

Tax Structures in M&A Transaction

THIS WHITEPAPER EXPLORES:

We'll discuss common tax structures in M&A transactions, including equity purchases, asset purchases, and key tax elections. We'll explore strategies like the Section 338(h)(10) election and Section 368(a)(1)(F) reorganizations, outlining their requirements, benefits, and potential concerns for both buyers and sellers.



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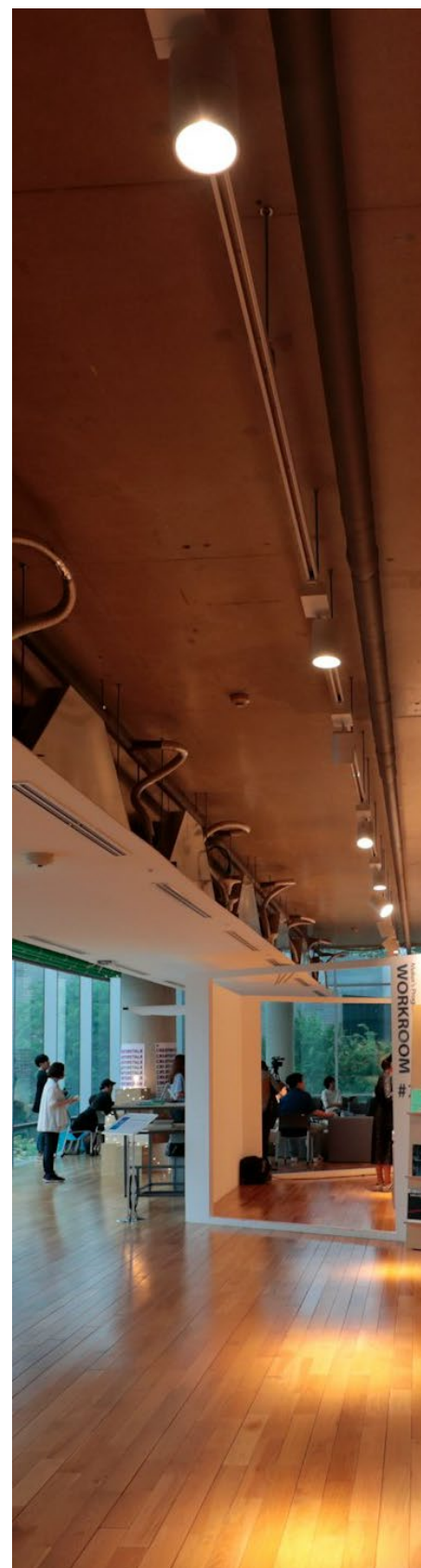
Many private-equity transactions are structured as an equity purchase (e.g., stock) rather than as a direct asset purchase. Sellers often prefer an equity sale because they expect to receive preferential capital gains treatment on any resulting gain and typically require a gross-up for any ordinary income tax liability on a deemed asset sale. At the same time, buyers generally prefer not to buy stock, since they do not receive a step-up in the tax basis of the corporation's assets.

Section 338(h)(10) Election

An election under Sec. 338(h)(10) provides a buyer of corporate stock the convenience of a stock purchase and obtains a step-up in basis for the assets owned by the seller. It gives the seller the liability protection of having sold the corporation's stock.

List Requirements/Limitations

- The purchaser must buy the selling company's stock; at least 80% of the voting power and equity of all classes in a taxable acquisition.
- The buyer and seller must both be taxed as corporations. Nothing taxed as a partnership or proprietorship may participate.
- Most 338(h)(10) elections are made when the selling company is an S corporation, but the rules allow the election when the selling company is taxed as a C corporation. The selling corporation may be a subsidiary in a consolidated group, a subsidiary in a group that is eligible to file a consolidated return but chooses not to, or an S corporation.
- Buyer and seller must jointly make the election and agree on the allocation of purchase price to each asset.
- The selling company must remain in existence after the sale.



Concerns/Issues

One of buyers' main concerns is making and maintaining a valid S corporation election for the target of the Sec. 338(h)(10) election. If the target's S corporation election was inadvertently invalidated at some point before closing, the buyer will have acquired the stock of a C corporation. To avoid that, many private-equity firms require S Corporation sellers to complete a restructuring using Sec. 368(a)(1)(F) – see these explained in the next section.

Another concern with Section 338(h)(10) elections is that they require coordination between the buyer and the seller with respect to the election and various other legal matters. Also, sellers cannot achieve a tax deferral on any rollover portion of the transaction, which is generally a norm in these private-equity transactions where buyers want sellers to have "skin in the game" for some percentage of the post-close business (or for sellers who might want some ownership in the buyer with the potential of continued future upside under private-equity ownership).

Section 368(a)(1)(F) Reorganizations

As mentioned earlier, the F reorganization strategy has gained popularity with private-equity LLC's or partnerships when buying S corporations because it delivers the tax and legal results sought by using 338(h)(10) elections while avoiding some of the challenges.

For sellers, this strategy allows shareholder(s) to: (1) defer gain recognition with respect to rollover equity; (2) to obtain the tax benefit of transaction costs; and (3) defer gain recognition with respect to deferred payments.

For buyers, the strategy allows them to: (1) obtain a step-up in the tax basis of Target's assets for the purchase portion of the transaction; (2) avoid the dependency on S corporation status for a valid Sec. 338(h)(10) election; and (3) avoid a need for cumbersome legal considerations common in an asset

purchase, while at the same time preserving continued use of Target's federal EIN post-closing in the buyer's structure.

List Requirements/ Limitations

Before the sale, the sellers (1) form a new holding corporation and contribute the shares of their existing company to the new holding company, (2) the existing company elects to be a qualified Subchapter S subsidiary (QSub), which extends S corporation status to the new holding company and the QSub (existing company) a disregarded entity, and (3) convert the QSub (existing company) from a corporation to a limited liability company (LLC).

Under final regulations (Regs. Sec. 1.368-2(m)) six requirements must be satisfied.

1. Holding corporation stock distributed in exchange for existing corporation stock. The goal is to ensure the transferor and transferee corporations have essentially the same stockholders.
2. The same person(s) must own all the stock of company before and after the potential F reorganization.
3. The holding company may not hold any property or have any tax attributes immediately before the potential F reorganization.
4. The existing corporation must completely liquidate, for federal income tax purposes, in the potential F reorganization; however, the transferor corporation is not required to dissolve under applicable law and may retain a de minimis amount of assets for the sole purpose of preserving its legal existence.
5. No corporation other than the holding company may hold property that was held by the existing corporation immediately before the potential F reorganization.

List Requirements/Limitations

6. The existing corporation is the only corporation acquired by the holding company.

This requires the seller to engage (and pay for) some meaningful pre-sale planning to make itself an attractive private equity target. This strategy can be implemented days prior to closing.

With an S corporation holding company now owning 100% of the LLC units of the existing company, the buyer has multiple options to close the deal. The buyer can purchase LLC units from the holding company, or the holding company contributes some of its LLC units into the buyer's acquisition structure, with the remaining LLC units being acquired by the buyer. Another popular option is to distribute LLC units to a holding company shareholder and/or key employees of target (making a multi-member LLC taxed as a partnership) with the remaining LLC units being acquired by the buyer.

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