Chicago Bar Association Corporation and Business Law Committee
Buying and Selling A Business Seminar – Part I

Mergers for Middle-Market and Lower Middle-Market Companies

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Outline of Presentation

- ✓ Differences between taxable and nontaxable ways to buy and sell a business.
- ✓ Types of nontaxable reorganizations.
- ✓ Type A merger.
  - ✓ Forward triangular merger.
  - ✓ Reverse triangular merger.
- ✓ Type B stock-for-stock reorganization.
- ✓ Type C stock-for-assets reorganization.
- ✓ Overall objective:

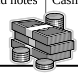
For you to recognize opportunities to use nontaxable reorganizations in your middle-market and lower middle-market transactions.

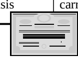
Differences between taxable and non-taxable ways to buy and sell a business

- ✓ Definition of taxable sale.
  - ✓ Sale of target corporation stock for cash, notes, or other property paid by the acquiring corporation.
  - ✓ Sale of target corporation's assets for cash, notes, or other property paid by the acquiring corporation.
- ✓ Definition of nontaxable reorganization.
  - ✓ Exchange of target corporation's stock ***for stock in the acquiring corporation***, plus (in some cases), cash or other property.
  - ✓ Exchange of target corporation's assets ***for stock in the acquiring corporation,*** plus (in some cases), cash or other property.

Differences between taxable and nontaxable ways to buy and sell a business

	Taxable sale for cash and notes		**Nontaxable reorganization for acquiring corporation's stock *only***	
Item	Stock sold	Assets sold	Stock exchanged	Assets exchanged
Federal income tax payable by target corporation shareholders	15% on capital gain. Principal paid with notes get installment treatment.	S-Corp: 15% on capital gain. C-Corp: 35% on capital gain paid by corporation, with second tax on liquidation.	***None!***	***None!***
Step-up in tax basis of target corporation assets	None, unless Section 338 election to step up basis	Automatic step-up in basis of assets to equal purchase price	None. Assets have a carry-over basis	None. Assets have a carry-over basis
What the seller gets for the business	Cash and notes	Cash and notes	Stock in the acquiring corporation, with a carryover basis	Stock in the acquiring corporation, with a carryover basis

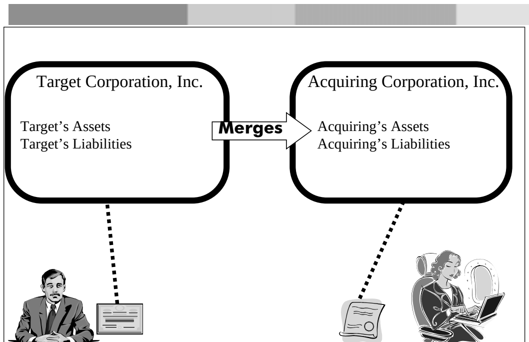




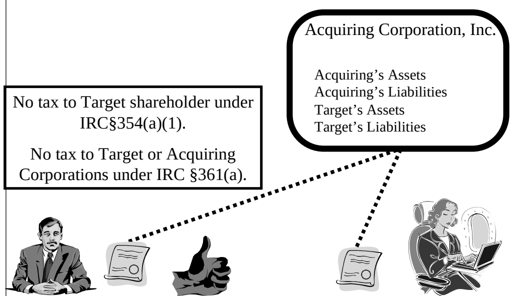
Types of nontaxable reorganizations

- ✓Type A merger under IRC § 368(a)(1)(A).
- ✓Type B stock-for-stock reorganization under IRC § 368(a)(1)(B).
- ✓Type C stock-for-assets reorganization under IRC § 368(a)(1)(C).

Type A Merger



Type A Merger



Type A Merger - 9 Requirements

- ✓ The target entity must be considered a corporation *for federal tax purposes*. Reg. §1.368-2(b)(1)(i)(B).
  - ✓ Includes corporations formed under state corporation laws.
  - ✓ Federal tax law has its own unique definition of a "corporation". For federal income tax purposes, a "corporation" can also include any business entity that elects to be taxed as an association, and therefore also as a corporation under Reg. §301.7701-3(a), such as:
    - ✓ Partnerships.
    - ✓ Limited partnerships.
    - ✓ Limited liability partnerships.
    - ✓ Limited liability companies.
- ✓ The acquiring entity must be considered a corporation *for federal tax purposes.* Reg. §1.368-2(b)(1)(i)(B).

Type A Merger - 9 Requirements

- ✓ All assets and liabilities of the target corporation must be transferred to the acquiring corporation in a statutory merger or consolidation effected under statutes. Reg. §1.368-2(b)(1)(ii). The merger or consolidation does not have to be under a state's *corporation* laws, but can also occur under a state's LLC Act, for example.

  a. Stock issued to target corporation shareholders can be voting or non-voting stock.

