gain
 - Deemed liquidation of Target is tax free
- Target has FMV tax basis
- Rarely inadvisable

Taxable Stock Acquisition

- Section 338(h)(10) election



*Actual transaction is Buyer purchases Target stock from Target shareholders.

Topics

- Transaction considerations
- Taxable asset acquisition
- Taxable stock acquisition
- **Tax-free reorganizations**
- Acquisitions using disregarded entities

Tax-Free Reorganizations

- **General considerations**

- Involves only corporations and requires issuance of qualifying consideration (stock)
- Tax effects
 - Generally no entity level taxes
 - Target Shareholders recognize gain only to extent of non-qualifying consideration (a/k/a “boot”). Remaining gain is deferred (not eliminated)
 - Acquiror has no tax basis step up in Target assets, regardless of gain recognition by Target Shareholders

Tax-Free Reorganizations

- **Application**

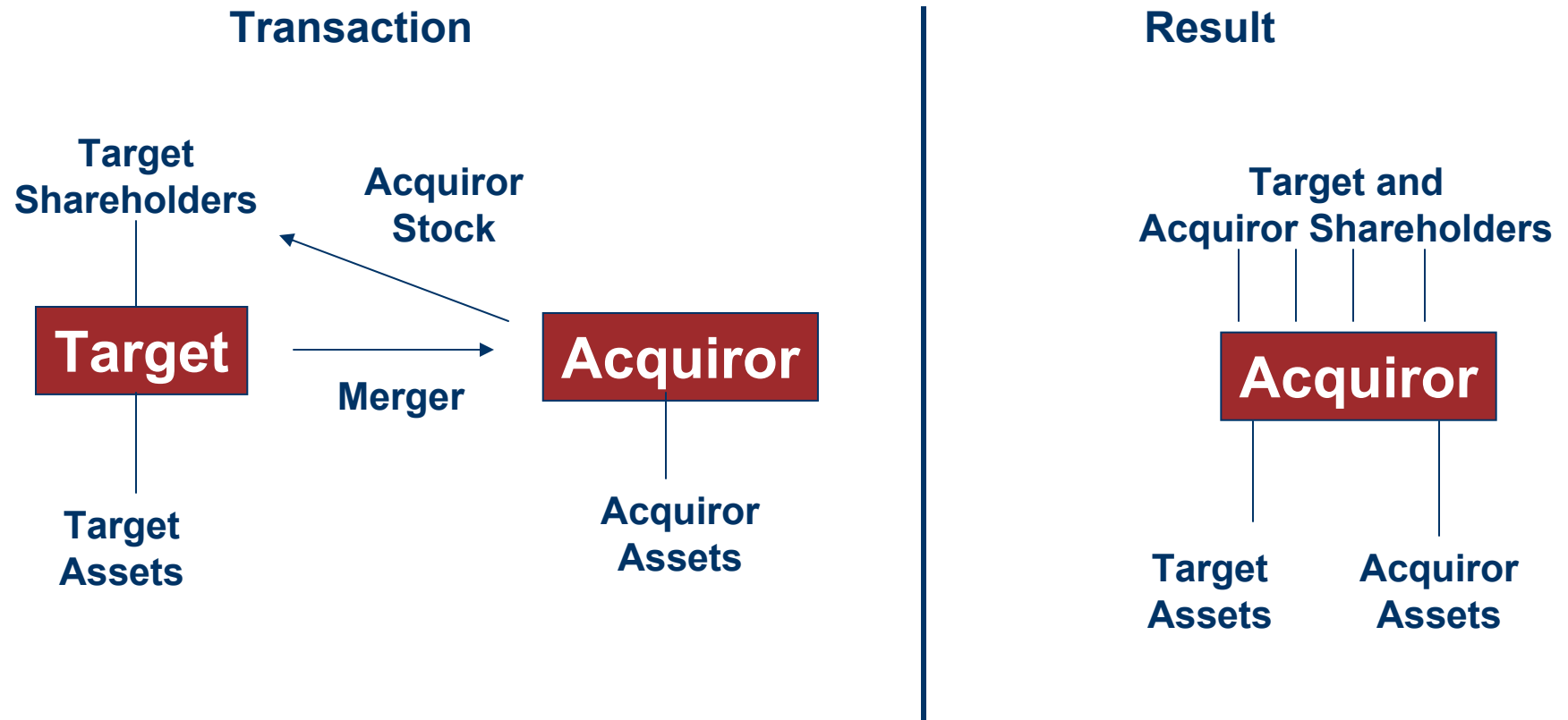
- Target = C corporation; low stock basis; high asset basis
- Internal reorganization of consolidated subsidiaries
- Spin-off C corporation subsidiary (divisive “D” reorganization)
- Bankruptcy reorganizations (“G” reorganization)

Tax-Free Reorganizations

- **Types of tax-free reorganizations**
 - A: statutory merger
 - B: stock for stock
 - C: assets for stock
 - D: assets for stock
 - E: recapitalization
 - F: change of identity, form, or place organized
 - G: bankruptcy reorganization

Tax-Free Reorganizations

- “A” reorganization (statutory merger)

