



# Methods for Maximizing Value in M&A Tax Structures

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# Agenda

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- **Building Blocks to Structure Transactions**
  - Entity characterization of Target and Buyer
  - Tax attributes of Target and Buyer (and planning for “step-up” in tax basis and transaction tax deductions)
  - Post-closing operating projections
  - Planning for the next exit
- **Buying or Selling an LLC**
- **Buying or Selling an S Corp**
- **Buying or Selling a C Corp (stand-alone or out of consolidated group)**
- **Recent / Pending Developments**

# Building Blocks to Structure Transaction

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- Entity Characterization and ownership of Target and Buyer
  - LLC
    - Owned by taxable individuals and trusts, US Corps (blockers or public), US tax-exempts (governmental or private), foreigners (taxable or tax-exempt)?
  - S Corp
    - Former C Corp with built-in-gains?
    - Owned by taxable person and trusts or ESOP?
  - C Corp
    - Standalone or US consolidated income tax group (federal and state income tax)
    - Owned by taxable US persons, tax-exempts and/or foreigners (taxable or tax exempt)?

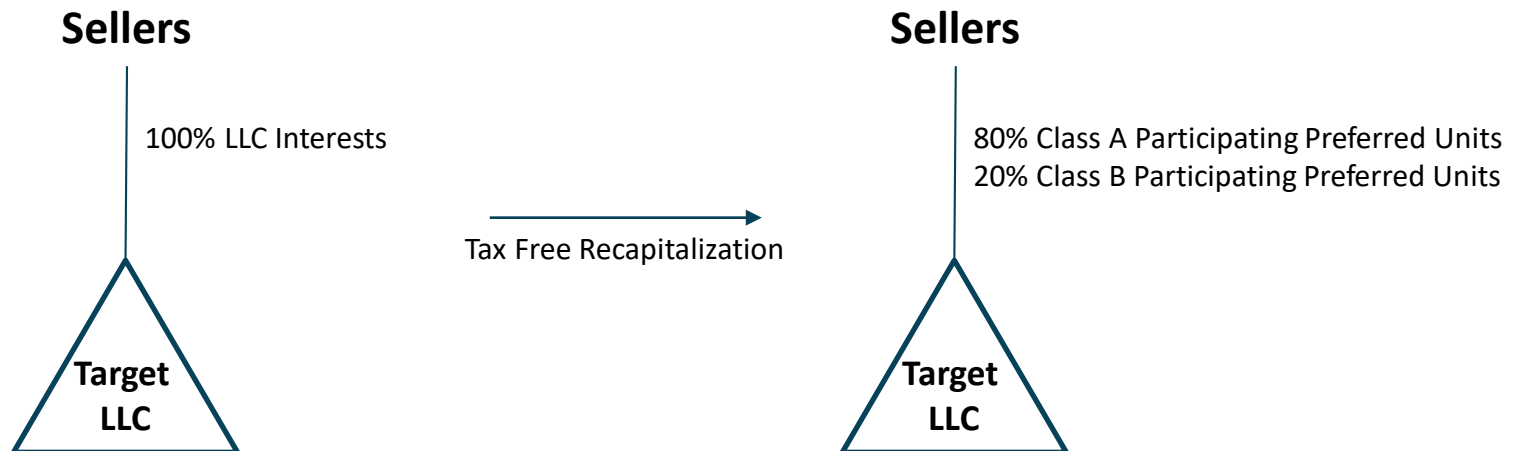
# Buying or selling LLC

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- Tax attributes of Target and Buyer
  - Target LLC
    - Owned by taxable individuals and trusts, US Corps (blockers or public), US tax-exempts (governmental or private), foreigners (taxable or tax-exempt)?
    - High or low tax basis in assets?
    - Ordinary income producing assets on sale?
    - Cash basis? Deferred revenue?
    - Transactions tax deductions (CIC and/or annual bonuses, options, investment banking fees)?
    - State tax consequences (entity vs owner taxation)?
    - LLC owners' tax attributes (Corp NOLs, tax-exempt governmental agency or pension or private pension, foreigner's home country tax rates and home country FTC position)?
  - Buyer
    - PE Firm (using blocker Corp, AIV, or LLC)?
    - Closely-held business (LLC, S Corp (with built-in-gains), C Corp)?
    - Strategic (i.e., public C Corp, Up-C, or PE portfolio company)?

