

MERGERS & ACQUISITIONS 2: TAX STRUCTURING CONSIDERATIONS: DEAL POINTS

October 2024

I. Executive Summary

This is the second of our series of expanded and updated advisories on Mergers & Acquisitions (M&A). Like the first in the series, “Mergers & Acquisitions 1: Overview and Transaction Types” ([M&A 1](#)), it is meant to offer to business executives and their professional advisers an M&A guide both accessible and of practical use when embarking on an M&A transaction in their own business. This advisory will survey the tax considerations that can influence and drive the structure of an M&A transaction, building on the concepts developed in [M&A 1](#). All advisories in the series will be available on our website at [Kurtin PLLC Mergers & Acquisitions](#).

Following the discussion in each advisory in the series are “Deal Points” on considerations in the purchase or sale of a business when we handle these types of transactions for our clients: what to do, and *what at all costs not to do*. Future editions in the series will drill down on issues like preliminary documentation like letters of intent (LOIs), memoranda of understanding (MOUs) and Term Sheets; due diligence; transaction documents; securities law considerations, especially when public reporting companies are parties to the M&A transaction (Public M&A); antitrust (competition) law issues; financing the M&A transaction; foreign investment review and technology export rules; employment and equity-based compensation; Cross-border M&A (where Acquirer and Target are domiciled in different countries) and industry-specific regulatory regimes. A progressively cumulative glossary of defined technical terms used will appear at the end of each advisory in the series.

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 Acquirer 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 §368 sets out these methods, generally known by their §368(a)(1) subsection letters A – G, of which A – D are specifically relevant to M&A transactions and frequently

drive or influence transaction structuring. The §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 or Merger Consideration, the price paid by Acquirer or Acquirer’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.

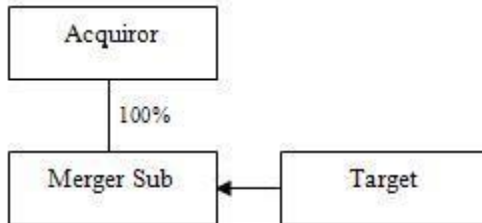
- a. “A” Reorganizations are Statutory Mergers carried out under one or more states’ Merger statutes, usually contained in their corporation statutes, such as the Delaware General Corporation Law, or DGCL. The Direct Merger, Forward Triangular Merger and Reverse Triangular Merger transaction structures diagramed and explained in [M&A 1](#) would, when carried out properly, qualify as tax-free reorganizations under §368(a)(1)(A). The parties merge pursuant to a negotiated Merger Agreement or 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 Acquirer, ceases to exist, and the other continues as the Surviving Entity, succeeding to all the merged company’s assets and liabilities.



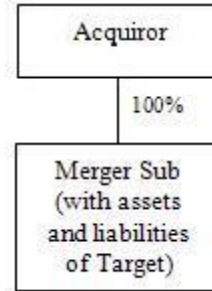
To qualify as a tax-free “A” Reorganization, at least 50% of the Merger Acquisition in a Direct Merger must normally be in Acquirer stock. Any amount of Merger Consideration paid in cash or assumption of debt, sometimes called “boot,” will be taxable to the Target’s shareholders.

Forward Triangular Merger

Pre-Merger Diagram



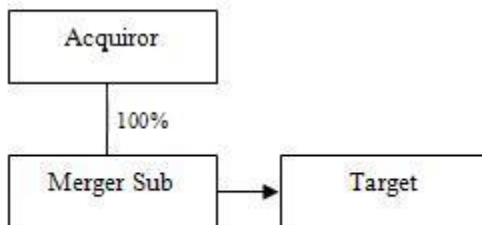
Post-Merger Diagram



To qualify as a tax-free “A” Reorganization, at least 50% of the Merger Acquisition in a Forward Triangular Merger must normally be in Acquirer stock, issued to Target shareholders. Merger Sub must be at least 80% owned by Acquirer. No Merger Sub stock may be used as Merger Consideration. As with a Direct Merger, any amount of Merger Consideration paid in cash or assumption of debt will be taxable to the Target’s shareholders. Post-transaction, Merger Sub must own “substantially all” of Target’s assets, meaning in general practice at least 90% of Target’s net assets and 70% of its gross assets.