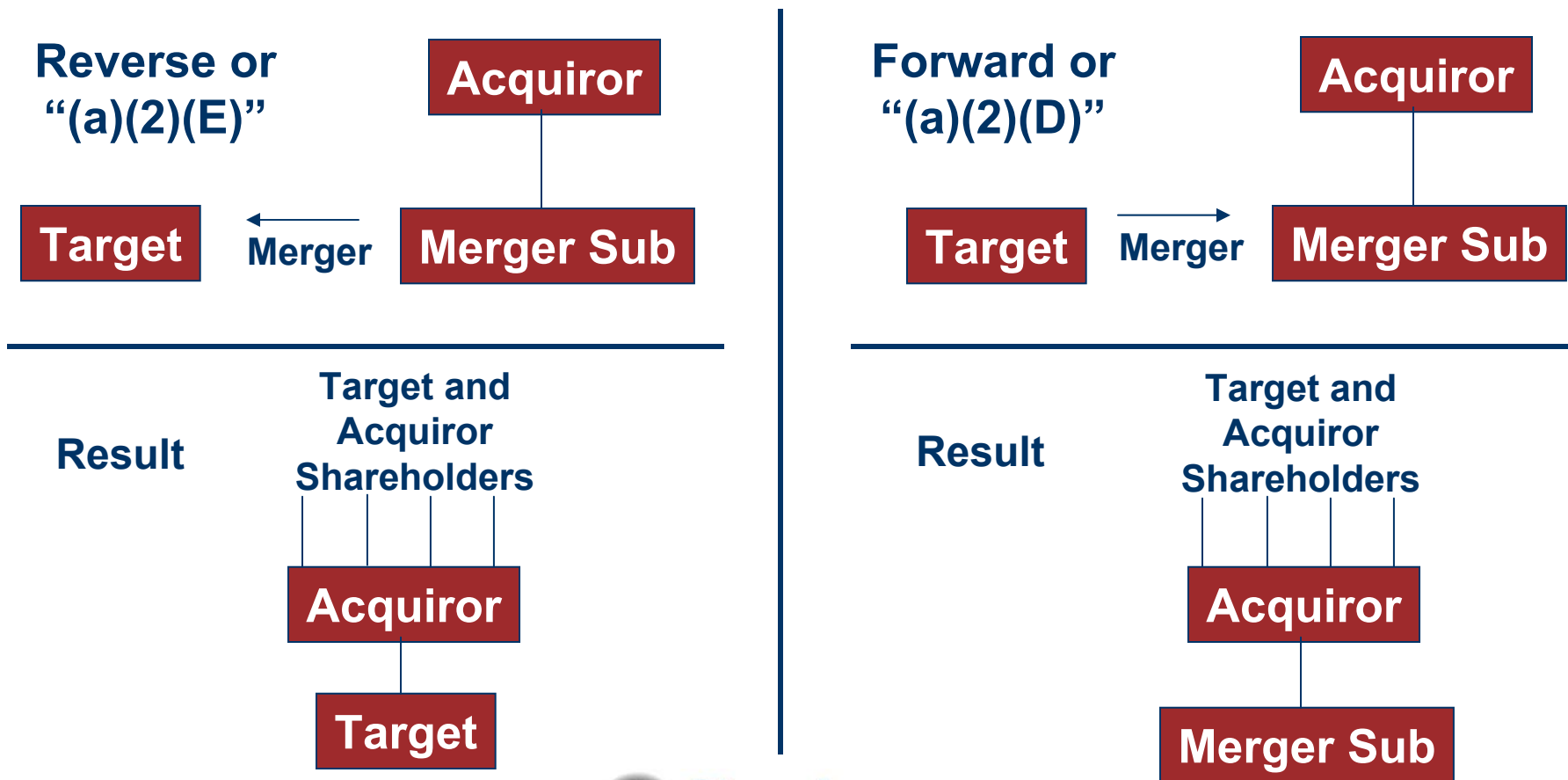


Tax-Free Reorganizations

- **“A” reorganization (statutory merger)**
 - Voting or nonvoting stock (other than nonqualified preferred stock) can be used
 - “Boot” (cash or other property) must be \leq $\sim 60\%$ of total consideration. Each Target Shareholder recognizes gain to the extent of boot received. Allows for:
 - Cash option merger
 - Exchange offer followed by cash “squeeze out” merger
 - Limitations on Target Shareholders selling Acquiror stock to Acquiror or related party

Tax-Free Reorganizations

- Triangular “A” reorganizations



Tax-Free Reorganizations

- **Triangular “A” reorganizations**

- Purpose

- Avoid board/shhr approval of Acquiror
- Avoid exposing Acquiror business to Target liabilities

- Reverse subsidiary merger – Target survives

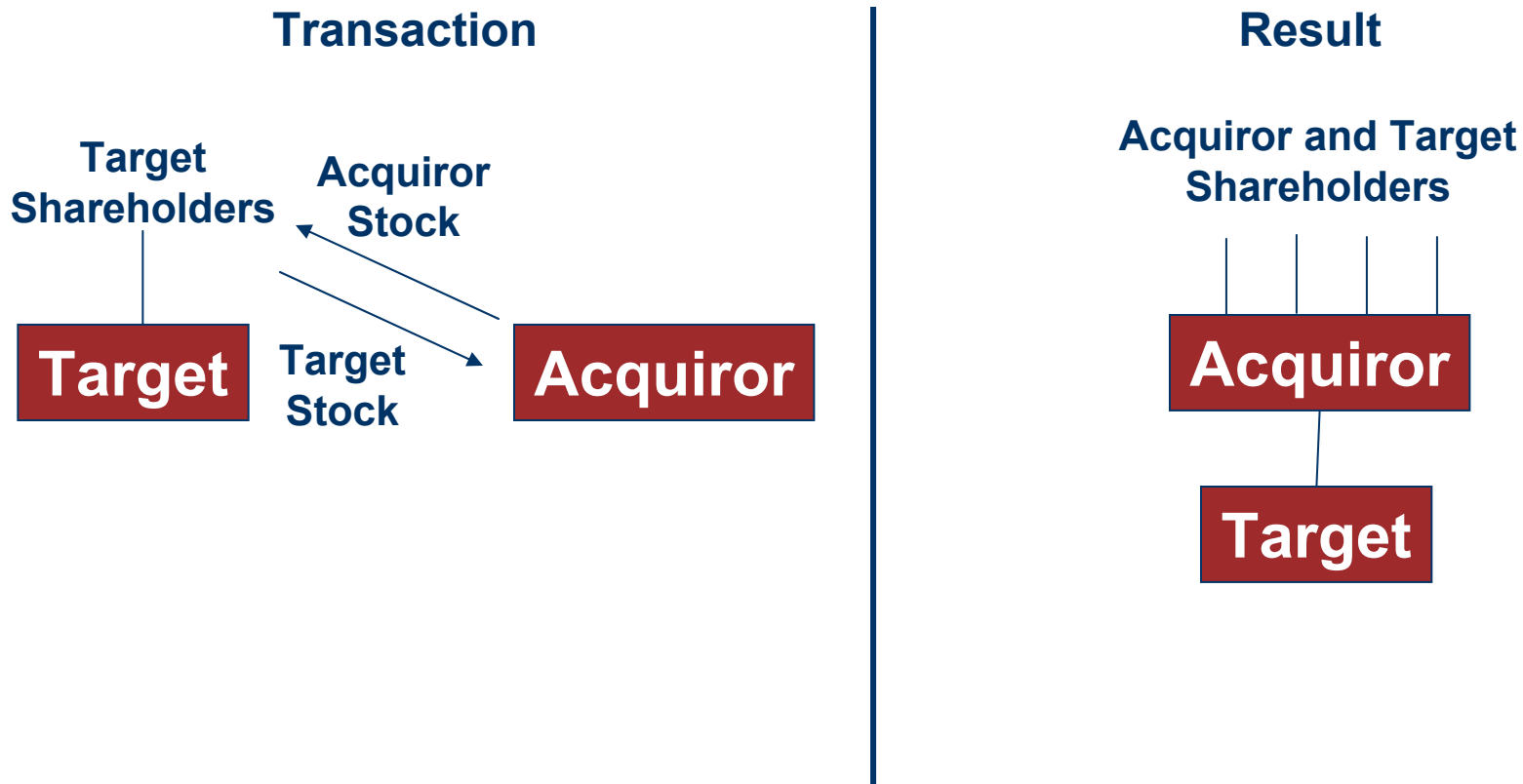
- Treated as stock purchase (triangular “B”)
- Requires $\geq 80\%$ voting stock consideration

- Forward subsidiary merger – Target terminates

- Treated as asset purchase (triangular “C”)
- Requires $\geq \sim 40\%$ stock consideration

Tax-Free Reorganizations

- “B” reorganization (stock for stock)