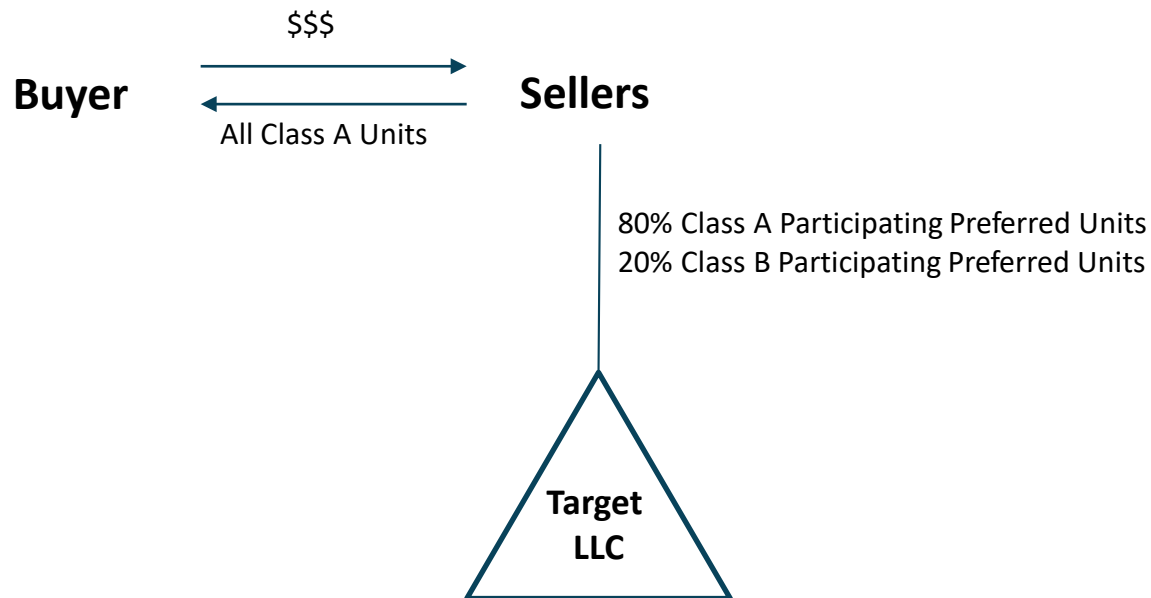
## PE Firm or other buyout of controlling interest of LLC – Step 1

- The Target LLC recapitalizes its outstanding equity interests to 80% Class A Participating Preferred Units with a senior liquidation preference and Class B Participating Preferred Units, which may stand behind the Class A Units on liquidation and perhaps other distributions. Participating Preferred Units generally have a liquidation preference and a preferred return preference at about 8% over management's profits interests.

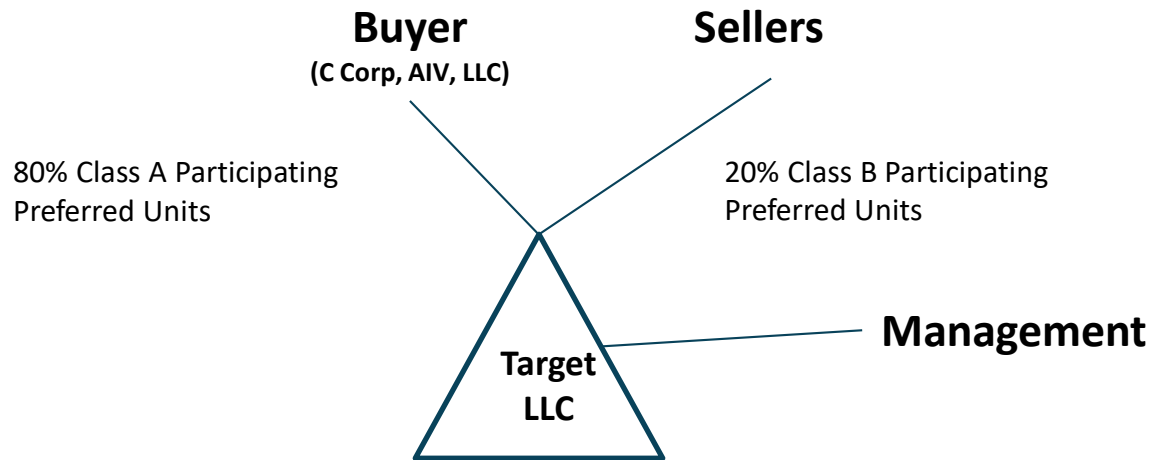


## PE Firm or other buyout of controlling interest of LLC – Step 2

- The Buyer purchases all of the issued and outstanding Class A Units from the Sellers.



# PE Firm or other buyout of controlling interest of LLC – Final Structure



## ■ **Notes:**

- Depending on the assets of the Target LLC, the Sellers may recognize both capital gains and ordinary income (i.e., depreciation or amortization recapture), so sellers would typically like to control purchase price allocation.
- The Buyer will want the Target LLC to make a Code §754 election if there is appreciation in the Target LLC's assets (and may increase the purchase price as a result of such election to reflect future amortization or depreciation deduction). In 100% LLC interest or asset purchase, 100% tax basis step-up.
- The Sellers will likely be subject to state income tax on sale of LLC interests, based on their residence.
- Even if the Target LLC was formed before 1993, there should not be anti-churning issues because partnership interest sold
- Debt financing at the LLC level may cause part of the acquisition to be taxed as a redemption or other distribution, which would generate a tax basis adjustment inside the partnership which would likely be shared by the partners (rather than the tax basis adjustment generated by an equity purchase, which belongs to the purchaser).
- Retention of the LLC structure provides a single level of tax for rollover and some AIV investors (i.e., increase in tax basis of equity for share of after-tax earnings and potential increased purchase price on future sale of the business or potential for Up-C IPO).
- Transaction deductions paid for by seller “pushed” into last LLC tax return so sellers may have tax arbitrage.
- Although buyer may inherit historic tax risks of Target, entity taxes usually not material.
- Determine whether Target is cash basis or has deferred revenue – may result in future tax liabilities (e.g., taxable income realization in the future) without corresponding cash recouped and thus decrease purchase price.

