





Recent trends in M&A deals

Thursday, November 9, 2023

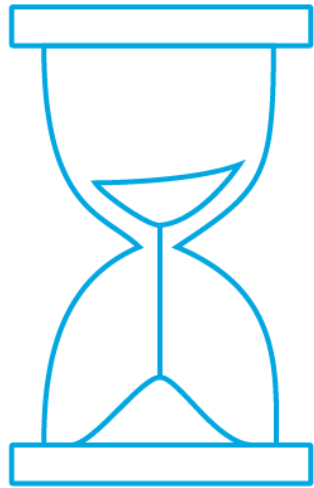
With you today



Patrick Phillips
Principal
RSM US LLP



Stefan Gottschalk
Managing Director
RSM US LLP



- Section 1202 capital gain exclusion
- Agreed-upon purchase price allocations
- Tax attributes' value in an acquisition
- Make-whole/gross-up provisions

Learning objectives

By the end of this presentation, participants will be able to:

1. Identify opportunities to achieve IRC section 1202 qualified small business stock when making an acquisition.
2. Compare the pros and cons of an agreed-upon purchase price allocation.
3. Determine the key issues affecting the value of tax attributes in an M&A deal.
4. Assess key drivers to decide on a make-whole/gross-up provision in an M&A deal.

Section 1202 capital gain exclusion

General requirements for eligibility

- Section 1202 eligibility requirements:
 1. Corporate-level: Apply to the corporation that issued the stock
 2. Shareholder-level: Apply to the taxpayer (directly or indirectly) holding the stock

1. Corporate-level section 1202 requirements include:	2. Shareholder-level section 1202 requirements include:
\$50M aggregate gross assets	Original issuance
Active trade or business	Five-year holding period
Qualifying business	Partnership interest continuity
C corporation	Not a C corporation

Also note further considerations when the shareholder is a partnership.

Original issuance requirement

- **Taxpayer must acquire the stock at its original issuance for:**
 - Money,
 - Property other than stock, or
 - Services provided to the issuing corporation (other than underwriting services). (Section 1202(c)(1)(B))
- Subsequent stock gifts or transfers at death do not negate qualification.
- Stock received in the conversion of a partnership to a C corporation can qualify.
 - See Revenue Rulings 2004-59 and 84-111.
- The original issuance requirement, in general, means taxpayer must sell stock acquired directly from the issuing corporation.
 - The stock may not be acquired from another shareholder
 - Some tax-free transfers maintain eligibility and some do not.

Original issuance requirement – traps and abuses

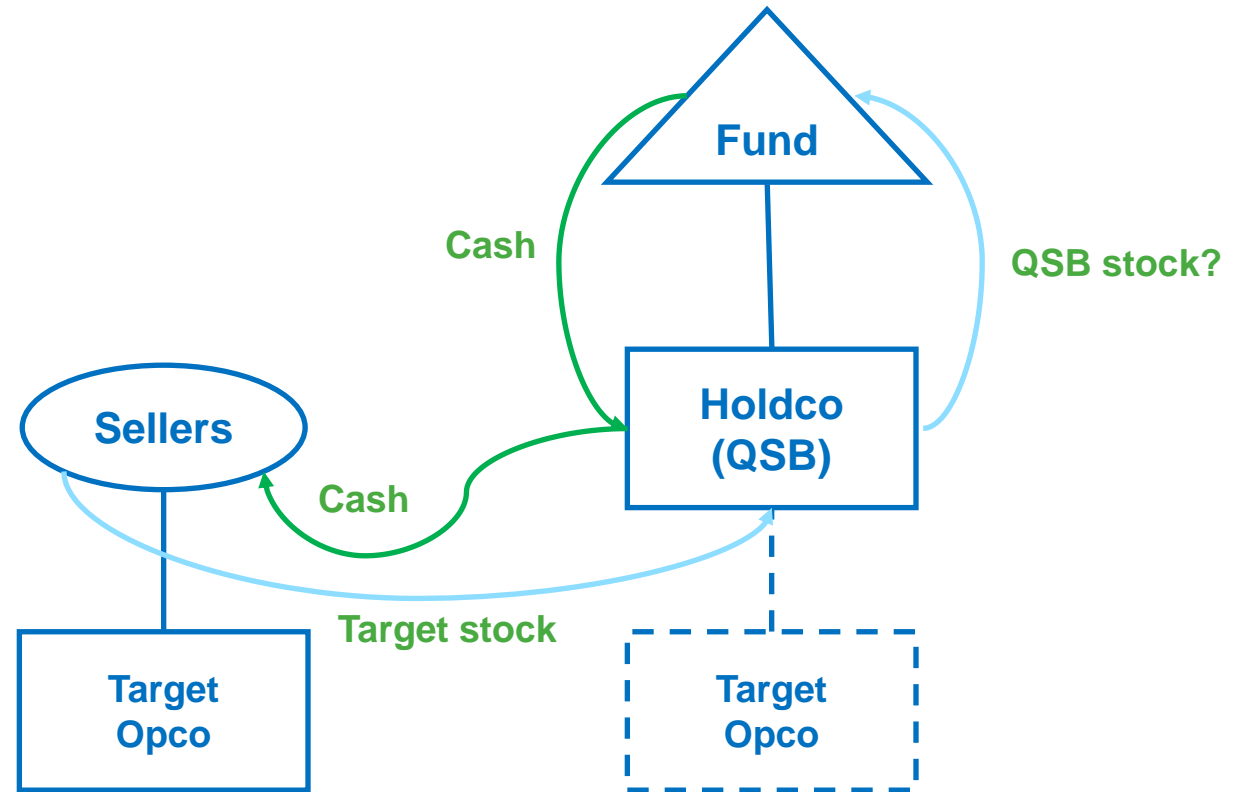
- Transfers **to** a partnership are disqualifying.
- Transfer from one private equity fund to another:
 - All transfers (however insignificant they seem) should be scrutinized very closely.
- Corporations often elect S corporation status in early years and only later convert to C corporation status.
 - Consider the effect of restructurings—e.g., contributing an S corporation to a newly formed C corporation does not qualify.
- Convertible notes, options/warrants, etc., do not qualify—so the five-year period begins only when they are converted into stock.
 - Similarly, restricted stock without a section 83(b) election.