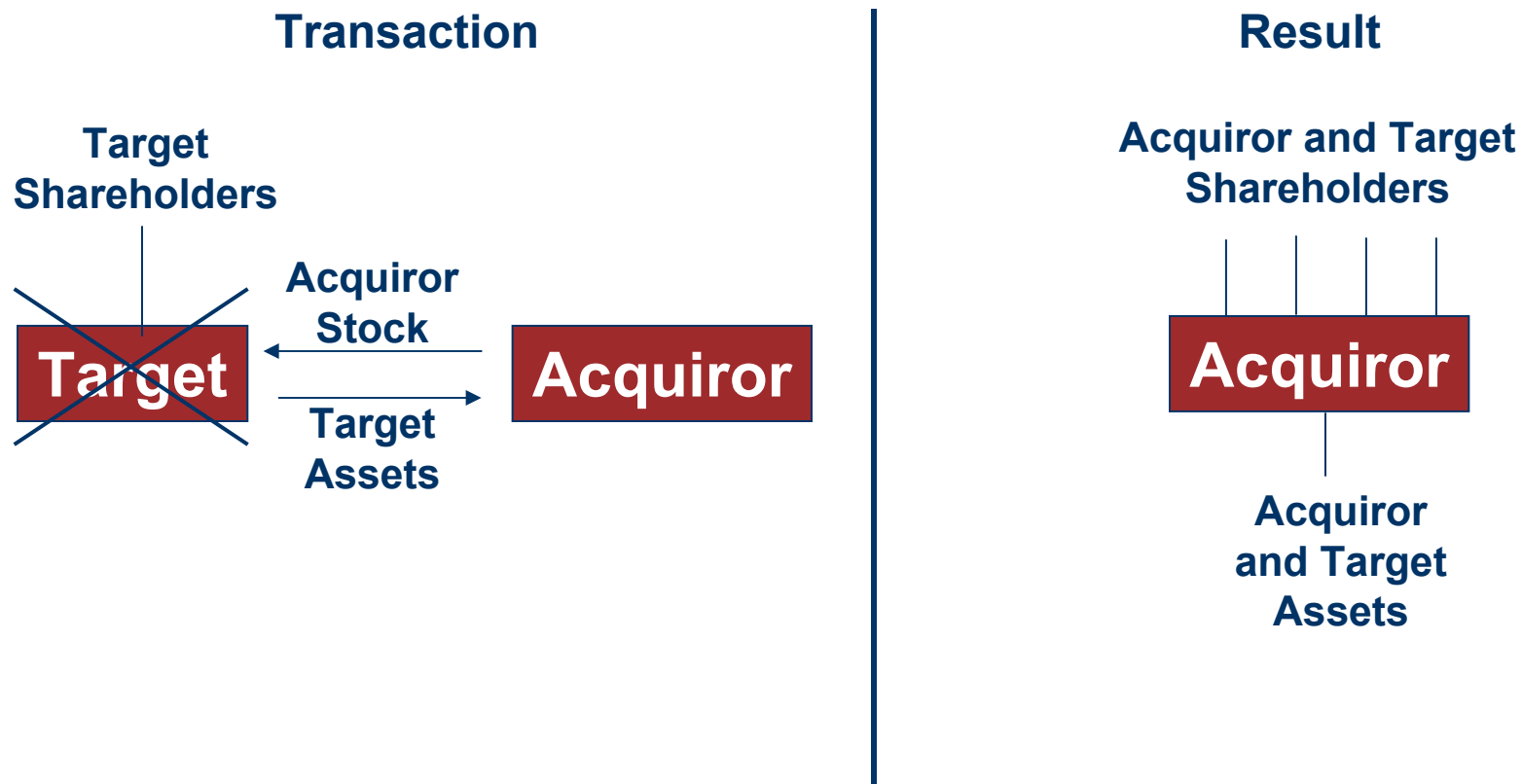


Tax-Free Reorganizations

- “B” reorganization (stock for stock)
 - Must acquire **control of Target**
 - Control = stock having $\geq 80\%$ of total voting power, plus $\geq 80\%$ of total number of each class of non-voting stock (“vote and value”)
 - Consideration is **solely voting stock** of Acquiror
 - Reverse subsidiary merger
 - Same effect without “solely voting stock” limit
 - If solely voting stock is used, qualifies as B reorg.

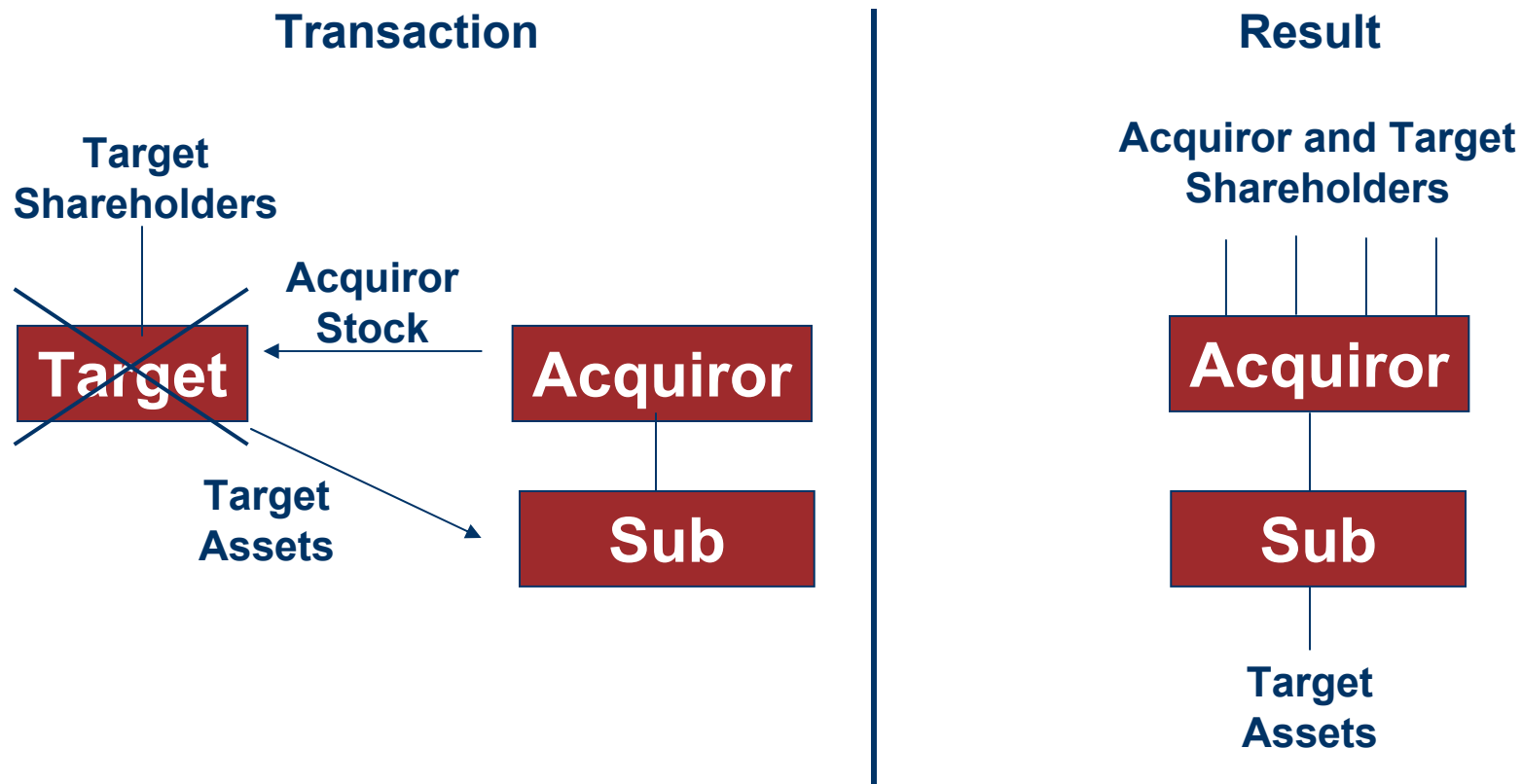
Tax-Free Reorganizations

- “C” reorganization (assets for stock)



Tax-Free Reorganizations

- Triangular "C" reorganization



Tax-Free Reorganizations

- **“C” reorganization (assets for stock)**
 - Must acquire “substantially all” Target’s assets
 - IRS definition = 70% of Target’s gross asset value or 90% of Target’s net asset value
 - Generally “solely for voting stock”
 - Boot relaxation rule: At least 80 percent of Target’s gross asset value (including retained assets) is acquired for voting stock; assumed liabilities = cash
 - Target must liquidate