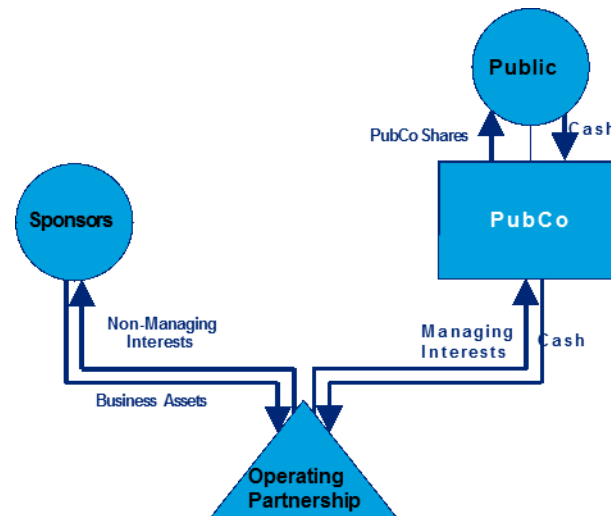
# Umbrella partnership with public C corporation

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- UP-Cs (a/k/a “Pubcos”) generally used to take public non-REIT-eligible flow-through entities
- Avoid entity-level tax on earnings allocable to the sponsors while providing liquidity through exchange rights for public stock

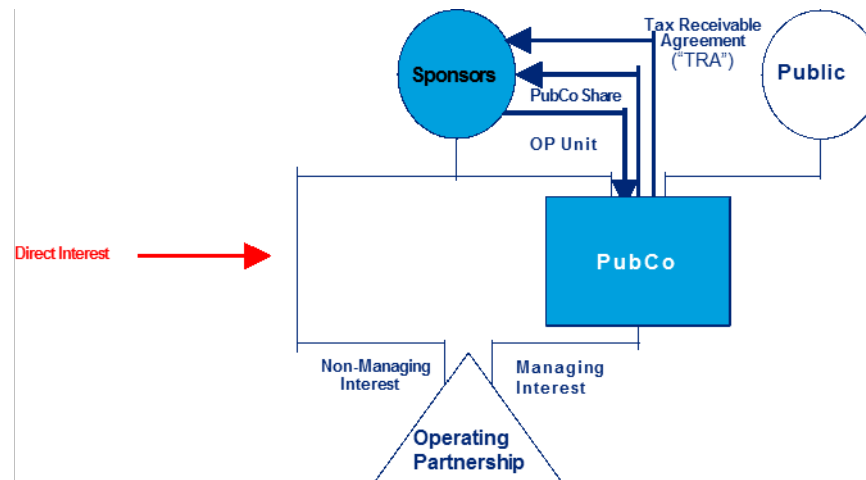


# Umbrella partnership C corporations



- Traditionally, sponsors transfer business assets to OP in a nontaxable exchange for OP units or hold OP units from prior acquisitions
- Newly formed PubCo issues shares to the public and transfers proceeds to the OP in exchange for a managing interest in the OP
- Sponsors may receive non-economic voting shares in the Pubco.

# Up-C Tax Benefits



- Interests in OP held directly by sponsors not subject to corporate tax
- PubCo receives a step-up in basis upon sponsors' exchanges of OP units for PubCo shares
- Benefit (i.e., 85%) of the step-up often paid over to sponsors under a tax receivable agreement ("TRA")
- OP units or public shares can be used in future acquisitions