Original issuance requirement – acquisition example 1

Target Opco is otherwise a qualifying small business.

Fund transfers cash to Holdco to fund the purchase of Target.

- Original issuance satisfied?
- \$50 million gross asset test satisfied?



Original issuance requirement – acquisition example 2

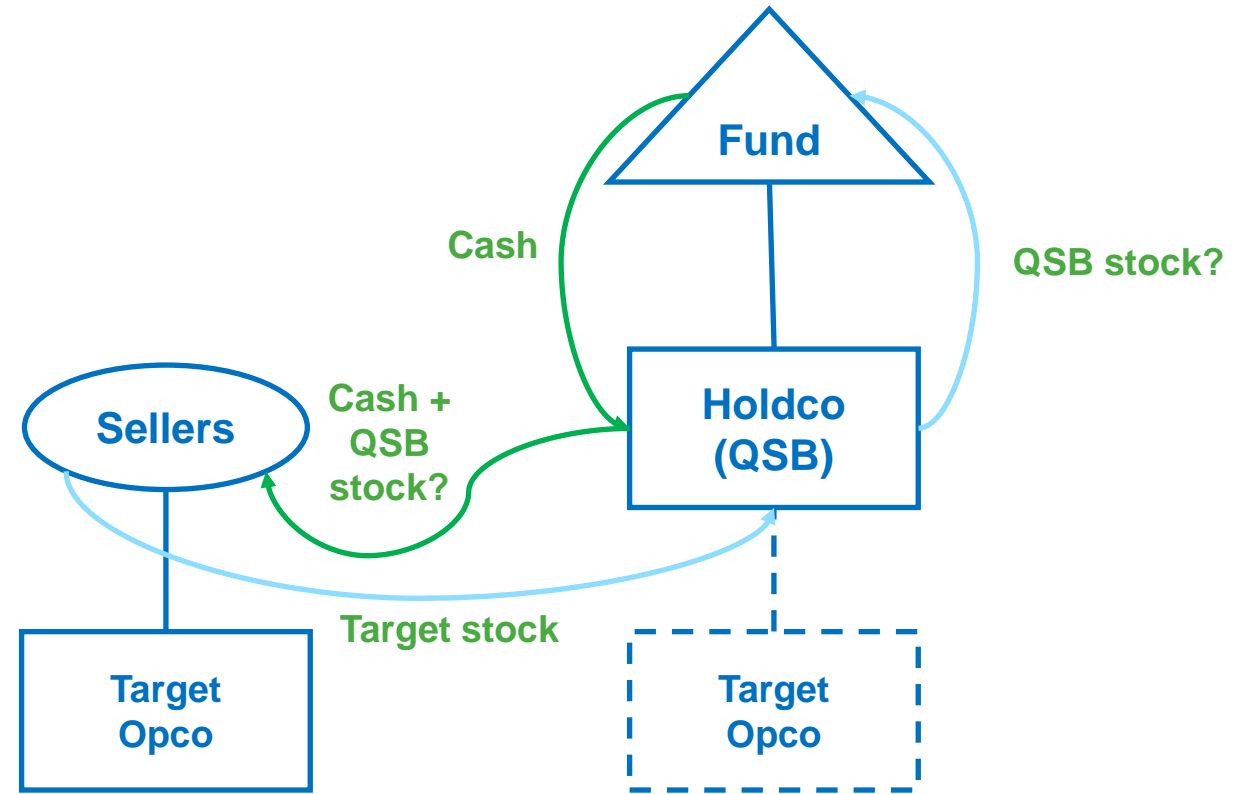
Target Opco is otherwise a qualifying small business.