Tax-Free Reorganizations

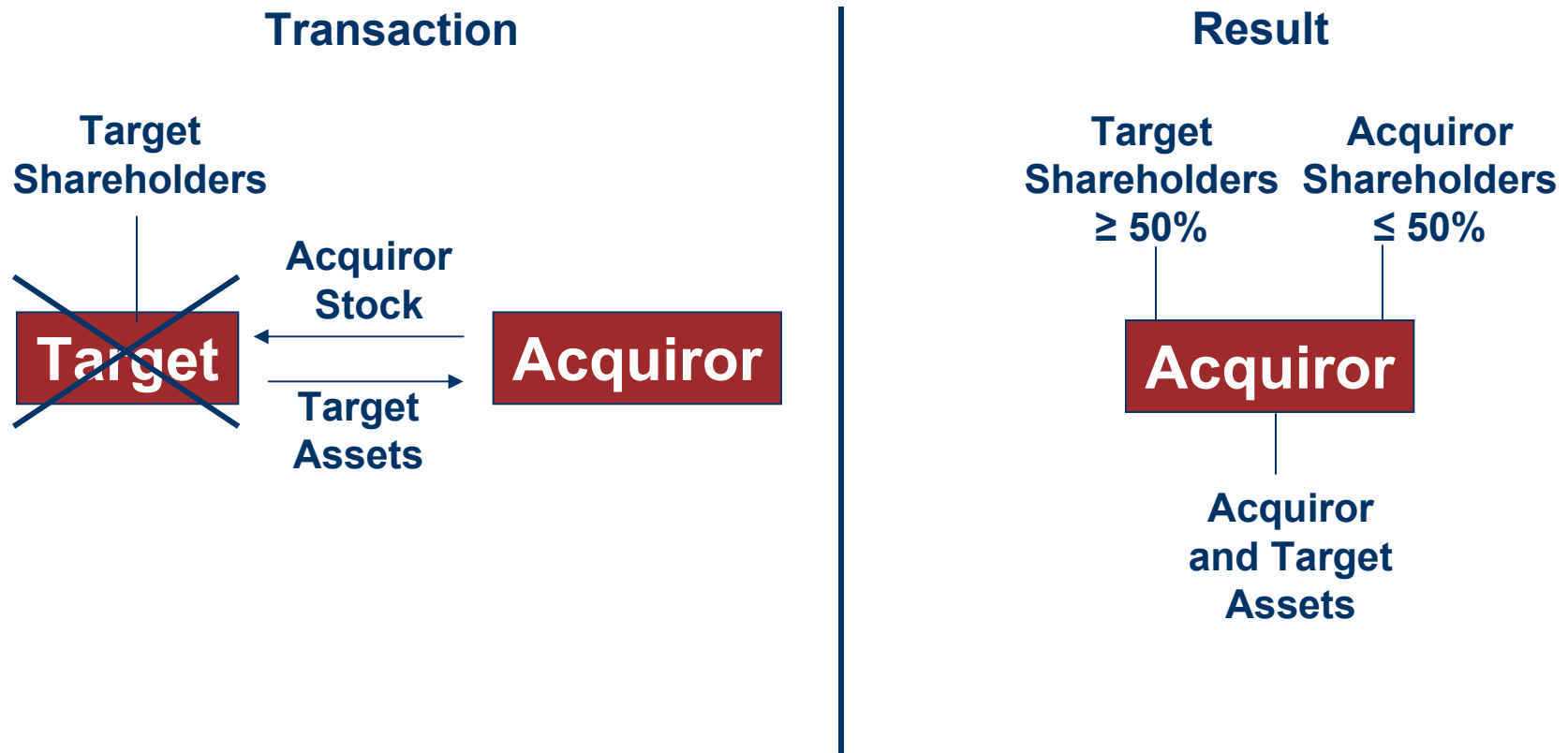
- “C” reorganization (con’t)
 - “D” reorganization overlap
 - “C” reorganization applies if Acquiror stock received by Target does not constitute control of Acquiror
 - “D” reorganization applies if Target obtains control
 - Forward merger or forward subsidiary merger
 - Same general effect as C reorg. or triangular C reorg.
 - “C” reorg. used if Target has minor unwanted assets or has unwanted liabilities (NB: divisive merger available in Texas)

Tax-Free Reorganizations

- **“D” reorganization (assets for stock)**
 - **Non-Divisive D reorganization**
 - **Substantially all** Target assets transferred to Acquiror
 - Target receives **50% control** of Acquiror
 - Target liquidates
 - **Divisive D reorganization**
 - **Less than substantially all** assets transferred
 - Target receives **80% control** of Acquiror
 - Target generally does not liquidate