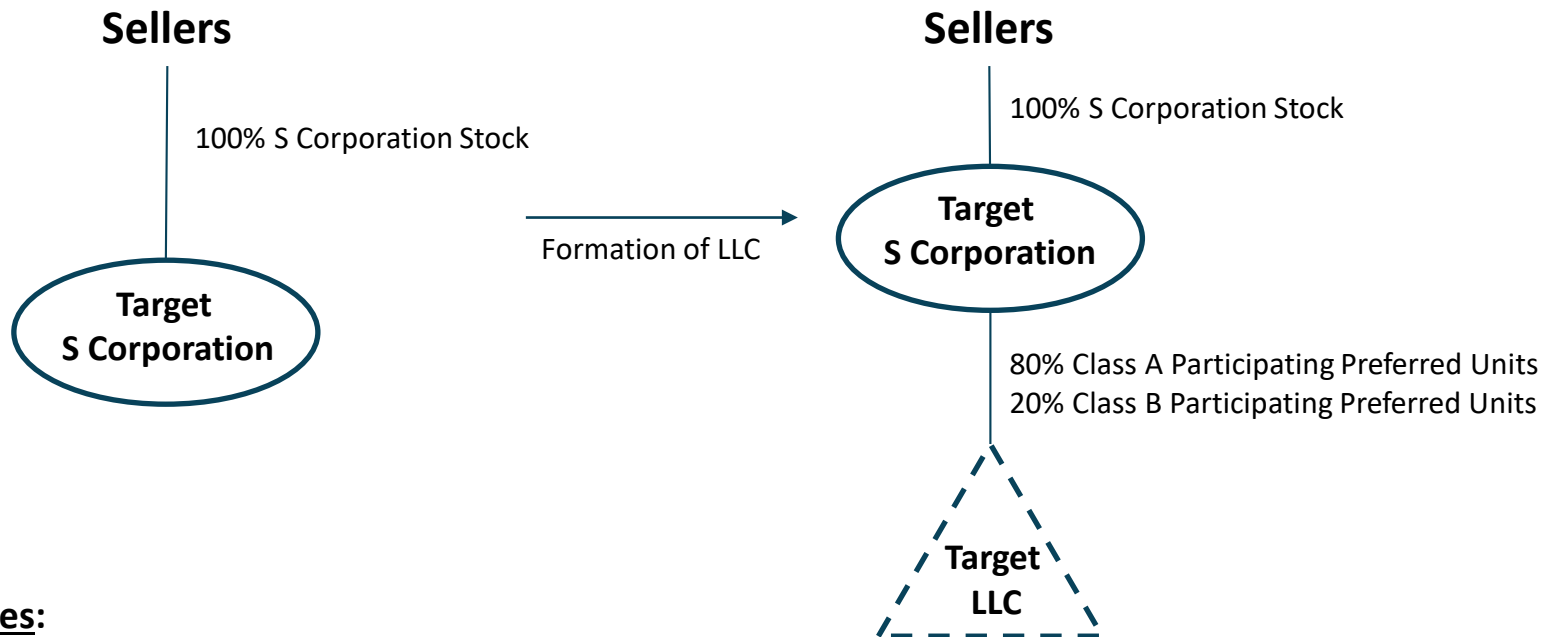
# Buying or selling an S corporation

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- Tax attributes of Target and Buyer
  - Target S Corp
    - High or low tax basis in assets (and/or stock), may be different numbers if former C corp or S corp, shares previously sold?
    - Assets producing ordinary income on sale?
    - Cash basis? Deferred revenue?
    - Former C Corp with built-in-gains?
    - Owned by taxable person and trusts or ESOP?
    - State tax consequences on stock vs asset sale?
    - Transaction tax deductions?
      - ❖ Potential timing issue when joining consolidated group and no 338(h)(10) election made where S election may terminate day before closing under 1502 regs.
  - Buyer
    - PE Firm (using blocker Corp, AIV, or LLC)?
    - Closely-held business (LLC, S Corp, C Corp)?
    - Strategic (i.e., public C Corp, Up-C, or PE portfolio company)?

# PE Firm or other buyer of S Corporation with “rollover” equity interests – Step 1, Alternative A

- The Target S Corporation forms a wholly owned LLC subsidiary, contributing operating assets of the S corporation to the LLC in exchange for 80% Class A Participating Preferred Units and 20% Class B Participating Preferred Units in the LLC.

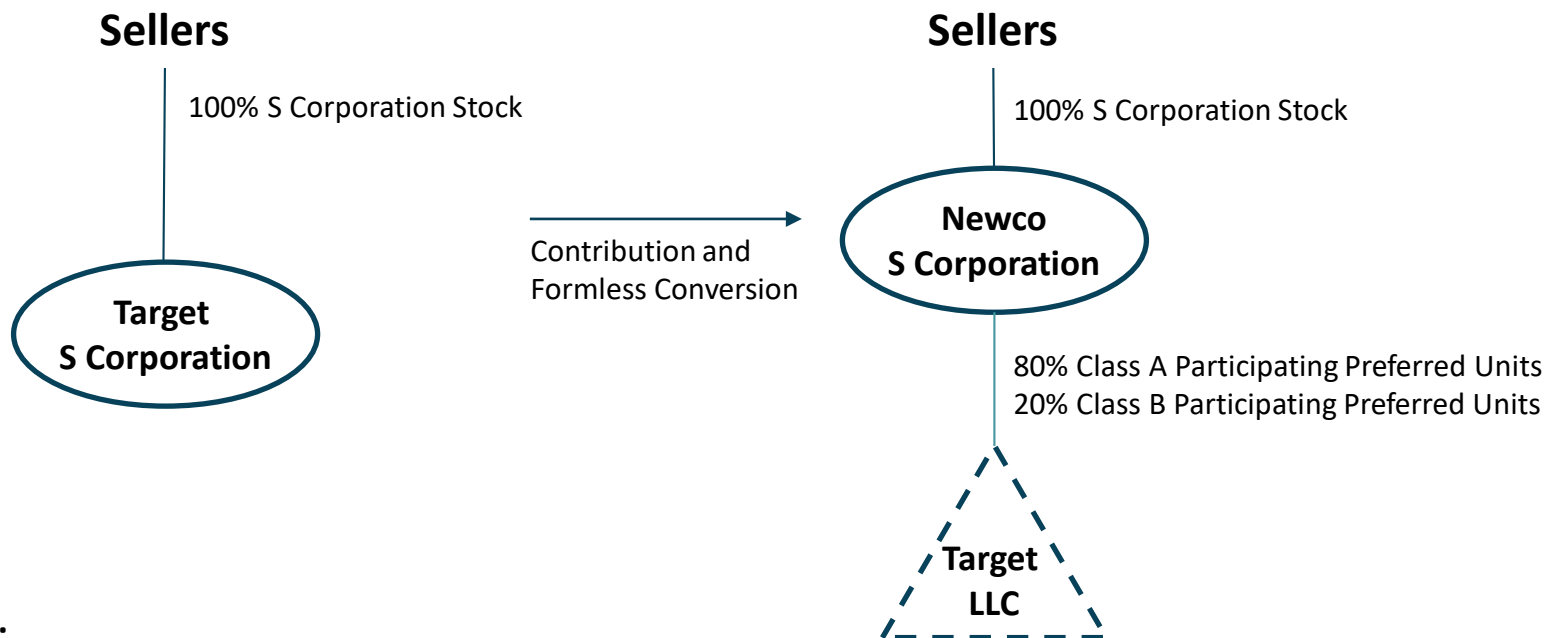


## Notes:

- If the transaction is structured as the acquisition of 80% or more of the S corporation stock, the Buyer may want to make a Code §338(h)(10) election, but a tax-free rollover is not possible with such an election.
- With a deemed sale of assets, whether due to a Code §338(h)(10) election or a sale of interests in a disregarded entity, success-based fees may need to be capitalized and treated as a reduction of the amount realized on the sale (as opposed to an ordinary deduction).