Reverse Triangular Merger

Pre-Merger Diagram



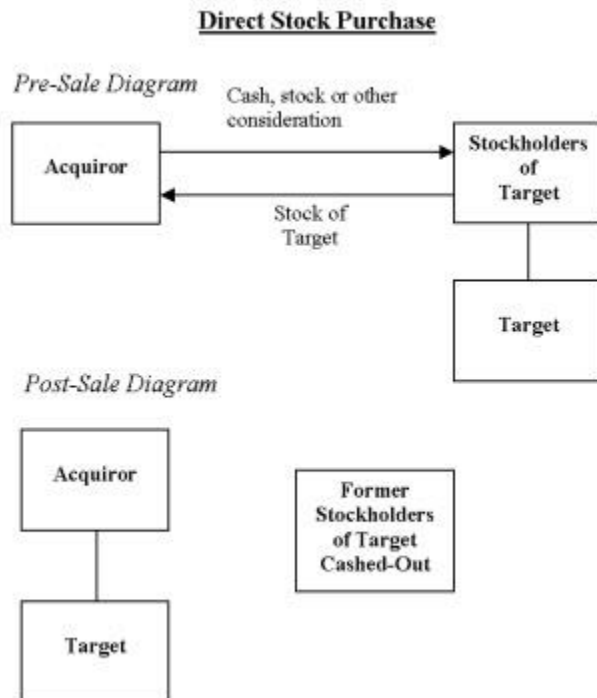
Post-Merger Diagram



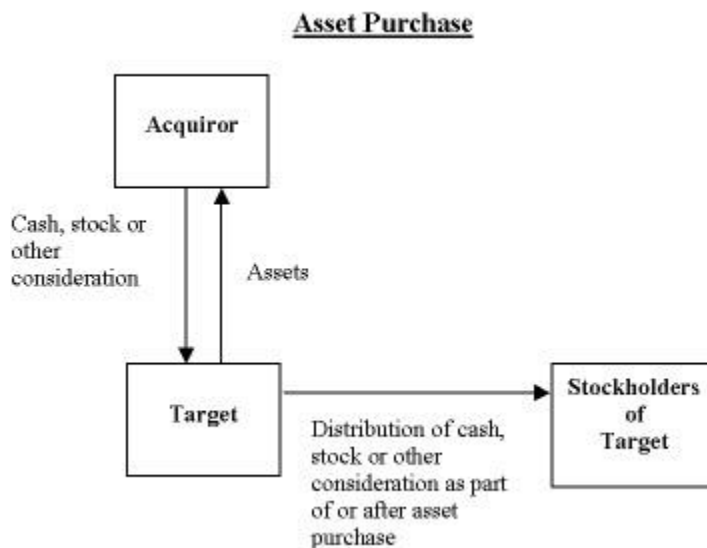
To qualify as a tax-free “A” Reorganization, a Reverse Triangular Merger, in addition to the requirements for tax-free treatment of a Direct Merger or a Forward Triangular Merger, Merger Sub must acquire at least 80% of Target’s voting stock and 80% of any other classes of Target

stock in exchange for the Merger Sub’s stock. Also, Target must retain substantially all its assets post-transaction. As with a Direct Merger or Forward Triangular Merger, any amount of Merger Consideration paid in cash or assumption of debt will be taxable to the Target’s shareholders but cannot exceed 20% of the value of Target’s stock.

- b. “B” Reorganizations are stock acquisitions in which the Target’s stock is acquired using only Acquirer’s voting stock (or only the stock of a corporation under Acquirer’s control). Immediately after the exchange of stock, Acquirer 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 met, the Stock Purchase transaction diagramed and explained in [M&A 1](#) would qualify as a tax-free reorganization under §368(a)(1)(B). However, if cash or other non-Acquirer stock consideration were used for 20% or more of the Target voting stock and/or non-voting stock, the same Stock Purchase transaction structure might not be granted tax-free reorganization status, and Target and Target’s shareholders and Acquirer and Acquirer’s shareholders would realize a taxable gain or loss on the whole transaction, not just the boot.



