MERGERS & ACQUISITIONS II: TAX STRUCTURING CONSIDERATIONS: DEAL POINTS

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I. Executive Summary

This is the second of a series of periodically issued advisories on Mergers and Acquisitions (M&A) that we started in April 2022. Like the first in the series, "Mergers & Acquisitions I: Overview and Transaction Types" ("M&A I"), our "Raising Capital through Private Placements," "SPACs: A Private Equity and IPO Alternative," "International Joint Venture Agreement Checklist" and others, all available for download at Kurtin PLLC Whitepapers and Advisories or on Lexology at https://www.lexology.com/contributors/kurtin-pllc, following the discussion are "Deal Points" on important considerations in the purchase or sale of a business: what to do, and *what at all costs not to do*. This M&A II advisory will review the principal U.S. tax considerations influencing M&A transaction structuring. Future editions will drill down on issues like transaction consideration – how and in what form the merger or acquisition purchase price is to be paid; preliminary documentation like letters of intent, memorandums of understanding and term sheets; due diligence; transaction documents; securities; antitrust (competition); foreign investment review and technology export rules; employment and equity-based compensation like stock options; industry-specific regulatory regimes; issues specific to public company M&A; and issues specific to cross-border M&A, between Acquirors and Targets based in different countries. We will also publish editions dealing with specialty topics like buy-outs, divestitures and spin-offs. In this and all future editions of this M&A series, familiarity with the preceding editions will be assumed and previously defined terms will be used without further introduction.

II. Tax-free M&A Reorganizations

The U.S. Internal Revenue Code, 26 U.S.C. (the "Tax Code") provides for "tax-free" reorganizations in which, if the Tax Code provisions are strictly followed, no taxable gain or loss is realized by Target or its shareholders and Acquiror or its shareholders on the transaction itself (of course, a taxable event may occur post-transaction, as when, for example, a person or business that received shares in the transaction later sells those shares). Tax Code section 368 sets out these methods, generally known by their section 368(a)(1) subsection letters A – G, of which A – D are specifically relevant to M&A transactions and

frequently drive transaction structuring. The section 368 tax-free reorganizations all require, as a general matter, that there be (i) a continuity of ownership interest, meaning that at least the majority of the acquisition consideration, the price paid by Acquiror or Acquiror's shareholders to Target or its shareholders, be in stock, allowing Target's shareholders' original investment to notionally continue, and not be cashed out; (ii) a post-acquisition or merger continuation of Target's business enterprise; and (iii) a valid business purpose for the transaction (i.e., not just tax avoidance). Each A – G subsection's individual requirements must also be followed to receive tax-free reorganization treatment.

a. "A" Reorganizations are statutory mergers carried out under one or more states' merger statutes, usually contained in their corporation statutes, such as the Delaware General Corporation Law. The Direct Merger, Forward Triangular Merger and Reverse Triangular Merger transaction structures diagramed and explained in M&A I would, when carried out properly, qualify as tax-free reorganizations under section 368(a)(1)(A). The parties merge pursuant to a negotiated merger agreement generally called a "Plan of Merger," file certificates of merger with their respective secretaries of state according to each state's merger statute, one company, whether Target or Acquiror, ceases to exist, and the other continues as the Surviving Entity, succeeding to all the merged company's assets and liabilities.

b. "B" Reorganizations are stock acquisitions in which the Target's stock is acquired using only Acquiror's voting stock (or only the stock of a corporation under Acquiror's control). Immediately after the exchange of stock, Acquiror must have control of at least a combined 80% of all classes of Target's voting stock and at least a combined 80% of Target's non-voting stock. Assuming those conditions are properly met, the Stock Purchase transaction diagramed and explained in M&A I would qualify as a tax-free reorganization under section 368(a)(1)(B). However, if cash or other non-Acquiror stock consideration were used for 20% or more of the Target voting stock and/or non-voting stock, the same Stock Purchase transaction structure would not be granted tax-free reorganization status, and Target and Target's shareholders and Acquiror and Acquiror's shareholders would realize a taxable gain or loss on the transaction.

c. "C" Reorganizations are asset acquisitions in which "substantially all" of the Target's assets are acquired using only the Acquiror's voting stock (or only the stock of a corporation under Acquiror's control), disregarding Acquiror assumption of Target liabilities. In practice, "substantially all" usually means that at least 90% of Target's net assets and 70% of its gross

assets must be acquired in the transaction, and some of the consideration, usually up to 20%, may be in cash, which would be taxable. Assuming those conditions are properly met, the Asset Purchase transaction diagramed and explained in M&A I would qualify as a tax-free reorganization under section 368(a)(1)(C). However, if cash or other consideration other than Acquiror stock were used for more than 20% of the acquisition consideration, the same Asset Purchase transaction structure would not be granted tax-free reorganization status, and Target and Target's shareholders and Acquiror and Acquiror's shareholders would realize a taxable gain or loss on the transaction. In most cases, Target is liquidated post-transaction and distributes Acquiror's stock received in the transaction to its shareholders, although Target may also continue its existence with its remaining assets, for example, in the case of having sold most of its business lines to Acquiror, to carry on with a remaining core business.

d. "D" Reorganizations are asset acquisitions in which one corporation ("Transferor") transfers all or part of its assets to another ("Transferee") in exchange for Transferee's voting stock, and immediately post-transaction the Transferor or its shareholders control Transferee, with "control" having the same definition as in "B" Reorganizations. Note that the concepts of "Acquiror" and "Target" do not fit as neatly into the "D" Reorganization paradigm as in the "A," "B" and "C" 368(a)(1) subsections. The distribution of Acquiror's voting stock must also comply with Tax Code sections 354, 355 or 356, which deal with tax treatment of shareholders and other security holders in stock and securities exchanges and other reorganizations and impose parameters on the tax-free treatment of shareholders and security holders in those circumstances. "D" Reorganizations are much less frequently used M&A transaction structures than "A," "B" and "C" Reorganizations.