Fund transfers cash to Holdco to fund the purchase of Target.

- Original issuance satisfied?
- \$50 million gross asset test satisfied?

Sellers transfer Target to Holdco for cash and Holdco stock.

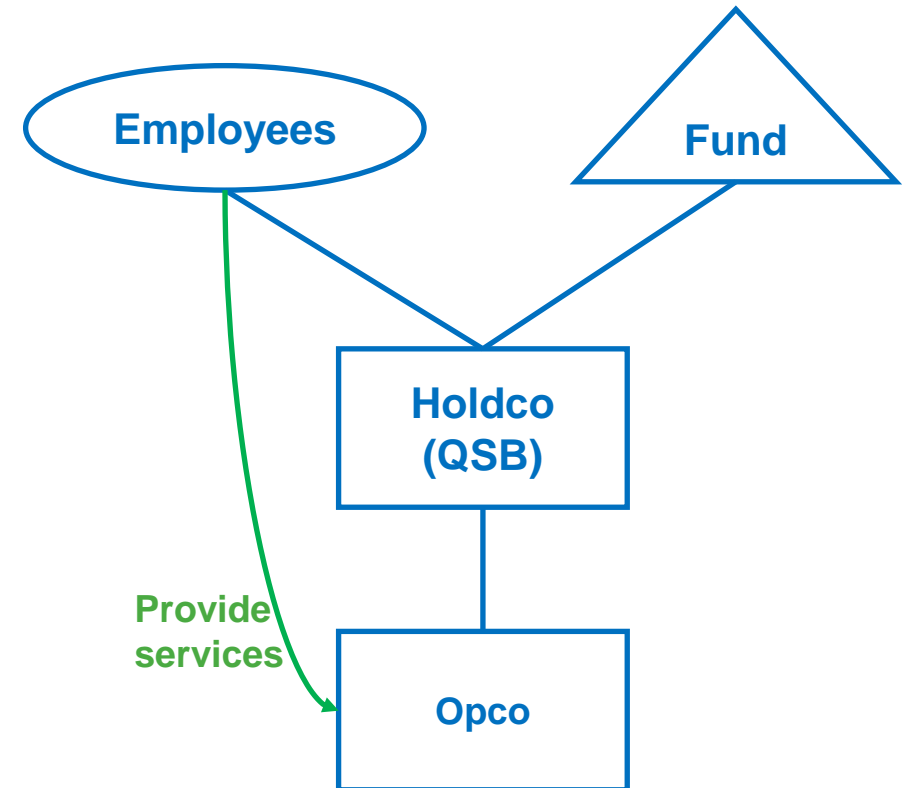
- 351 with boot?
- What if the Holdco is old and cold and gross tax basis is >\$50 million due to other holdings?



Original issuance requirement – shares issued for services

Issues to address:

- Holding period
 - Vested vs. nonvested stock
 - Section 83(b) election with respect to restricted stock
- Original issuance
 - Consider Opco employees who receive grants of Holdco stock (see diagram)
 - Is Holdco stock acquired “as compensation for services provided to [the issuing] corporation,” as the Code requires?
 - Shareholder stock transfers may negate eligibility



Agreed-upon purchase price allocations

A taxable asset acquisition can be structured in several ways:

- As a **direct purchase** of the target's assets by the acquirer for cash and/or notes
- By utilizing a **limited liability company** (LLC) or other entity that is disregarded for tax purposes
- Forward merger of the target into the acquirer or subsidiary of the acquirer
- Acquisition of stock with a section 338 or 336(e) election
- Acquisition of a partnership interest with a section 754/743 election in place

Section 1060

- The seller's total amount to be allocated is called ADSP and the buyer's total amount to be allocated is called AGUB.
 - Seller: (1) Amount received, plus (2) liabilities assumed, **less** (3) seller's transaction costs
 - Buyer: (1) Amount paid, plus (2) liabilities assumed, **plus** (3) buyer's transaction costs
- Will AGUB and ADSP be the same amount?
- Section 1060 prescribes statutory allocation rules to be applied to multi-asset sales of a business in computing the seller's gains and losses and the buyer's basis.
 - Allocation to seven asset classes
- Only applies to an “applicable asset acquisition”
 - Section 355 ATB or anything goodwill and going concern could attach to

Taxable asset acquisition – GAAP vs. tax?