- c. “C” Reorganizations are asset acquisitions in which “substantially all” of the Target’s assets are acquired using only the Acquirer’s voting stock (or only the stock of a corporation under Acquirer’s control), disregarding Acquirer assumption of Target liabilities. Again, 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 met, the Asset Purchase transaction diagrammed and explained in [M&A 1](#) would qualify as a tax-free reorganization under §368(a)(1)(C). However, if cash or other consideration other than Acquirer stock were used for more than 20% of the Acquisition Consideration, the same Asset Purchase transaction structure might not be granted tax-free reorganization status, and Target and Target’s shareholders and Acquirer and Acquirer’s shareholders would realize a taxable gain or loss on the entire transaction. In most cases, Target is liquidated post-transaction and distributes Acquirer’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 Acquirer, 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 “Acquirer” 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 Acquirer’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 during 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 limited partnership (LP), 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 §§354, 355 or 356, which we will cover in a future advisory in this series on distressed asset acquisitions in and out of bankruptcy.

III. Taxable M&A Transactions

Other than M&A transactions complying with one or the other of the §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 §368 provisions? There are many reasons, including an inability or unwillingness to use Acquirer 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 §338 and its subsection elections.

As we mentioned in [M&A 1](#), all other things being equal, Acquirers 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, and because it can “step up” its tax basis in Target’s assets and depreciate and amortize them more advantageously. Tax Code §338 provides for two different elections under §338(g) and §338(h)(10) to allow both Acquirer and Target preferences to be accommodated by a Stock Purchase (preferred by Target) that allows Acquirer to receive a stepped-up tax basis in Target’s assets as though an Asset Purchase had taken place. For the Acquirer, the depreciation and amortization of the stepped-up assets are deductible. The §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.

§338(g), available for independent (not subsidiary of another corporation) C-corporation Targets, provides that Acquirer can *unilaterally* 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 Acquirer, while Target is deemed notionally a new corporation with a stepped-up basis in the assets. The §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 §338(g) election is less often used, except in Cross-border M&A transactions with non-U.S. Targets.

By contrast, in the §338(h)(10) election, available for certain Targets that are either subsidiaries, 80% controlled affiliates or S-corporations and made *jointly* by Acquirer 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 Acquirer receives a stepped-up basis in the acquired assets and the corresponding benefit of depreciation and amortization deductions. The §338(h)(10) election results in only one level of tax on the taxable transaction, making it much more popular than the §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 Acquirer. By contrast, when structuring a §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 Acquirer to conduct a Stock Purchase instead of an Asset Purchase at Target's insistence even if it means assuming assets and liabilities that Acquirer 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 §338 elections discussed above may mitigate the situation for Acquirer.

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 (which, as stated, is an impermissible basis for tax-free treatment). 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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Mergers & Acquisitions: Deal Points
Cumulative Glossary
Appendix 1

- 1. Acquiror (or Acquirer, Buyer or Purchaser):** the purchaser, or “buy side” party in an M&A transaction, whether an Asset Purchase or a Stock Purchase, which acquires all or the majority of the stock or assets of another business. In a Merger, the parties are not technically purchaser or seller, but when one party is clearly the dominant party in the transaction, and is often the Surviving Entity (though not always, as in the case of a Reverse Merger), that party can be thought of as the Acquiror.
- 2. Acquisition Consideration:** the purchase price paid by Acquiror to Target in an M&A transaction, whether in cash, stock, assumed debt or a combination thereof.
- 3. Asset Purchase:** a transaction by which one party to an M&A transaction purchases all or the majority of the assets of another party. Distinguished from a sale by Target in the ordinary course of business, as in selling a part of its inventory, or surplus equipment not needed for continuing its business operations.
- 4. Asset Purchase Agreement:** a contractual agreement serving as the principal document by which an Asset purchase is effected.
- 5. Cross-border M&A:** M&A transactions in which Acquiror is domiciled in one country, and Target in another country. For purposes of this M&A: Deal Points series, one of those countries in which either Acquiror or Target is domiciled is the United States.
- 6. DGCL:** the Delaware General Corporation Law, serving as a paradigm corporation statute in the U.S., and frequently the basis of incorporation by U.S. companies, wherever physically based, that intend to do business across the U.S. as well as inbound subsidiaries of non-U.S. companies wishing to have operations in the U.S.
- 7. Due Diligence:** the scope of the parties’ disclosures to each other before the M&A transaction closes, generally buttressed by deal protections in the form of warranties, representations, covenants and linked rights of indemnification, termination, conditions to closing and others.

