Osler, Hoskin & Harcourt LLP

Tax Considerations for Equity Rollovers in M&A Transactions

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Agenda

I. Deal Objectives

II. Basic Tax Consequences of Middle Market Acquisition Transactions

III. Requirements for Stepped-Up Basis to Purchaser

IV. Requirements for Tax-Free Rollover to Sellers

V. Structuring Opportunities to Harmonize Buyer and Sellers Objectives - Examples

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I. Deal Objectives

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I. Deal Objectives

- Buyer's objectives
  - Acquire control
  - Maximize after-tax returns
    - stepped-up asset basis
  - Minimize fiduciary complexities or impediments to resale
  - Preserve historic licenses without inheriting or assuming tax contingencies
  - Preserve and provide economic incentives to existing management

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I. Deal Objectives (con't)

- Seller's objectives
  - Achieve liquidity event
  - Maximize after-tax proceeds
    - one level of tax
    - tax deferral on rollover equity
  - Potentially (secondarily) to retain participation in post-transaction appreciation

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I. Deal Objectives (con't)

- Harmonize objectives of buyer and seller
  - Structure tax free rollovers with basis step-up
  - Ability to harmonize objectives depends on entity classification of the target company
    - Partnership and flow-through entities
    - C corporations
    - S corporations

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II. Basic Tax Consequences of Middle Market Acquisition Transactions

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II. Basic Tax Consequences – Sale of Flow-Through Entities

- Sale of partnerships, branches, or disregarded entities
  - Transparent or flow-through entities for tax purposes
  - Buyer may buy ownership interest or assets
    - purchase price treated as paid for assets.
    - stepped-up asset basis increases depreciation and amortization deductions allowing tax-sheltered cash flow.
  - Sellers sell assets or ownership interest in the entity
    - sellers realize capital gain on assets (except certain items taxed at ordinary rate, e.g., depreciation recapture)
    - one level of tax

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II. Basic Tax Consequences – C Corporation

- Stock sale of C corporation
  - Sellers sell shares
    - realize capital gain on shares
    - one level of tax
  - Buyer buys shares
    - obtains a cost basis in shares
    - Share investment not depreciable (reducing after tax cash flow); share basis will only produce a tax benefit when resold
- Sale of C Corporation's assets
  - C corporation sells assets, then distributes after-tax proceeds to shareholders
    - Two levels of tax
    - Selling corporation pays taxes on asset gains at 35%; then shareholders pay taxes on their share gains when after-tax proceeds are distributed by selling corporation to them (assuming 332 not available)
    - Alternatively, may look to shareholder non-compete or personal goodwill to reduce overall taxes if available
  - Buyer purchases assets
    - Buyer gets stepped-up (i.e., cost) basis in assets, value allocated to goodwill and going concern amortizable over 15 years
    - Generally does not inherit target C corporation's historic and contingent liabilities

II. Basic Tax Consequences – S Corporation

- Sale of S corporation
  - Treated as modified flow-through
  - Sale of assets by S corporation
    - Buyer receives stepped-up basis in assets
    - Generally only one level of tax to selling shareholders. Asset gains may flow through and increase outside basis, eliminating the second level of tax (gains may be taxed at ordinary rates for receivables and depreciable assets)
    - Consider Section 1374 entity level tax for S corporation that converted from C corporation or acquired assets from C corporations in a referenced basis transaction during the prior 5 years
  - Stock sale of S corporation
    - Selling shareholders subject to one level of tax
    - Buyer has cost basis in shares
    - No stepped-up basis in assets
  - Asset v. stock sale for selling shareholders
    - Deferred revenue
    - Differences between inside v. outside basis

II. Basic Tax Consequences – Section 338 Elections

- Section 338 Election
  - If election made in connection with a taxable stock sale, then transaction treated as a hypothetical asset deal for tax purposes
  - Section 338(g) election
    - Unilateral election by the acquirer
    - Acquirer generally bears the tax burden from the deemed asset sale
    - Generally results in two levels of tax
  - Section 338(h)(10)
    - Joint election by acquirer and sellers
    - Seller bears tax burden from the deemed asset sale
    - Only applies to acquisitions of corporate subsidiaries from consolidated group or S corporations
  - Only a deemed asset sale – buyer inherits target's liabilities
  - Similar results may exist under Section 336(e)