- Significant differences exist between GAAP and tax accounting
- GAAP generally does not care what type of transaction occurred for tax purposes.
- Understand the transaction before doing any numerical analysis.
- E.g., contingent consideration is not included until the amount becomes fixed/paid.
 - GAAP generally estimates value and includes upon acquisition.

Section 1060

When section 1060 applies, it has these results:

- Seven asset class allocation.
- If the parties have agreed in writing on the price allocation or the fair market value of any assets, the parties are bound to respect that agreement but the IRS is not.
- There is no requirement that the parties agree to an allocation or that they share the allocation with the other side.

The parties may have adverse interests, particularly in asset deals with individual sellers

Agreed-upon methodology vs. post-closing valuation

Binding vs. going separate ways

Dispute resolution methodology?

IRS reporting (see below)

Contract provision: “Buyer and Seller agree that for all purposes (tax and financial accounting) the purchase price shall be allocated pursuant to (A) Schedule 3.4 or (B) the post-closing purchase price allocation provisions.”

- Seller: We should agree ahead of time (Alternative A).
- Buyer: We should agree post-closing (Alternative B); Buyer should control post-closing valuation process, subject to Seller consent.
- Buyer and/or Seller: We should go separate ways if do not agree or we should go to binding third party.
- Tax reporting
- Tax vs. financial accounting

Asset classes in section 1.338-6(b)(2)

Class	Definition	Examples
Class I	Cash and cash equivalents	<ul style="list-style-type: none"> Cash and general deposit accounts (including savings and checking accounts)
Class II	Actively traded personal property, such as U.S. government securities and publicly traded stock	<ul style="list-style-type: none"> In addition, certificates of deposit and foreign currency Do <u>not</u> include stock of seller's affiliates, whether or not actively traded, other than actively traded stock described in section 1504(a)(4).
Class III	Assets that the taxpayer marks-to-market at least annually for federal income tax purposes and debt instruments	<ul style="list-style-type: none"> Includes accounts receivable Does <u>not</u> include convertible, related party debt instruments, and certain contingent liabilities
Class IV	Inventory, property held primarily for sale to customers	
Class V	All other assets-constituting all or part of a TOB	<ul style="list-style-type: none"> Furniture and fixtures, buildings, land, vehicles and equipment
Class VI	All section 197 except goodwill and going concern value	<ul style="list-style-type: none"> Workforce in place, noncompete agreements, licenses and permits issued by the government, customer lists, trademarks
Class VII	Goodwill and going concern	

In addition to Reg. section 1.338-6, see instructions for Forms 8594 and 8883 for lists of common assets that are included in each class for purposes of purchase price allocation.

If the parties have agreed in writing on the price allocation or the fair market value of any assets, the parties are bound to respect that agreement but the IRS is not.

