

# Tax Considerations in M&A Transactions

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## Key themes Influencing Acquisition Structure

What is being used as consideration?



What is being bought/sold?



Who is buying/selling?

# What is Being Used as Consideration?

- **Cash vs. Equity of Buyer Entity (or combination thereof).**
- **THE key factor.**
- **Parties (and investment bankers) generally expect for equity-exchange portion of transaction to receive tax-deferred treatment.**
- **Corporate Stock as Consideration: In most cases, will need at least 40% of consideration to be stock for the stock portion to be treated as tax-free.**
- **Presence of “earn-out” can impact structure.**

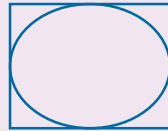
# What is Being Bought/Sold?

- **Two ways to acquire a company – acquire its assets or acquire its equity**
- **Many non-tax differences. For example:**
  - Successor liability
  - Transactional difficulties
- **Tax-deferred: Asset deals have similar tax consequences as equity deals, though may have different requirements to achieve tax-deferred classification.**
- **Taxable: Asset deal has very different consequences from a stock deal.**
- These differences can be less pronounced when acquiring partnership interests.

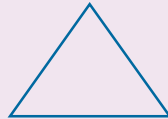
# Who is Buying/Selling?

## Tax Classification of the Target (and Buyer)

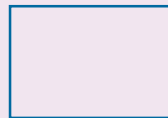
- “Disregarded entity”  
(*i.e.* asset sale)



- Partnership



- C Corporation



- S Corporation



## Jurisdiction of Parties

- U.S. vs. Non-U.S.
- State (*e.g.*, S Corp sensitivities)

## Structure of Parties

- Corporate or Pass-Through
- Member of a consolidated group?
- Multiple targets?

## Combination of the above

# Taxable or Tax-Deferred

## Key Differences: Tax and Basis

### Tax-Deferred: Consequences

- Seller: No Taxes (Good!); Buyer: No Basis “Step-Up” (Bad!)
- Often higher tax structuring sensitivities associated with qualification for tax-deferred treatment.

### Taxable: Consequences

- Seller: Taxes (Bad!); Buyer: Basis “Step-Up” (Good!)
- Tax structuring is still important, but for different reasons (often, basis).
  - It is usually preferred, where possible, that the “step-up” in tax basis occur at the asset-level (i.e. for items that produce depreciation/amortization deductions).

**Can, and in many cases does, impact total purchase price.**

# Taxable Transactions

## **Sellers generally prefer sale of equity.**

- May result in milder tax consequences (e.g. no second layer of tax or ordinary income from “hot” assets in stock sales).
- Less administrative difficulty.

## **Buyers generally prefer purchasing assets.**

- Benefit through “step up” in basis of assets (i.e. future depreciation/amortization).
- Less concern regarding historic liabilities (including tax liabilities) apart from successor or transferee liability concerns.

# Taxable Equity Transactions Common Buyer Goal: Make it an Asset Transaction

## Target is a Partnership

- Rev. Rul. 99-6: Acquisition of 100% of equity interest to single buyer treated as an asset sale to buyer (partnership collapses into disregarded entity).
- If the partnership continues with multiple owners, then if it has (a) made a “Section 754” election or (b) has “substantial built-in loss”, acquirer will get a special basis adjustment under Section 743 that mimics, to the acquiring partner, a “step-up” in the basis of the partnership assets.

## Target is a Disregarded Entity.

- Always treated as an asset sale for tax purposes.



# Taxable Equity Transactions Common Buyer Goal: Make it an Asset Transaction

## Target is a C Corporation

- Forward Merger
  - Rev. Rul. 69-6. Treated as asset sale followed by liquidation of target.
- Deemed asset sale election under Section 338(h)(10) can only be made if being sold out of a consolidated group and there is “qualified stock purchase.”

## Target is an S Corporation

- Can be achieved through a “Section 338(h)(10) Election.”
- Pre-closing “F” reorganization.

# S Corp or Consolidated C Corp Subsidiary Target: Section 338(h)(10) Election

## Joint election by buyer and seller(s).

- **Requires Qualified Stock Purchase (“QSP”).**
  - “[A]ny transaction or series of transactions in which stock (meeting the requirements of §1504(a)(2)) of one corporation is acquired by another corporation by purchase during the 12-month acquisition period.” Section 338(d)(3).
  - “Purchase” means any acquisition of stock where (1) there is no carry-over basis, (2) Sections 351, 354, 355 and 356 do not apply, and (3) acquired stock is not attributed to the buyer under Section 318.
- **Creates a fictional asset sale for U.S. federal income tax purposes. Section 1.338(h)(10)-1(d).**
  - Target corp (“Old T”) is treated as though it had sold (prior to the close of the acquisition) all its assets, subject to its liabilities, to a newly formed corporation (“New T”) in an amount equal to their fair market value.
  - Following this deemed sale (and prior to the close of the acquisition), Old T is deemed to liquidated.
  - New T remains liable for tax liabilities of Old T.