e. "E" Reorganizations are recapitalizations, which may occur in the course of M&A transactions, but which are not M&A transactions in and of themselves.

f. "F" Reorganizations are changes in the identity, form or place of organization of a corporation; no taxable gain or loss is recognized on simple operations of those kinds. For example, changing the domicile of a corporation from Delaware to New York, or from a corporation to a limited liability company ("LLC"), or its name, are categorized as "F" Reorganizations and are not taxable.

g. "G" Reorganizations are certain qualifying transfers by a corporation of all or part of its assets to another corporation in a proceeding under the U.S. Bankruptcy Code (11 U.S.C.) or a related proceeding like foreclosure or receivership, and also qualifying under Tax Code sections 354, 355 or 356, which we will cover in a future edition on distressed asset acquisition in and out of bankruptcy.

III. Taxable M&A Transactions

Other than M&A transactions complying with one or the other of the section 368 Reorganizations, M&A transactions are "taxable" under the Tax Code, meaning a gain or loss is recognized on the transaction itself. For example, a Stock Purchase or Asset Purchase for cash, or majority cash, consideration is a taxable transaction. Why would a party not take advantage of the tax-free section 368 provisions? There are many reasons, including an inability or unwillingness to use Acquiror stock as acquisition consideration, or Target/Target shareholders' unwillingness to accept it. There are, however, Tax Code provisions that can be used in structuring even taxable M&A transactions to minimize taxes due on the transaction. Most important are Tax Code section 338 and its subsection elections.

As we mentioned in M&A I, all other things being equal, Acquirors tend to prefer Asset Purchases, since they can pick and choose what Target assets to buy and which Target liabilities to assume or exclude. By contrast, all other things being equal, Targets and their shareholders tend to prefer Stock Purchases, since they dispose of all assets and liabilities together in what is usually a simpler transaction. Tax Code Section 338 provides for two different elections under subsection 338(g) and subsection 338(h)(10) to allow both Acquiror and Target preferences to be accommodated by a Stock Purchase (preferred by Target) that allows Acquiror to receive a "stepped-up" tax basis in Target's assets as though an Asset Purchase had taken place. For the Acquiror, the depreciation and amortization of the stepped up assets are deductible. The section 338 elections trigger a taxable "deemed asset sale," and therefore make sense only when the stepped up basis is more valuable than the tax cost of the deemed asset sale.

Subsection 338(g), available for independent C-Corporation Targets, provides that Acquiror can make an irrevocable election within a strict time frame post-transaction to treat the Stock Purchase as an Asset Purchase, the "deemed asset sale," for tax purposes. The Target recognizes a gain on the deemed sale of its assets, and that gain is borne by Acquiror, while Target is deemed notionally a new corporation with

a stepped-up basis in the assets. The section 338(g) election, however, ordinarily results in two levels of taxation on the taxable transaction: Target's recognition of a taxable gain on the deemed asset sale, and Target selling shareholders' recognition of a taxable gain on the sale of their shares. For this reason, the section 338(g) election is less often used, except in cross-border transactions with non-U.S. Targets.

By contrast, in the section 338(h)(10) election, available for certain Targets that are either subsidiaries, 80% controlled affiliates or S-Corporations and made jointly by Acquiror and Target before the transaction closing, The sale of shares, which must be at least 80% of Target stock, is notionally ignored, and Target is deemed to have sold its assets to a deemed "new Target" and distributed the sale proceeds to the old Target's shareholders. The Acquiror receives a stepped-up basis in the acquired assets and the corresponding benefit of depreciation and amortization deductions. The section 338(h)(10) election results in only one level of tax on the taxable transaction, making it much more popular than the section 338(g) election.

IV. Deal Points

Deal Point No. 1: Don't skimp on the tax advice, especially when structuring a tax-free reorganization. Taxable M&A transactions are often done with basic corporate accounting advice, especially in mid-market M&A and when the Target is smaller than Acquiror. By contrast, when structuring a section 368 Reorganization, the tax-free treatment is often a major driver of transaction structuring and sometimes the deal itself, to the point that the transaction would not happen without those tax benefits, which can be worth large amounts of money. M&A experienced tax attorney and/or corporate accounting advice to pass on and approve a transaction as structured by in-house and outside attorneys and corporate executives is indispensable. Skimping on that advice and approval is penny wisdom, pound foolishness on steroids.

Deal Point No. 2: Tax structuring is critical, but still should not drive the business case. Any decision to elevate tax considerations over the business case for the transaction, even in part, should be an affirmative and considered one. For example, a decision by Acquiror to conduct a Stock Purchase instead of an Asset Purchase at Target's insistence even if it means assuming assets and liabilities that Acquiror would have preferred to exclude in an Asset Purchase may make sense if necessary to get the deal done, but should be done on a cost-benefit analysis. In such a case especially, the section 338 elections discussed above may mitigate the situation for Acquiror.

Deal Point No. 3: Tax Optimization is Not Tax Avoidance. The foregoing said and acknowledged, it's important to add: tax optimization is not tax avoidance. The M&A tax structuring methods reviewed above are U.S. federal statutes expressly set out in the Tax Code. Expertise is required to use them correctly, but they are there to be used. Don't be timid. Use them when appropriate. Pay required M&A transaction taxes, but not more than required.

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