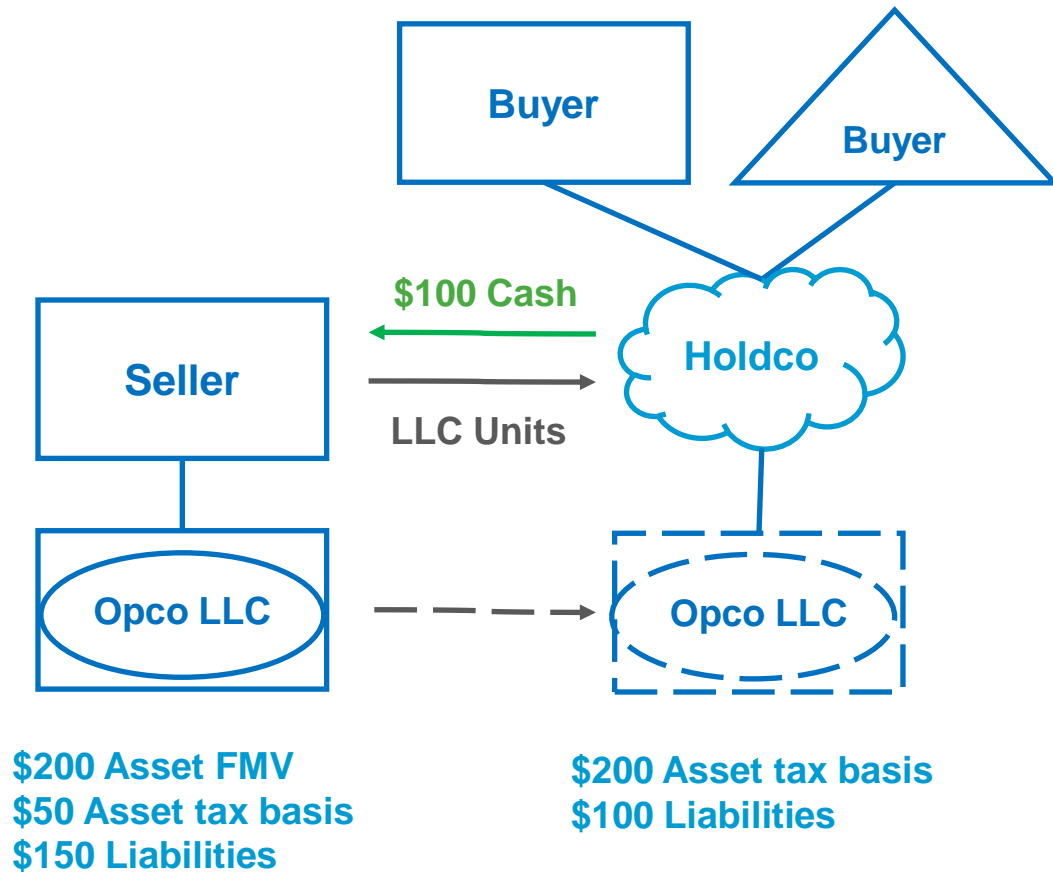
- What if new facts are discovered after the drafting of the agreement?
 - *Peco Foods, Inc. v. Commissioner*, rejecting allocations based on a cost-segregation study performed after the closing where unambiguous written allocations were previously agreed upon at closing.

Can the taxpayer report an allocation that differs from what was agreed upon? Maybe...

- Legislative history is clear that a party may avoid an agreed-upon allocation if the contract is unenforceable because of mistake, undue influence, fraud or duress. *See Danielson v. Commissioner. See also Reg. section 1.1060-1(c)(4).*
- Does the substance-over-form doctrine apply?
- IRS LB&I Division compliance campaign announced Jan. 27, 2021 "addresses...[taxpayers] that either did not report...on Form 8594 or Form 8883, or that reported...inconsistent[ly] with the other party"

Tax attributes' value in an acquisition

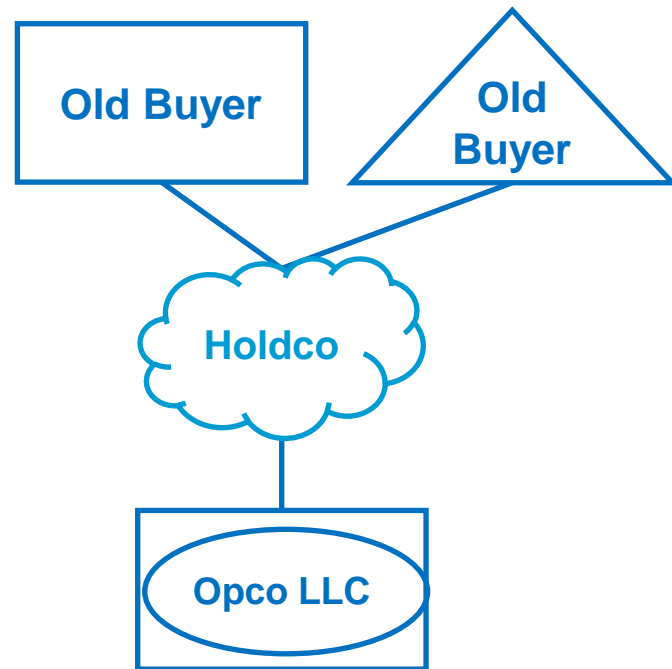
Asset tax basis in M&A – illustration



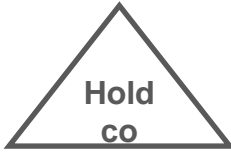

- Asset acquisition
- Via purchase of disregarded LLC
- New Holdco will get:
 - \$200 tax basis in Opco assets
- Should New Owners use:
 - Corporate Holdco or
 - Partnership Holdco?