# PE Firm or other buyer of S Corporation with “rollover” equity interests – Step 1, Alternative B

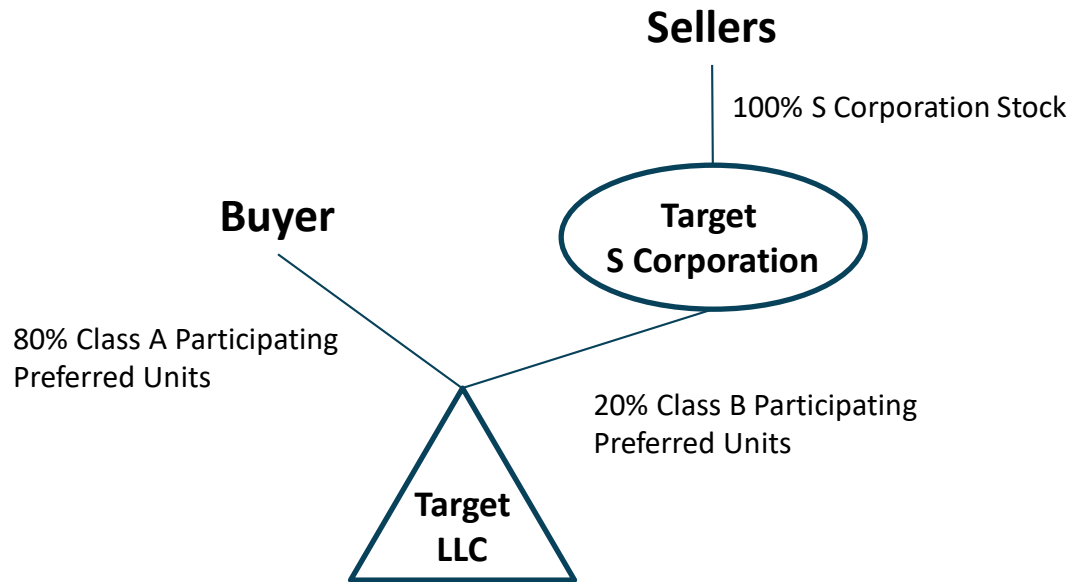
- The Sellers form a new S corporation (“Newco”) and contribute all of the issued and outstanding Target S Corporation stock to Newco. Effective as of the contribution, the Sellers convert the Target S Corporation to a limited liability company under a state conversion statute; the contribution and conversion is intended to qualify as a Code §368(a)(1)(F) reorganization and should have no tax effect. After the conversion, the outstanding equity of old Target S Corporation, now Target LLC, will be 80% Class A Participating Preferred Units and 20% Class B Participating Preferred Units.



## Notes:

- The use of an F reorganization allows the Target LLC to retain its employer identification number it obtained as an S corporation, helping to prevent headaches related to the transaction, such as payroll difficulties or reporting to regulators such as Medicaid or Medicare.