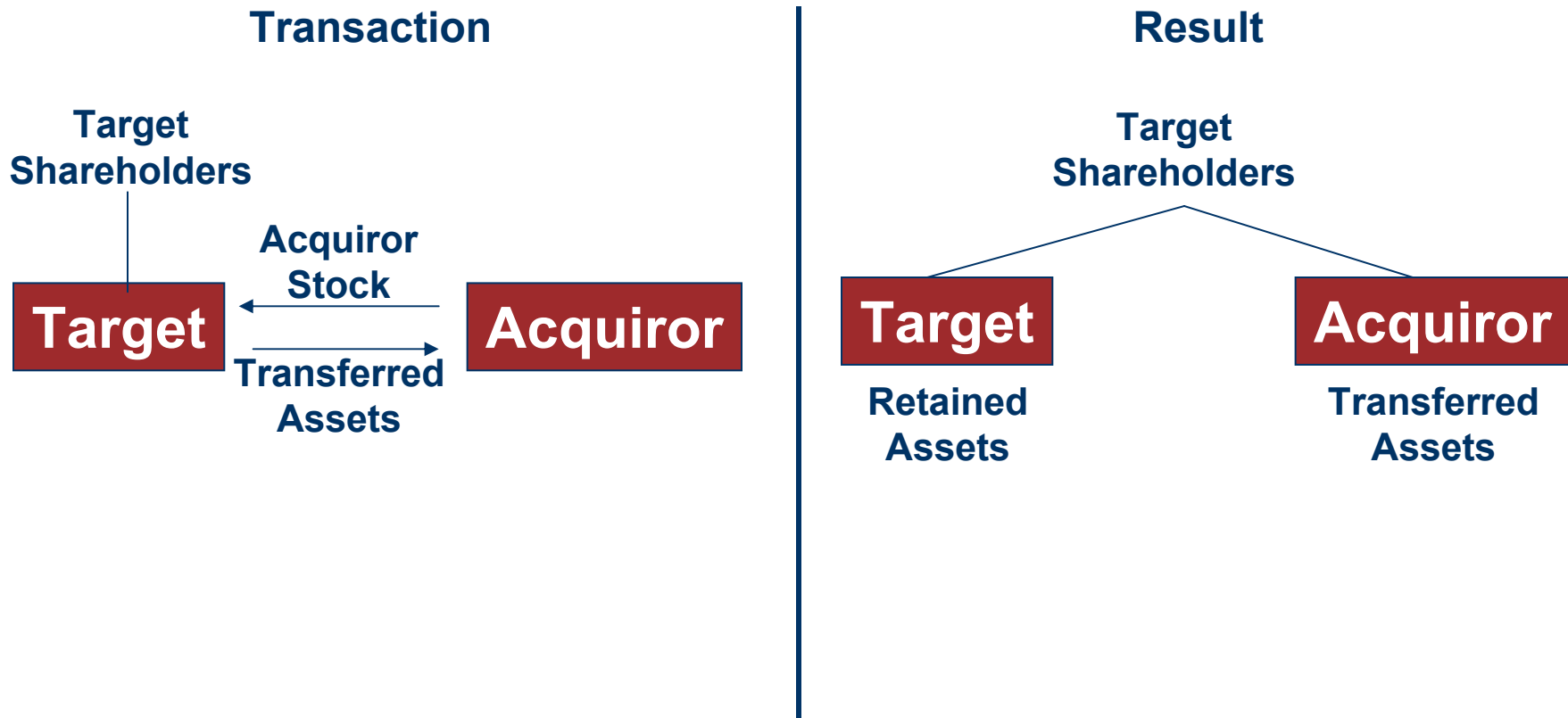
Tax-Free Reorganizations

- Acquisitive “D” reorganization



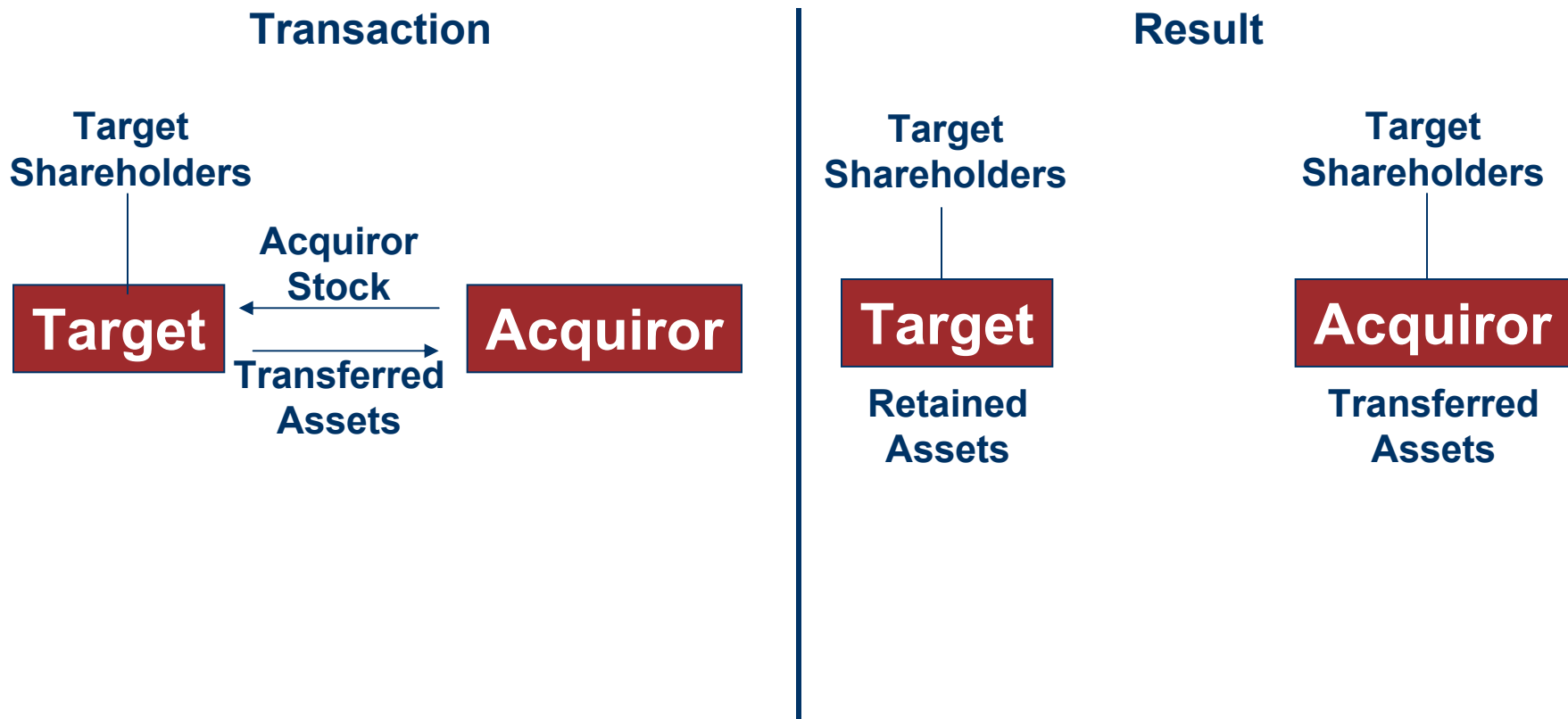
Tax-Free Reorganizations

- Divisive “D” reorganization – SPIN-OFF



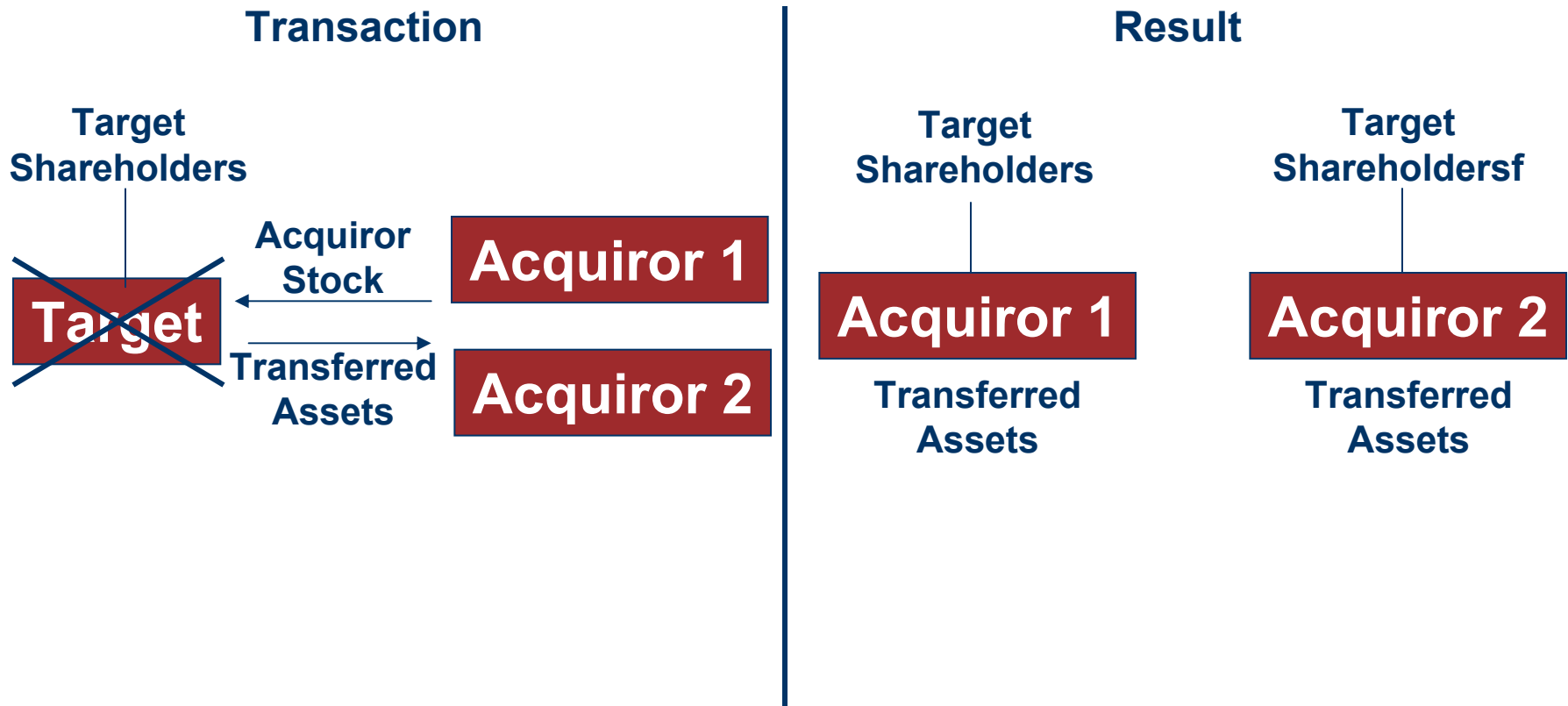
Tax-Free Reorganizations

- Divisive “D” reorganization – SPLIT-OFF



Tax-Free Reorganizations

- Divisive “D” reorganization – SPLIT-UP



Tax-Free Reorganizations

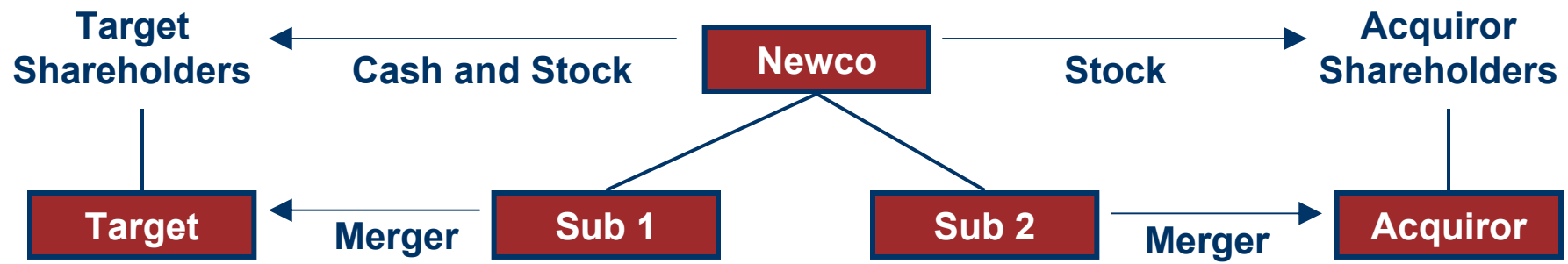
- **“E” reorganization (recapitalization)**
 - Exchange of stock or securities of a corporation for other stock or securities of the corporation
- **“F” reorganizations (change in form, etc.)**
 - A mere change in identity, form, or place or organization of one corporation
- **“G” reorganizations (bankruptcy)**
 - Transfers of assets under bankruptcy plan