Asset tax basis in M&A – illustration (cont'd)

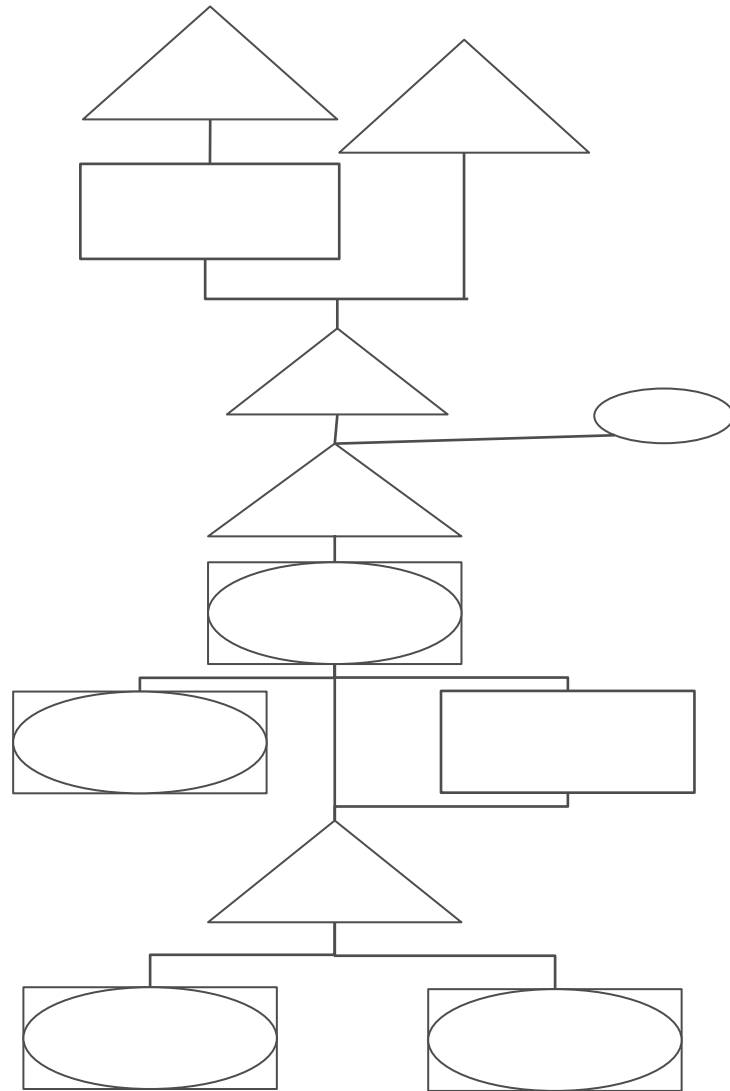
Four years later...



\$300 Asset FMV
\$50 Asset tax basis
\$150 Liabilities

- Time to sell to New Buyer (not pictured)
- If Holdco is a partnership: 
 - One level of tax: Asset sale requires Old Buyers to pay tax on gain.
 - Deal can be structured for asset sale treatment.
 - New Buyer can acquire Opco LLC with \$300 asset tax basis.
- If Holdco is a corporation: 
 - Asset sale could require payment of two levels of tax: (1) Holdco level and (2) Old Buyers level.
 - Deal gets structured as sale of Holdco stock.
 - New Buyer acquires Holdco with Opco LLC asset tax basis of \$50.

Asset tax basis in M&A – getting more complex



- Flow through holdco structures
 - Often not so simple
 - Blocker corporations
 - New blockers
 - Old blockers
 - Management equity

Other than tax basis, are other attributes available?

Certain attributes carry over in a stock acquisition, and should be considered in determining target value:



Asset sale

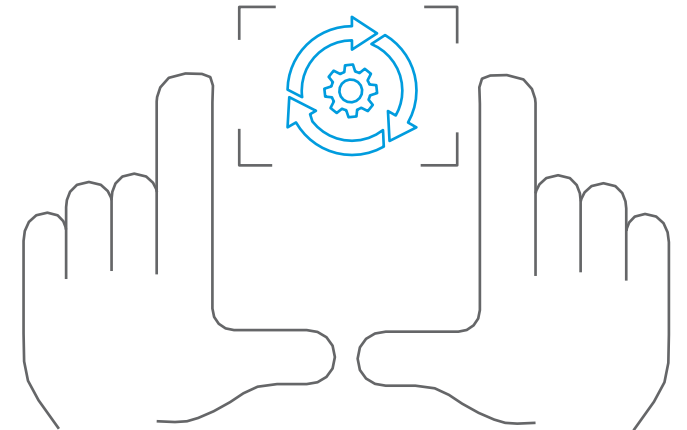
- Taxable or tax-free (“G” reorg)
- Need to keep entity in place?
 - Section 338(h)(10)
- Step-up or step-down in assets
- Availability of historic NOLs to offset gain
- Applicability of bonus depreciation
- Acceleration of deferred revenue pre-transaction
- State income tax considerations
- Benefit of fresh start clear of historic income tax liabilities
- Continuing ownership by former owners
- NPV of overall tax shield acquired in transaction compared to a stock transaction