8. **EBITDA:** Earnings Before Interest, Taxes, Depreciation and Amortization, a common accounting metric.
9. **IRS:** the Internal Revenue Service, the U.S. federal tax regulatory and enforcement agency.
10. **LLC:** a limited liability company organized under a state’s LLC statute, generally offering the limited liability protection for shareholders of corporations with the “pass-through” taxation of partnerships (i.e., not taxed at the LLC level, but taxable income or loss is “passed through” to the owners, called “members,” equivalent to a corporation’s shareholders). Also usually featuring less burdensome management and governance costs and formalities than equivalent corporations.
11. **LP:** a limited partnership under a state’s limited partnership statute (usually modeled on the Uniform Limited Partnership Act), generally offering the limited liability protection for shareholders of corporations with the “pass-through” taxation of partnerships (i.e., not taxed at the LP level, but taxable income or loss is “passed through” to the limited partners, equivalent to a corporation’s shareholders). Also usually featuring less burdensome management and governance costs and formalities than equivalent corporations.
12. **M&A:** generally used abbreviation for “Mergers & Acquisitions,” a catch-all term sweeping up Stock Purchases, Asset Purchases and Mergers, all involving the legal or *de facto* acquisition of all or a majority of one business’s stock or assets by another business.
13. **Merger (or Statutory Merger):** a process set forth in the company law statutes of the individual states by which two companies merge with each other, leaving one company or its subsidiary as the Surviving Entity, while the other company merges into that company or its subsidiary and ceases to exist as a separate legal entity.
 - a. **Direct Merger:** A Merger structure in which Target merges directly into Acquiror, which is the Surviving Entity, while Target ceases to exist.
 - b. **Reverse Merger:** A Merger structure in which Acquiror merges into Target, which is the Surviving Entity, while Acquiror ceases to exist.

- c. Forward Triangular Merger:** A Merger structure in which Acquiror forms a subsidiary (**Merger Sub**) (or uses a pre-existing subsidiary), Target merges into Merger Sub, Merger Sub is the Surviving Entity and a subsidiary of Acquiror, while Target ceases to exist.
- d. Reverse Triangular Merger:** A Merger structure in which Merger Sub merges into Target, Target is the Surviving Entity and becomes a subsidiary of Acquiror, while Merger Sub ceases to exist.

All these Merger structures are diagrammed in [M&A 1](#).

- 14. Merger Agreement (or Agreement and Plan of Merger):** a contractual agreement serving as the principal document by which a Merger is effected.
- 15. Merger Consideration:** the Acquisition Consideration in a Merger.
- 16. Preliminary Document: (MOU, or Memorandum of Understanding; LOI, or Letter of Intent; or Term Sheet. Also, NDA, or Non-Disclosure Agreement, which may be part of an MOU, LOI or Term Sheet or a standalone Preliminary Document):** forms of preliminary documentation used to set a framework for an M&A transaction and confidentiality before executing documents like an Asset Purchase Agreement or Stock Purchase Agreement. Some terms in preliminary documentation may be binding on the parties for a certain period, for example confidentiality or exclusivity, while others are usually not binding.
- 17. Public M&A:** M&A transactions involving a Target that is a public reporting company under the Exchange Act, requiring a substantial Exchange Act and SEC regulatory overlay of requirements for the transaction.
- 18. SEC:** the Securities and Exchange Commission, the U.S. federal securities regulator.
- 19. Stock Purchase:** a transaction by which one party purchases all or the majority of the stock of another

party. Distinguished from a minority investment by one party in the other, such as a typical venture capital investment, which is not an M&A transaction.

20. Stock Purchase Agreement: a contractual agreement serving as the principal document by which a Stock Purchase is effected.

21. Surviving Entity: the company that continues its corporate existence and operations following a merger.

22. Target (or Seller): the seller, or “sell side” party in an M&A transaction, whether an Asset Purchase or a Stock Purchase, which sells all or the majority of its stock or assets to another business, the Acquiror. In a Merger, the parties are not technically purchaser or seller, but when one party is clearly the less dominant party in the transaction, and is often the merged party (though not always, as in the case of a Reverse Merger or Reverse Triangular Merger, that party can be thought of as the Target.

23. Tax Code: the U.S. Internal Revenue Code, 26 U.S.C.

24. TCJA: the Tax Cut and Jobs Act of 2017.