III. Requirements for Stepped-Up Basis to Purchaser

III. Requirements for Stepped-Up Basis

- Asset basis step-up requires:
  - Asset purchase
  - A constructive asset purchase (purchase of flow-through entities such as partnership, branch or disregarded entities)
  - Deemed asset purchase under Section 338 or 336(e)
- Asset purchase may be prohibitively expensive if:
  - Seller is a C corporation with substantial asset gains
    - For example, self-created goodwill has a zero basis
  - Seller is a C corporation without a large NOL

III. Requirements for Stepped-Up Basis – Section 338 Election

- Section 338 Requirements
  - Buyer acquires 80% of vote and value of shares
  - Share acquisition obtained by "purchase" (not non-taxable share contribution or tax-free reorganization)
  - Share acquisition must occur within a 12-month acquisition period
  - Buyer election 338(g) or mutual election by buyer and seller under Section 338(h)(10) with agreed upon purchase price allocation
  - Difficult for tax free rollover because all target's assets will be treated as having been sold, so all selling shareholders will recognize proportionate share of taxable gain

IV. Requirements for Tax-Free Rollover to Sellers

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IV. Requirements for Tax Free Rollover

- Generally all sellers will be taxed on cash received for target entity
- Compensatory shares will generate ordinary income to employees. Post closing vesting requirements may be inconsistent with rollover treatment
- Sellers either:
  - Don't sell (some or all sellers retain some or all equity) or
  - Exchange old equity for new equity in a tax free incorporation transaction
- Other potential tax deferral options

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IV. Requirements for Tax-Free Rollover (con't)

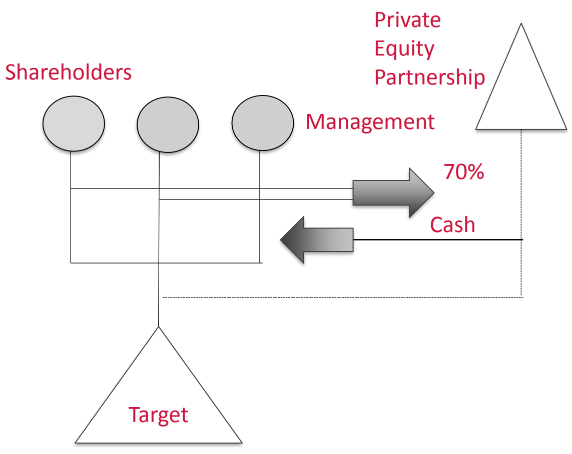
- Consistency with buyer's asset step-up objectives
  - Targets that are classified as partnerships are most consistent with competing objectives
    - Sellers subject to one level of tax
    - Rollover opportunity
    - Asset basis step-up for buyer
  - Sellers retaining equity in excess of 20% can prevent Section 338(h)(10) election and can also implicate anti-churning concerns
  - Leveraged acquisition or rollover equity into buyer could cause 80% acquisition test not to be met for 338(h)(10) election
  - Target S corporations and C corporations – certain structures exist

V. Structuring Opportunities to Harmonize Buyer and Sellers Objectives - Examples

V. Harmonizing Buyer and Seller Objectives – Flow-Through Entities

- Partnerships and disregarded entities are generally not taxed as entities. Instead, taxable income follows through to owners
- Flow through entities most easily accommodate harmonization of buyer's stepped-up basis objective with seller's tax-deferred rollover objective
- Seller rollover can be proportionate or disproportionate

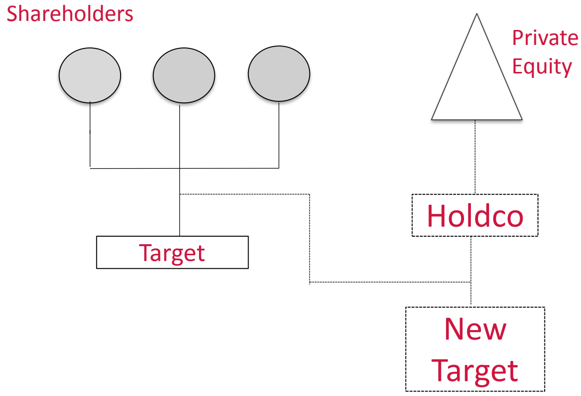
V. Harmonizing Buyer and Seller Objectives – Flow-Through Entities