Stock sale

- Impact of prior or new section 382 limitation of NOL and attributes post-transaction
 - Notice 2003-65
- Cancellation of debt income (CODI) incurred and related attribute reduction
 - Section 1017 liability floor
- In or out of bankruptcy?
 - Section 382(l)(5) availability?
 - Interest haircut
 - Subsequent change
 - Qualified creditors?
 - Section 382(l)(6) impact
- Impact of Treas. Reg. section 1.1502-36(d) and -28 on attributes
- Historic tax liabilities
- State and local tax considerations
- Two levels of tax considerations
- NPV of overall tax shield acquired in transaction compared to an asset transaction

Overview of tax considerations when acquiring a distressed business

- Many of the same tax issues that exist with any normal acquisition
- Entity type is very significant (flow-through vs. C corp)
- Which structure provides the most valuable tax-shield post-transaction?
 - Step-up (or down) of assets compared to NOL/attribute availability
- In or out of bankruptcy:
 - Asset or stock deal for tax purposes
 - Note that a section 363 transaction could represent either
- Consider treatment of the holder of distressed debt
 - Taxable or tax-free exchange of debt for equity/assets



Distressed acquisitions: Entity type is key

If distressed business is a pass-through entity, most acquisitions represent asset/asset-type acquisitions (like a standard acquisition).

- Step up or down to asset basis
 - Mandatory section 743
- Does not inherit tax attributes such as NOLs
- CODI incurred is generally reported by prior owners
- Existence of blocker corporations must be dealt with
- Allocation of CODI and changes in section 752 allocations must be considered

If distressed business is a C corp, the transaction may have added complexity.

- Asset/asset type transaction with step up or down or an equity transaction
- May need to account for CODI in the year of the acquisition
- May inherit attributes (tax shield) subject to section 382 and attribute reduction
 - Fresh start of an asset acquisition may be preferable
- Potential benefits in bankruptcy (including section 363 sales)

Make-whole/gross-up provisions

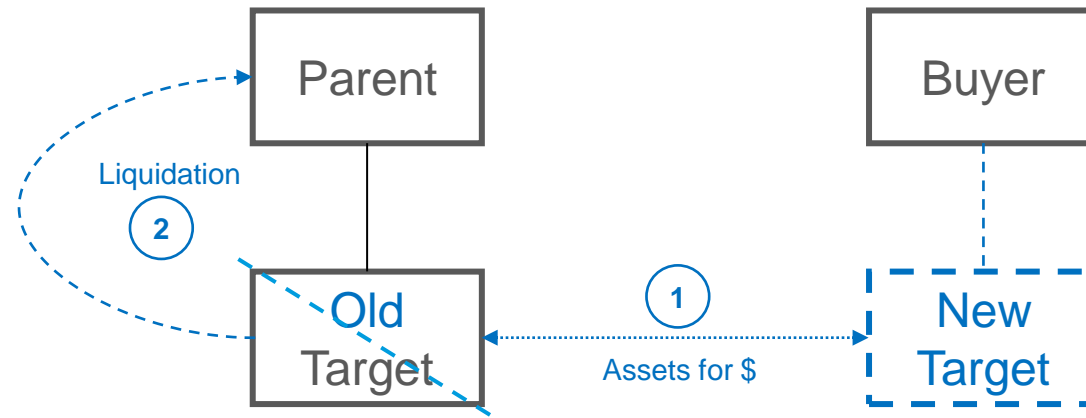
Taxable asset acquisition

A taxable asset acquisition can be structured through:

- A **direct purchase** of the target's assets by the acquirer for cash and/or notes
- Utilizing a **limited liability company** (LLC) or other entity that is disregarded for tax purposes
- A forward merger of the target into the acquirer or subsidiary of the acquirer
- Acquisition of stock with a section 338(h)(10) election:
 - A subsidiary in a consolidated group (cannot be the common parent of the group)
 - A subsidiary in an affiliated group, or
 - An S corporation
- Disposition with a section 336(e) election
- Acquisition of a partnership interest with section 743 adjustments providing step-up to buyer (requires section 754 election)