# PE Firm or other buyer of S Corporation with “rollover” equity interests – Final Structure

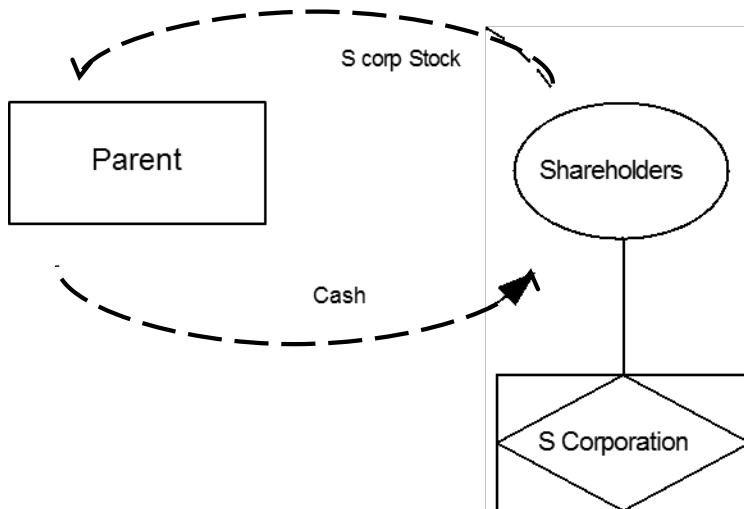


## Notes:

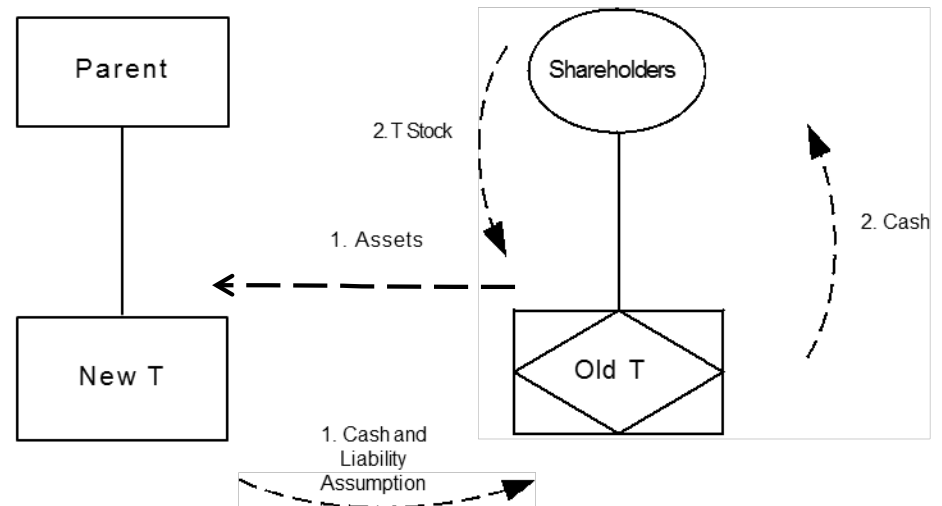
- Depending on the assets contributed to the Target LLC, the Sellers may recognize both capital gains and ordinary income. The Buyer may provide a gross-up to account for the extra taxes compared to a stock sale (including additional state income taxes).
- The Buyer will be treated as purchasing a pro rata share of the assets of the Target and contributing such assets to the Target LLC in exchange for its Class A Units.
- The Sellers will likely be subject to state income tax on their flow-through share of the gain from the S corporation's sale of LLC interests/deemed asset sale, based on their residence and perhaps based on where the S corporation conducts business. Sellers should also consider potential application of section 1374 built-in gains tax.
- If the business began before 1993, there may be anti-churning concerns if the Buyer purchases less than 80% of the outstanding equity. Any LLC interests redeemed through use of bank debt, should likely not be counted in determining if Buyer has purchased at least 80% of the outstanding equity, which means that if the redemption represents a significant portion of the overall acquisition, the Buyer may end up “purchasing” less than 80% of the outstanding equity.
- If the LLC is established as a partnership at least one day before the transaction, query whether the anti-churning issue can be avoided in the LLC structures previously discussed.
- Transaction deductions “pushed” into S corporation's returns to allow them to be deducted against ordinary income, including ordinary income from sale.
- Consider that buyer generally inherits historic tax risks of Target in F reorg structure.
- Determine whether Target is cash basis or has deferred revenue – may result in future tax liabilities (e.g., taxable income realization in the future) without corresponding cash recouped and thus decrease purchase price.

# Section 338(h)(10) transactions where generally 100% of S corp stock purchased

## Actual



## Tax fiction of asset purchase



## Requirements specific to section 338(h)(10) election

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- Requires that T must be:
  - An S corporation (S election may terminate depending on purchasing group);
  - A member of a federal tax consolidated group; or
  - A domestic, non-consolidated affiliate owned 80% by another domestic corporation.
- Requires both purchaser and seller (or selling consolidated group) make a joint election.
- Requires a Qualified Stock Purchase (“QSP”)
  - Corporate Purchaser
  - Acquire > 80% vote and value in fully taxable transaction – Acquired within 12 months
  - Acquire within 12 months
- Other tax considerations include:
  - Corporate attributes lost
  - Anti-churning rules



## Availability of Section 336(e) vs. Section 338(h)(10)

- Generally, a Section 336(e) election may only be made if a Section 338(h)(10) election is not available. The following are the key differences between the Sections:

<u>Section 338(h)(10)</u>	<u>Section 336(e)</u>
Joint seller and buyer election	Seller and target election by agreement
Election within 8.5 months of acquisition	Election by due date of buyer's tax return (made by buyer)
One corporate purchaser	Any number of corporate or non-corporate acquirer(s)
Seller is a U.S. corporation, and Target is affiliated corporation; or Target is an S corporation	Seller is a U.S. corporation, and Target is affiliated corporation, or Target is an S corporation
12-month acquisition period	12-month acquisition period
Sale of 80% vote and value (excluding Section 1504(a)(4) stock)	Sales and/or taxable distributions totaling 80% vote and value (excluding Section 1504(a)(4) stock)
Related person restriction (Section 318(a) attribution)	Related person restriction (Section 318(a) attribution but not between partnerships with < 5% partners)
Not available if Seller or Target is foreign	Not available if Seller or Target is foreign

# Recap of Section 336(e) Election

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- Key reasons a Section 336(e) election may be used to obtain a tax basis step-up:
  - A transaction does not qualify for a Section 338(h)(10) election
    - Non-corporate purchaser
    - Multiple buyers
  - A transaction is not a taxable stock purchase, but a disposition occurs (sale, exchange, or distribution)
  - Note the election is not available in the related party context