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**S Corporation  
F Reorganizations**

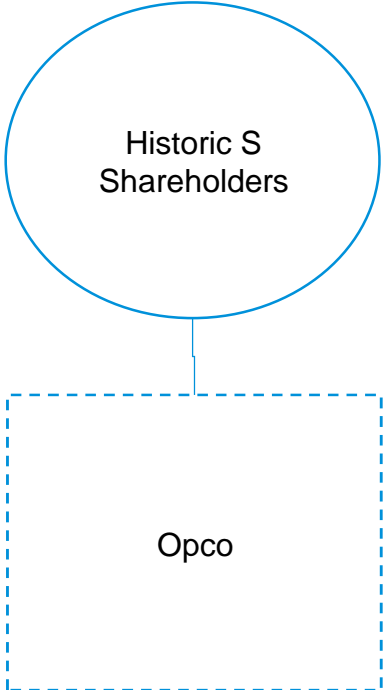
## What is an F Reorganization – IRC § 368(a)(1)(F)

A mere change in  
identity, form, or  
place of organization  
of one corporation

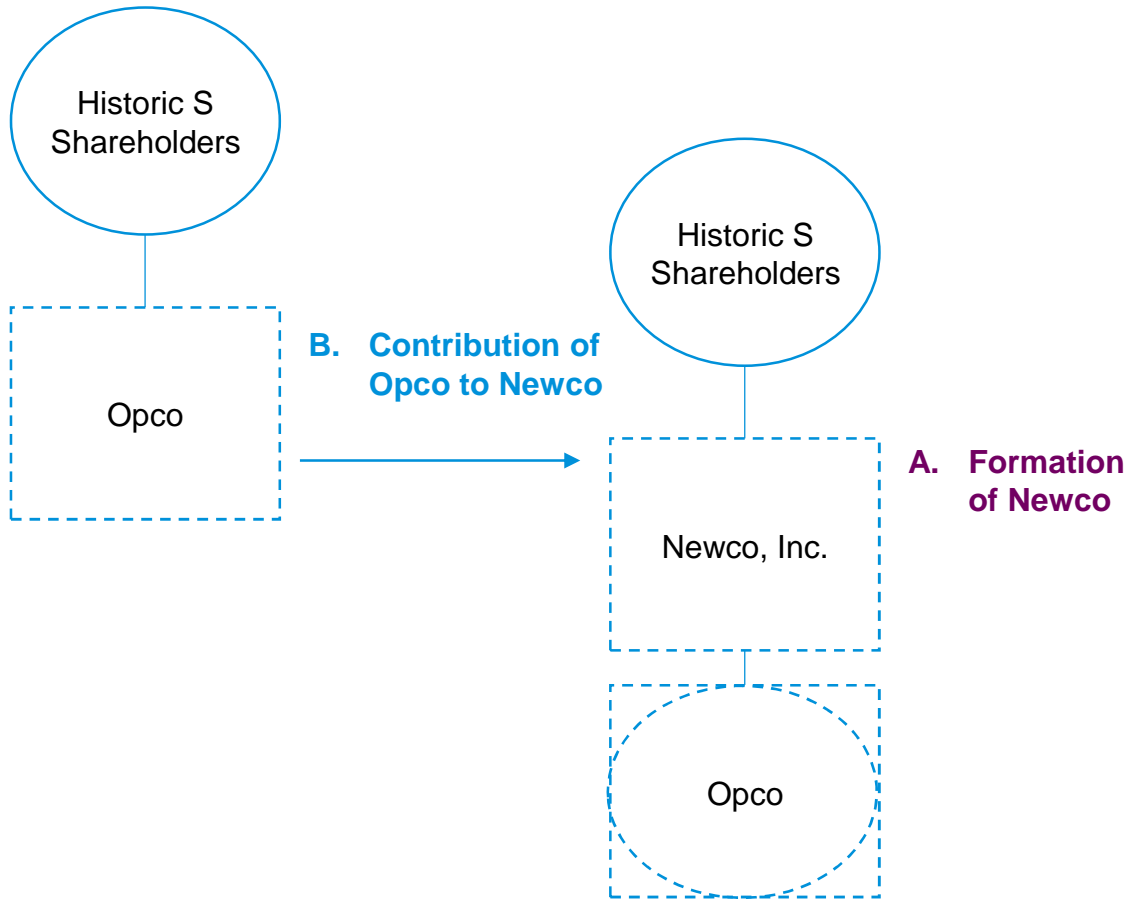
- Same shareholders before and after (minor differences are permitted);
- Identity of Ownership - The shareholders retain their same proportionate ownership;
- The resulting corporation must not have held any assets or have any tax attributes of its own prior to the reorganization;
- The original corporation must liquidate;
- Only the resulting corporation may hold assets owned by the original corporation; and
- The resulting corporation cannot hold assets of any other corporation other than the original corporation.