Tax-Free Reorganizations

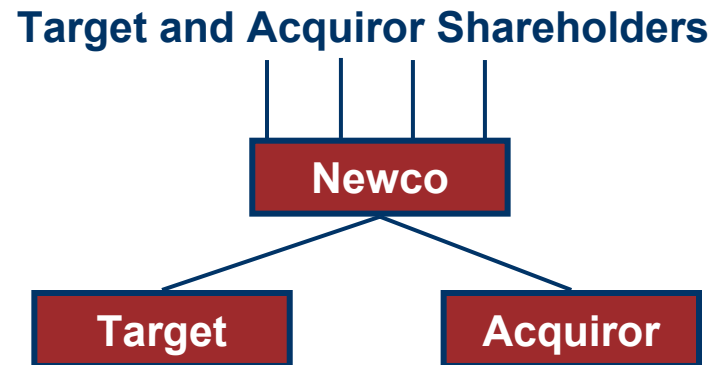
- **Strategies to avoid boot limitations**
 - Horizontal double dummy merger
 - National Starch rollover
 - Stock repurchase transactions
 - Partnership Acquiror

Tax-Free Reorganizations

- Horizontal Double Dummy



Result



Tax-Free Reorganizations

- **Horizontal Double Dummy**

- Tax consequences

- Shareholders are deemed to contribute their Acquiror and Target stock to Newco for Newco stock and cash (boot)
 - Transaction qualifies as a tax-free §351 transaction because “property transferors” own >80% of Newco stock immediately after the transaction
 - Shareholders’ gain is taxable only to extent of boot

Tax-Free Reorganizations

- **Horizontal Double Dummy**

- Also useful when Target is not a C Corporation

- Transfer of Target equity or assets to Acquiror for cash and Acquiror stock (<80%) is not tax-free under §351
- Compare: simultaneous transfer of Acquiror stock and cash, and Target equity or assets, to Newco in exchange for Newco cash and stock (100%) is tax-free under §351

- Variation:

- Acquiror contributes cash to Newco and simultaneously merges Newco sub into Target in cash option merger

Tax-Free Reorganizations

- **Horizontal Double Dummy**

- Key Issues

- Business purpose: form of transaction not solely an accommodation to Target shareholders
 - No immediate liquidation of Acquiror into Newco
 - Rev. Rul. 68-349
 - Non-qualified preferred stock
 - Alternative structures to avoid vote of Acquiror shareholders

Tax-Free Reorganizations

- **LLC/Psp Acquiror**

- Exchange of Target assets for LLC Acquiror “stock”
 - Treated as non-taxable contribution to capital; generally no limitations on type or quantity of stock
 - Acquiror generally can’t be publicly traded
- Exchange of Target assets for “boot”
 - Seller basis allocated between stock and boot; contrast to “gain recognized to the extent of boot” rule
- Acquiror obtains FMV tax basis to the extent of Target gain, including gain on subsequent sale of Acquiror stock
- Purchase consideration resides in Target; Target may be able to borrow against Acquiror stock to “monetize” the nontaxable sale consideration

Topics

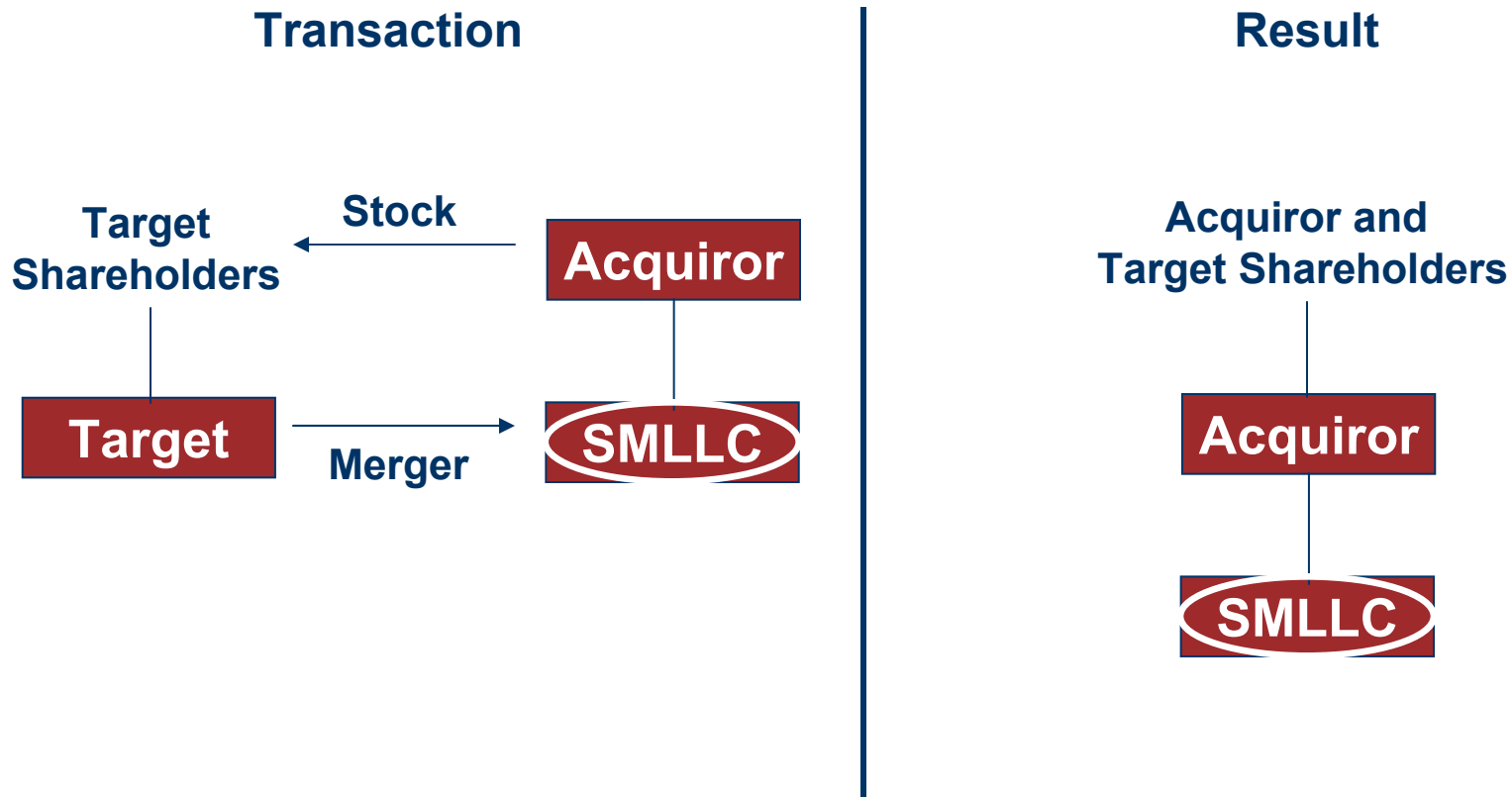
- Transaction considerations
- Taxable asset acquisition
- Taxable stock acquisition
- Tax-free reorganizations
- **Acquisitions using disregarded entities**

Acquisitions Using Disregarded Entities

- **Common Types of Disregarded Entities**
 - Corporate form
 - Qualified subchapter S subsidiary (QSUB)
 - Qualified REIT subsidiary (QRS)
 - Non-corporate form
 - Single member limited liability company (SMLLC)
 - Certain wholly-owned partnerships