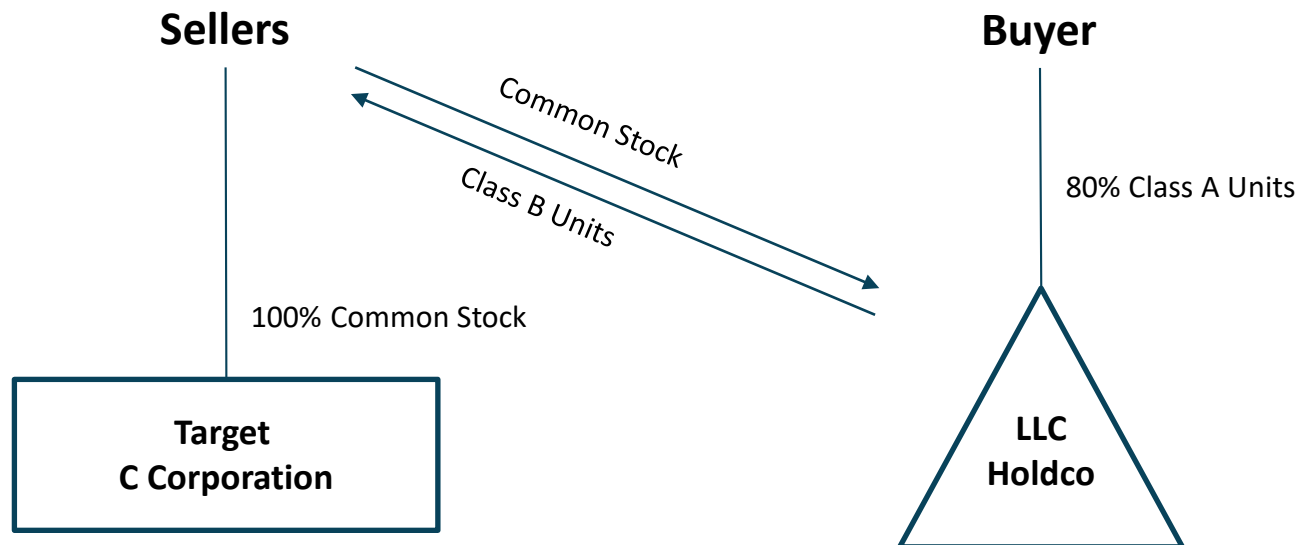
# Buying or selling C corporation

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- Tax attributes of Target and Buyer
  - Target C Corp (stand-alone or part of consolidated group)
    - Owned by taxable US persons, tax-exempts and/or foreigners (taxable or tax exempt)?
    - Buying a division (branch) or an entire corporate entity?
    - Cash basis? Deferred revenue?
    - High or low tax basis in its assets (and/or stock), stock frequently higher?
    - State tax position?
    - NOLs, foreign tax credits?
    - Transaction tax deductions – timing issues?
      - ❖ When corp enters or leaves consolidated group, its taxable year closes at the end of the day of the transaction. Items of income and loss for the day on which it enters the group are generally included in its separate tax return for the tax year that ends at the close of the day of the sale – the “next day” rule.
  - Buyer
    - PE Firm (using blocker Corp, AIV, or LLC)?
    - Closely-held business (LLC, S Corp, C Corp)?
    - Strategic (i.e., public C Corp, Up-C, PE portfolio company)?

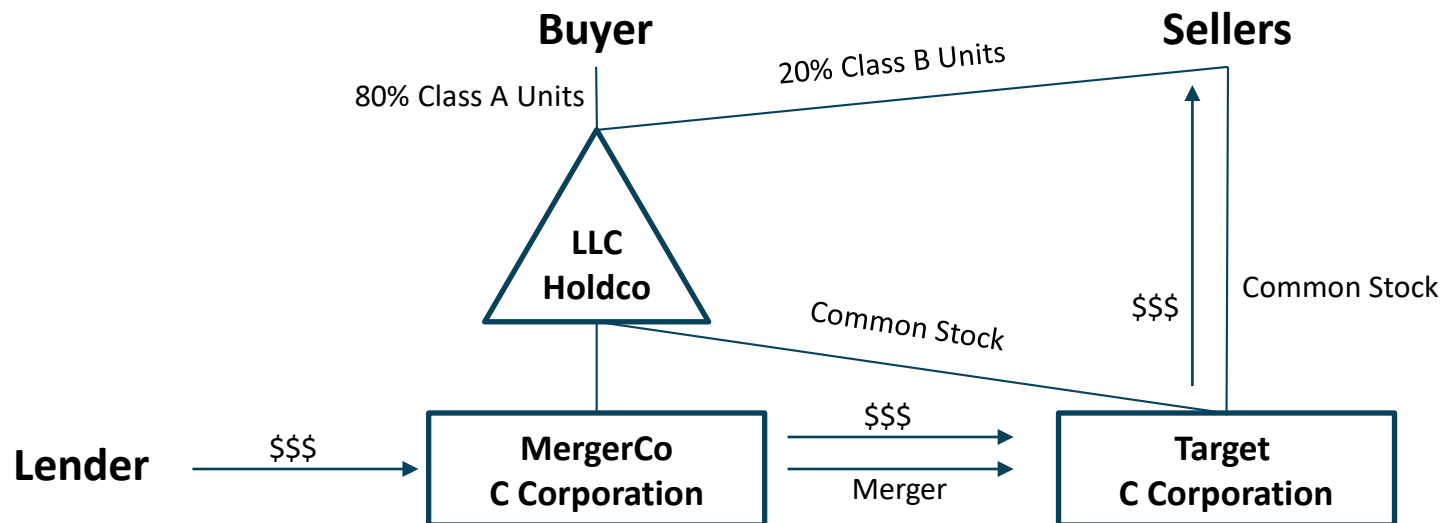
## Buying a C Corporation (stand-alone or out of consolidated group) with LLC Holdco Structure because business may be sold separately in the future – Step 1

- The Buyer will form an LLC holding company (“LLC Holdco”) and contribute cash for 80% Class A Participating Preferred Units. The Sellers will contribute a portion of their Target Stock to LLC Holdco in exchange for the Class B Participating Preferred Units. The Class A Units will have a liquidation preference over the Class B Units.