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# Initial Structure



# Restructuring Steps



**Step A:** Historic shareholders of Opco Inc. (“Opco”) form Newco, Inc. (“Newco”).

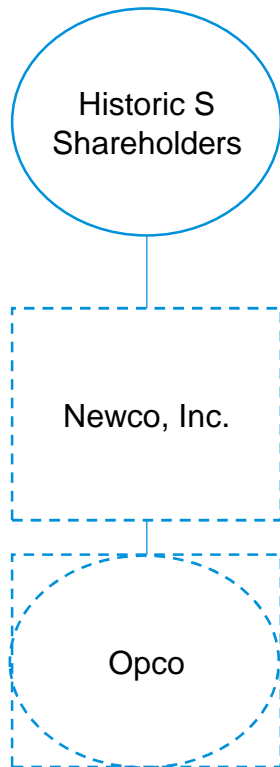
**Step B:** Historic shareholders of Opco contribute Opco stock to Newco.

**Step C:** A qualified subchapter S subsidiary (“QSub”) election is made immediately for Opco on Form 8869.

- The S election for Opco will carry over to Newco, Inc.
- Steps A-C, taken together, constitute an “F” reorganization for tax purposes, so not a tax event.
- Opco retains existing EIN #
- Newco must obtain a new EIN #

**Step D:** Opco converts into an LLC.

# Post-F Reorg Structure



**A sale of interests or assets of Opco is expected to trigger capital gain, except to the extent attributable to assets that generate ordinary income (e.g., accounts receivable) or other non-capital items (e.g., depreciation recapture).**

**The sale will provide basis step-up in the assets for the purchaser.**



# Tax Indemnity Provisions in M&A Documents

troutman  
pepper



# Coverage for Pre-Closing Taxes

## **Our-watch, your-watch construct.**

- Seller is responsible for taxes for pre-closing periods and buyer is responsible for taxes for post-closing periods.
- Need to allocate taxes between pre-closing and post-closing periods.
- Ensure that the tax obligation matches transaction structure.

# Coverage for Pre-Closing Taxes

## Known Pre-Closing Tax Liabilities

- May be deducted from the purchase price (e.g., Indebtedness, Transaction Expenses or NWC).
- Include in NWC (generally for non-income taxes).
- Covenant to pay taxes when returns are filed.

## Unknown Pre-Closing Tax Liabilities

- Breaches of tax representations.
- Typically fundamental reps, and not subject to baskets or standard cap.
- Line item tax indemnity.

# Asset Deal Overlay

- Pre-Closing Taxes are typically an Excluded Liability.
- Then, there is a line item indemnity for Excluded Liabilities.
- Also need to consider impact of transfer taxes and bulk sales.

# RWI Overlay

## **No survival of reps.**

- Taxes typically not considered fundamental in RWI transactions.

## **True walkaway or not?**

- In a true walkaway, it's important to ensure all pre-closing taxes are an upfront deduction to the purchase price.
- Sometimes see a line item tax indemnity.



Morgan advises clients on federal and international income tax and private equity matters. Her practice includes advising on mergers, acquisitions, reorganizations, dispositions, capital markets, and restructurings. Morgan has advised private equity sponsors, as well as their portfolio companies and other strategic clients, on the tax aspects of investments, acquisitions, and divestitures. She is also involved in the formation of private equity and hedge funds.

Morgan is an adjunct tax professor at Temple University Beasley School of Law, vice chair of the Partnership Committee of the Tax Section of the American Bar Association, an elected member of the Philadelphia Bar Association's Tax Council, and treasurer of the Philadelphia Tax Conference. Additionally, Morgan is a frequent speaker on a variety of transactional tax matters and has lectured at several major conferences and forums, including the American Bar Association Tax Conference, the Tulane Tax Institute, and the Chicago Tax Club.