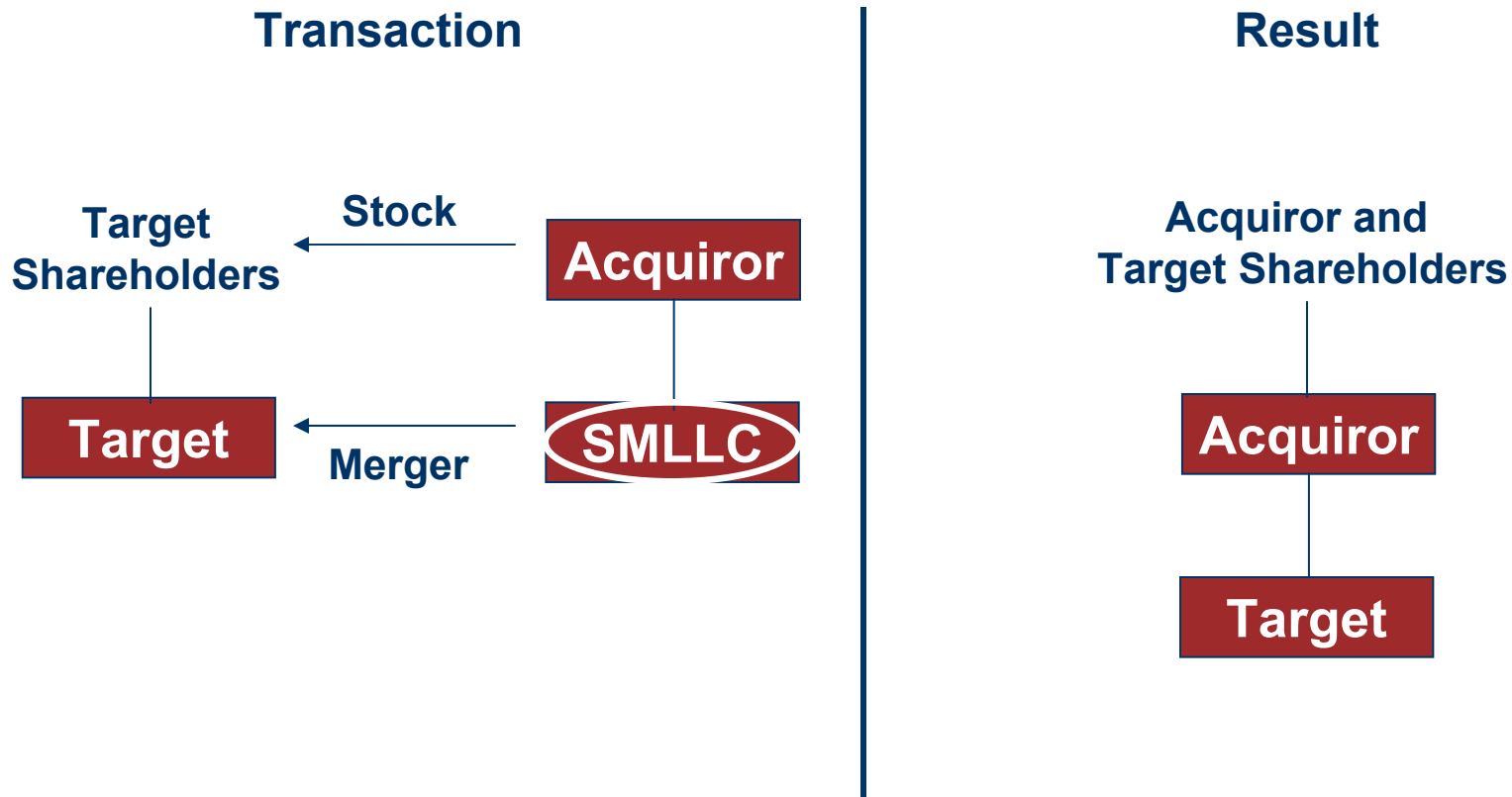
Acquisitions Using Disregarded Entities

- Forward subsidiary merger into DE (A reorg?)



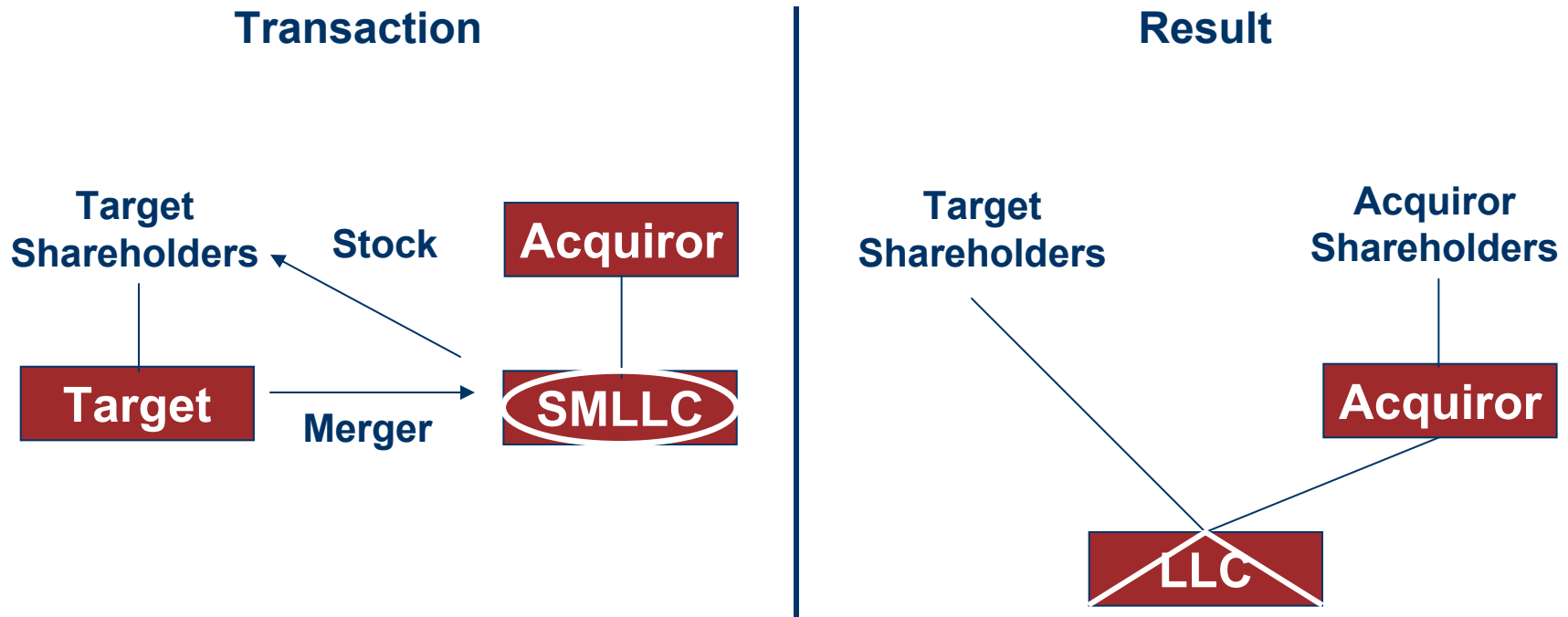
Acquisitions Using Disregarded Entities

- Reverse subsidiary merger into DE (B reorg.?)