## Buying a C Corporation (stand-alone or out of consolidated group) with LLC Holdco Structure because business may be sold separately in the future – Step 2

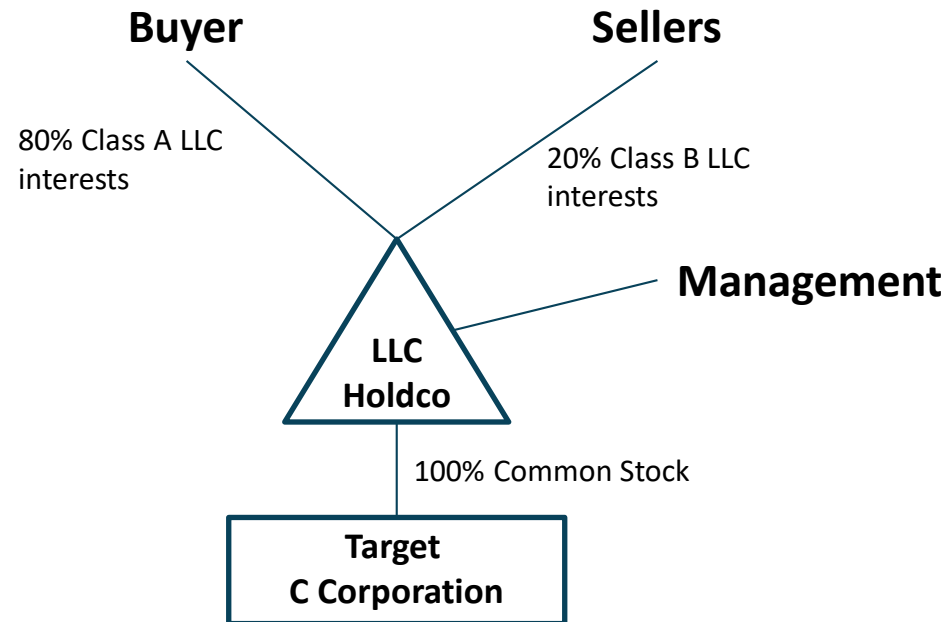
- The LLC Holdco forms a transitory merger subsidiary (“MergerCo”), which is capitalized with some equity and borrows part of the purchase price from a third party lender. MergerCo merges with and into Target, with Sellers receiving cash in exchange for their remaining Target Common Stock and LLC Holdco receiving Common Stock in Target in exchange for its MergerCo stock.



### Notes:

- The receipt of cash from Target by the Sellers that is funded by third party debt should be treated as a redemption of the Sellers' Common Stock. If the Sellers being redeemed are the rollover shareholders, then the distribution received by such Sellers may be treated as a dividend to the extent of earnings and profits in the Target if the redemption is not a substantial reduction of such Sellers' interests in the Target.
- The cash received by Sellers from MergerCo which was contributed to MergerCo by Buyer should be treated as an acquisition of shares by Buyer.

# Corporation with LLC Holdco Structure because business may be sold separately in the future – Final Structure



## ■ Notes:

- The LLC Holdco allows for the issuance of profits interests to management and other key employees.
- The operating agreement of an LLC will contain all of the substantive provisions otherwise contained in a shareholder's agreement, articles of incorporation, and bylaws of a corporation in a single document.
- The LLC Holdco will allow the parties to more easily split proceeds on a sale and account for escrows and shareholder representative amounts.
- The LLC Holdco provides an additional liability shield for the owners.
- The LLC Holdco allows for add-ons to be acquired and held in a brother-sister corporate subsidiary which can be sold separately without corporate tax.
- The Sellers should recognize capital gains on the stock sale or redemption, with the previously discussed caveat that a portion of the redemption may be taxed as a dividend.
- Many states will tax the Sellers on their gain if they are residents there, but some, such as Florida or Nevada, will not.
- There are no anti-churning concerns because any intangible assets would be held inside the corporation, and the transaction is a stock sale.
- Buyer generally inherits historic tax risks of Target, subject to indemnity or reps and warranty ("R&W") insurance.
- Determine whether Target is cash basis or has deferred revenue – may result in future tax liabilities (e.g., taxable income realization in the future) without corresponding cash recouped and thus decrease purchase price.

# Tax developments

- Potential tax reform under Trump administration
  - Expected proposal for reduced corporate, pass-through, individual tax rates
  - Potential implementation of boarder adjustments under House blueprint – destination (consumption) based
    - Destination based system would provide for boarder adjustments exempting exports and taxing imports.
  - Revamp of international tax system (end of deferral? territorial taxation?)
  - Trump plan vs. House Blueprint
  - Brady: no timetable for draft legislation, however GOP lawmakers are working under assumption of Summer 2017.

	Trump	Blueprint
<b>Investment income</b>	Maintain 20% cap gain rate, eliminate NIIT	Cap gains, dividends, interest taxed at ordinary rates, but allow for 50% deduction, eliminate NIIT
<b>Passthrough</b>	15% maximum rate	25% maximum rate
<b>Corporate</b>	15% maximum rate	20% maximum rate

# Panel Discussion

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