- Buyer obtains a basis step-up in partnership assets for its purchase price (Sections 754 and 743)
- Sellers retained rollover shares can be proportionate or disproportionate
- Introducing new holdco can complicate analysis (see Sections 708 and Rev. Rul. 99-6)

V. Harmonizing Buyer and Seller Objectives – C Corp

- C Corporation Target - Rollover and Step-Up Together are Difficult



- Rollover without step-up - shareholders sell some shares to P.E. fund in taxable transaction; shareholders retain (or contribute to holdco) rollover equity
- No tax basis step-up to buyer or holdco!! (Might consider interest expense on acquisition debt at holdco offset or shareholder level goodwill)
- Rollover can be proportionate or disproportionate

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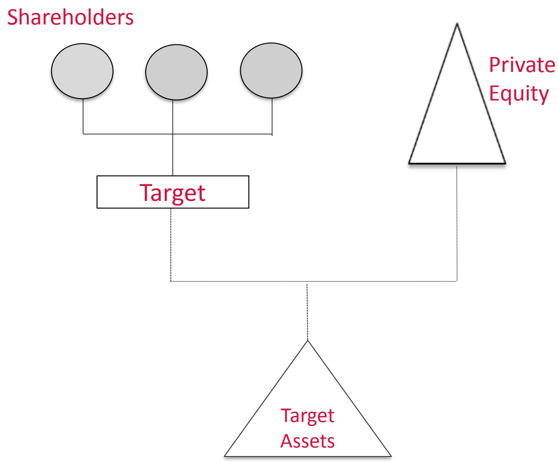
V. Harmonizing Buyer and Seller Objectives – C Corp

- C Corporation Target - Basis Step-Up But With Two Levels of Tax



- Target transfers assets to a wholly owned LLC
- Part sale/part retained ownership. Assume P.E. fund purchases 70% of the LLC for cash
- P.E. fund buyer gets asset step-up
- Selling shareholders have two levels of tax on cash portion of the transaction

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V. Harmonizing Buyer and Seller Objectives (S Corp)

- S corporation target
  - Section 338(h)(10) election available to treat stock sale as an asset purchase
    - Buyer must acquire 80% by "purchase"; all assets deemed sold
    - S corporation's taxable gain allocated to selling shareholders on a pro rata basis. Sellers seeking rollover will be subject to tax
  - Buyer acquires historic entity with any tax contingencies
- F reorganization structure
  - Preserves historic licenses
  - Buyer avoid tax contingencies from the sale and mitigates inheritance of historic tax contingencies

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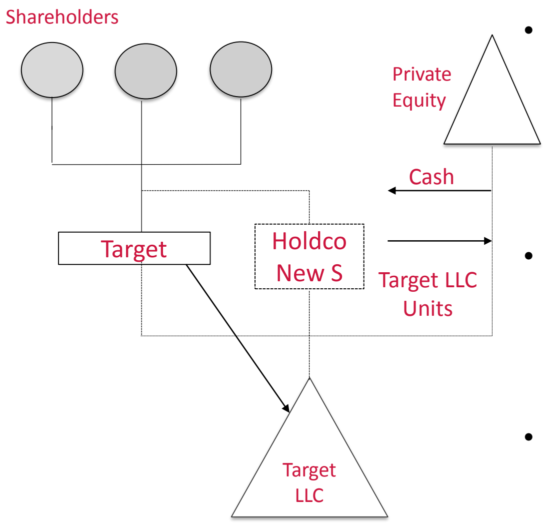
V. Harmonizing Buyer and Seller Objectives – S Corp



- F reorganization steps:
  - Sellers drop target S corp into new holdco and elect Q sub status for target – tax free Section 368(a)(1)(f) reorg
  - Target merges or converts into an LLC
- Buyer purchases all or most of LLC. Not a 338, but an asset purchase by buyer followed by contributions by Holdco and Buyer to a partnership (Rev. Rul. 99-5). Can acquire less than 80%)
- Buyer gets stepped-up basis; sellers get one level of tax (pro rata). Proportionate rollover opportunity

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Questions/Takeaways

- Tax reform
- Recent trends

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