Acquisitions Using Disregarded Entities

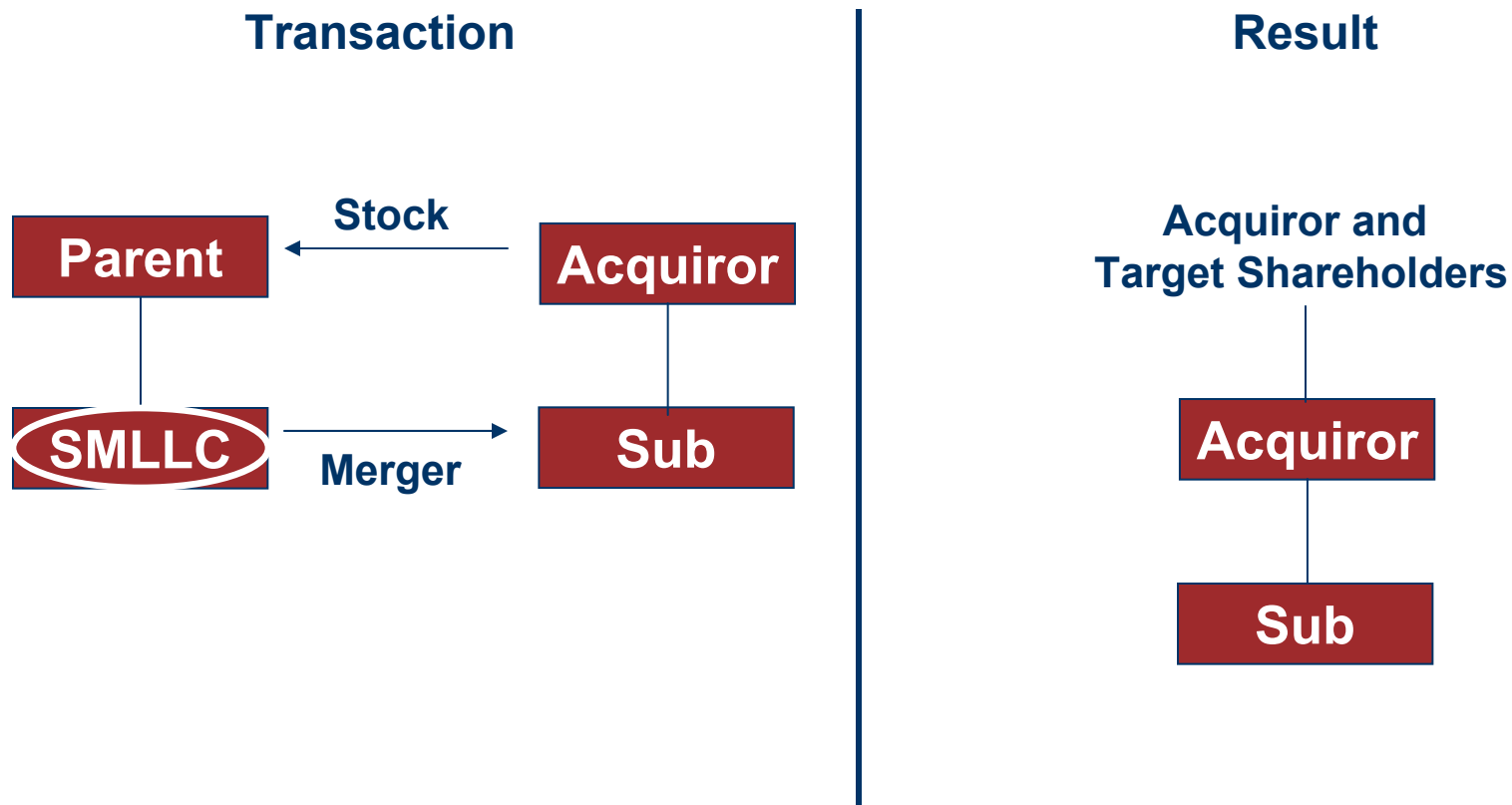
- Forward merger into DE (= 721/331)



Tax treatment = Target contribution of assets to LLC followed by Target liquidation
Cf. Rev. Rul. 99-5 (situation 2).

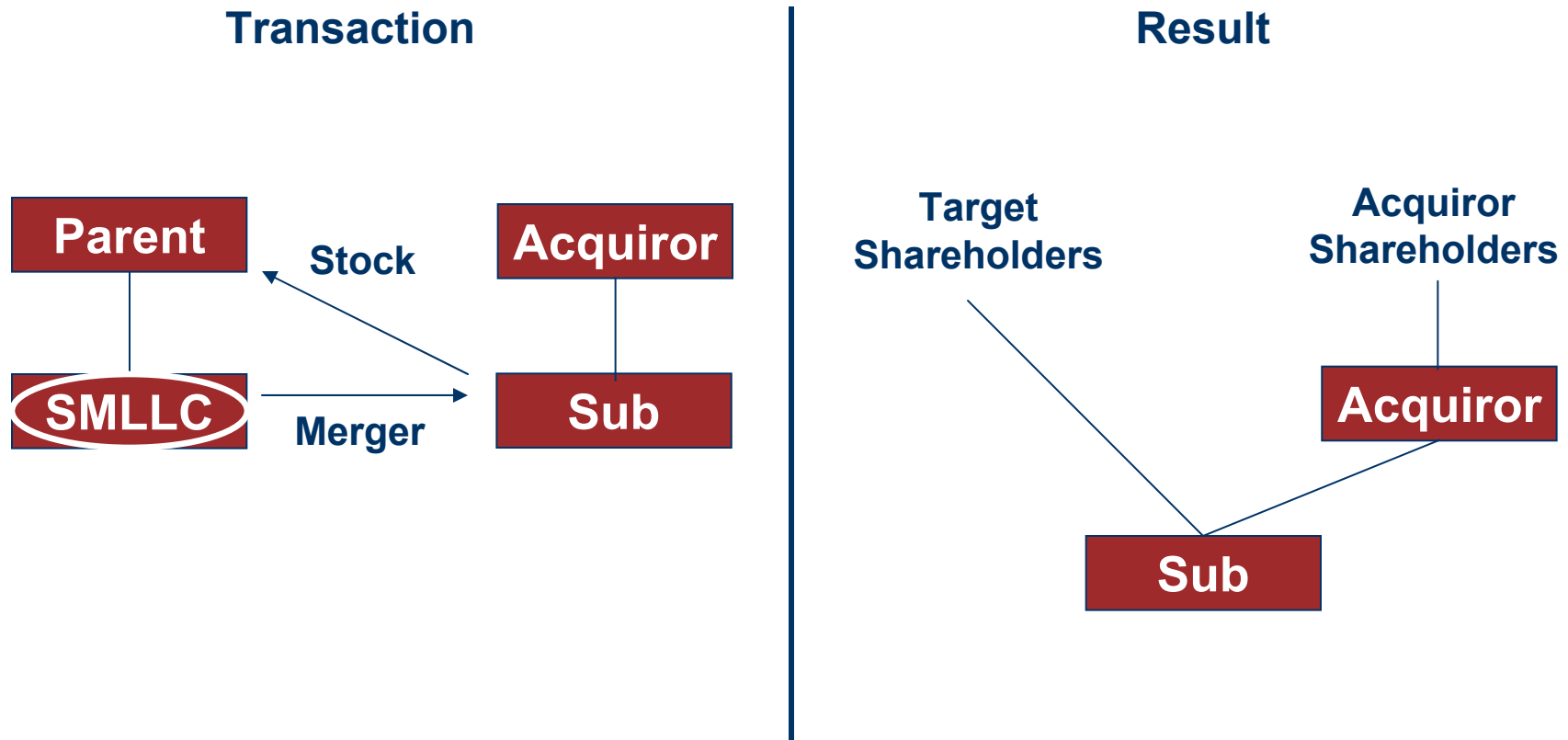
Acquisitions Using Disregarded Entities

- DE forward subsidiary merger (= failed ΔC ?)



Acquisitions Using Disregarded Entities

- Acquisition of DE assets (= failed C?)



Summary

- **Taxable asset acquisition**
 - Preferred form for Buyer (selectivity)
 - Consider divisive merger under Texas law
 - Double taxation if C corporation
- **Taxable stock acquisition**
 - No buyer step unless 338(h)(10) applies or Target is partnership/LLC
 - Seller generally recognizes capital gain, except
 - OI on 338(h)(10) deemed asset sale gain
 - §1254 recapture on sale of S corporation stock
 - OI on partnership/LLC “hot assets”

Summary

- **Tax-free reorganizations**

- Target Shareholders recognize gain only to the extent of boot received; remaining gain is deferred rather than eliminated
- No tax basis step up in Target assets, regardless of gain recognition by Target Shareholders
- Consider hybrid transactions to avoid boot limitations or obtain step up to extent of gain recognition

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