Section 338(h)(10) – consolidation subsidiary

- Deemed transactions = taxable asset sale followed by liquidation



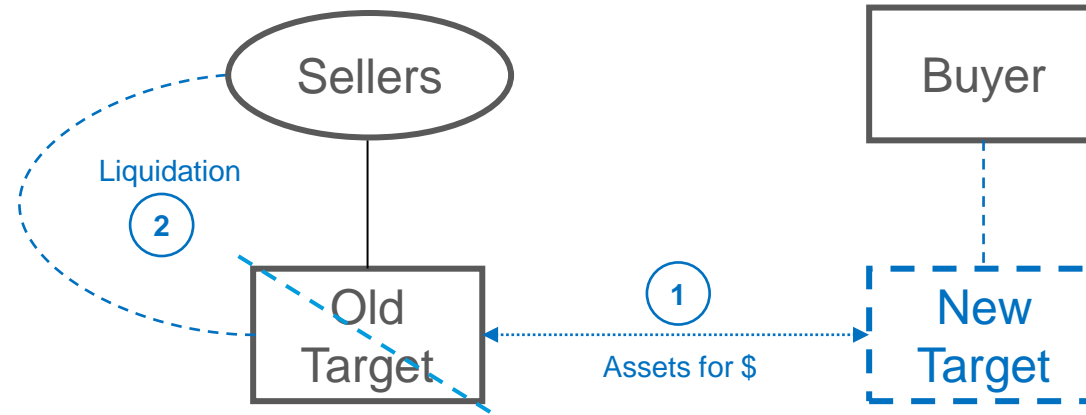
Impacts of Section 338(h)(10): Will the gain with or without a section 338(h)(10) always be the same?

Example: T is a subsidiary of a consolidated group and its stock is purchased by B in a QSP for \$150. The selling parent (S) has \$100 of tax basis in the T stock and T has \$50 of tax basis in the assets.

- If a section 338(h)(10) election is not made, S would have \$50 of gain.
- However, if the election is made, S would have \$100 of gain (followed by a section 332 liquidation).

Section 338(h)(10) – S corporation

- Deemed transactions = taxable asset sale followed by liquidation



Section 338(h)(10) – gross-up payments

- Example: T is an S corporation and its stock is purchased by B in a QSP for \$150. Seller (S) has \$50 of tax basis in the T stock and T has \$50 of tax basis in the assets.
 - Total gain on a stock vs. asset sale would be the same (\$100).
 - However, what if the assets were subject to depreciation recapture?
 - T's tax basis reflects \$50 of accelerated depreciation.
 - T (and indirectly T shareholders) recognize \$50 of gain at OI rates (39+%) rather than cap gain.
 - Tax of \$20 on stock sale
 - Tax of \$29.5 on asset sale
 - Seller would ask for \$9.5(+) of additional purchase price (plus additional payment for a gross-up on the gross-up) to make the 338(h)(10) election.
 - Would the buyer be willing to make this additional payment?
 - Buyer would obtain full FMV basis in the assets (indirectly), \$10 of annual deductions (assuming all due to goodwill/intangibles). Buyer would likely recoup the cost within the first three to four years in the form of tax-effected deductions.

Gross-up payments - drafting

- How would the agreement be drafted to reflect the gross-up?
- Bind buyer and seller to an allocation methodology at close?
- Should a gross-up calculation be prepared prior to close?
- Prepared after the closing balance sheets and working capital adjustments have been finalized?

With you today



Patrick Phillips

Principal
RSM US LLP

Patrick.Phillips@rsmus.com



Stefan Gottschalk

Managing Director
RSM US LLP

Stefan.Gottschalk@rsmus.com

THANK YOU FOR
YOUR TIME AND
ATTENTION



RSM US LLP

+1 800 274 3978

rsmus.com

RSM Canada LLP

+1 855 420 8473

rsmcanada.com

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute assurance, tax, consulting, business, financial, investment, insurance, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. Information has been obtained from a variety of sources believed to be reliable though not independently verified. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. Internal Revenue Service rules require us to inform you that this communication may be deemed a solicitation to provide tax services. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed. Past performance does not indicate future performance. The sole purpose of this document is to inform, and it is not intended to be an offer or solicitation to purchase or sell any security, or investment or service. Investments mentioned in this document may not be suitable for investors. Before making any investment, each investor should carefully consider the risks associated with the investment and make a determination based on the investor's own particular circumstances, that the investment is consistent with the investor's investment objectives.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit rsmus.com/aboutus for more information regarding RSM US LLP and RSM International.

RSM, the RSM logo and *the power of being understood* are registered trademarks of RSM International Association.

© 2023 RSM US LLP. All Rights Reserved.

A decorative footer bar at the bottom of the page, consisting of three horizontal segments: a grey segment on the left, a green segment in the middle, and a blue segment on the right.