- ✓ There must be a plan of reorganization. Reg. §1.368-1(c). The Plan of Merger and Articles of Merger under state corporate law will suffice.

5. The merging corporation must dissolve. Reg. §1.368-2(b)(1)(ii)(B).

Type A Merger - 9 Requirements

6. Continuity of shareholder interest must be maintained. Reg. §1.368-1(e)(1)(i).
   - ✓ In general, a substantial part of the consideration paid for the target stock must be stock in the acquiring corporation.
   - ✓ For years, "substantial" meant 50% or more. Rev. Rul. 77-37, 1977-2 C.B. 568.
   - ✓ The Regulations now have an example approving a reorganization with only 40% of the consideration paid in acquiring corporation stock. Reg. §1.368-1T(e)(2)(v), Examples 1. See also PLR 2006100007.
   - ✓ ***Importance: the target corporation shareholders (as a group) can get up to 60% cash!***

Type A Merger - 9 Requirements

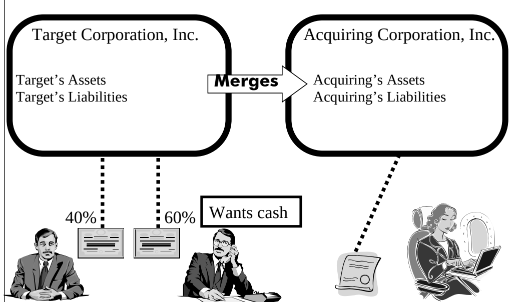
7. Continuity of business enterprise must exist. Reg. §1.368-1(d)(1).
   a. The acquiring corporation must continue the target corporation's historic business or use a significant part of the target corporation's historic business assets in a business.

✓ A business purpose for the reorganization must exist.
   a. "[A] mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization." Reg. §1.368-1(c).
   b. Example: The target corporation has a net operating loss carryforward, and the only purpose of the merger is to allow the acquiring corporation to use the net operating loss carryforward to offset its taxable income. This does not qualify as a business purpose.
   c. There is almost always a business purpose if the target corporation and the acquiring corporation are at arm's length.

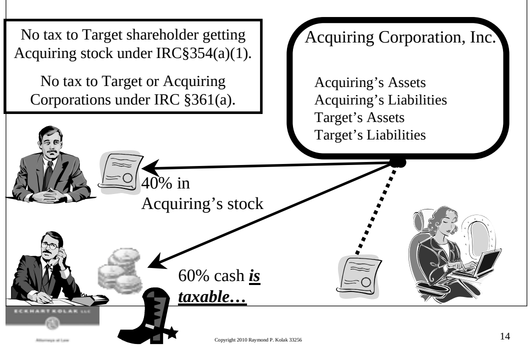
Type A Merger - 9 Requirements

9. Reporting and record keeping requirements must be met. Reg. §1.368-3.
   a. Tax return disclosure statements must be filed by:
      (1) Acquiring corporation.
      (2) Target corporation.
      (3) Target corporation's shareholders.
   b. All parties must retain their permanent records with regard to the reorganization.

Type A Merger



Type A Merger

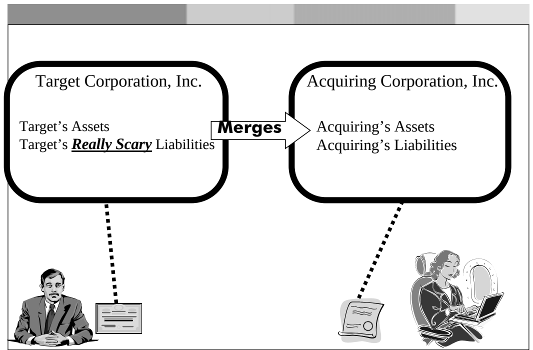


Type A Merger Take-Away

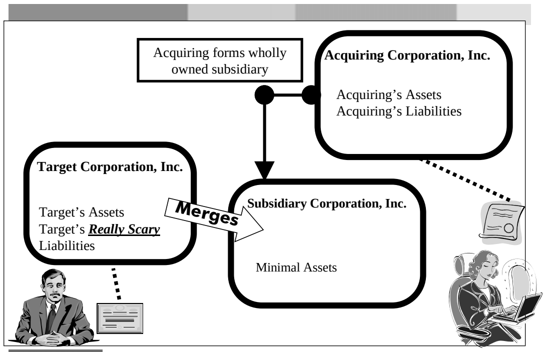
If your Target Corporation shareholders receive at least 40% of the consideration for the business in stock of the Acquiring Corporation, that 40% could be received tax-free…

…even though 60% of the consideration received by the Target Corporation's shareholders was cash or other property!

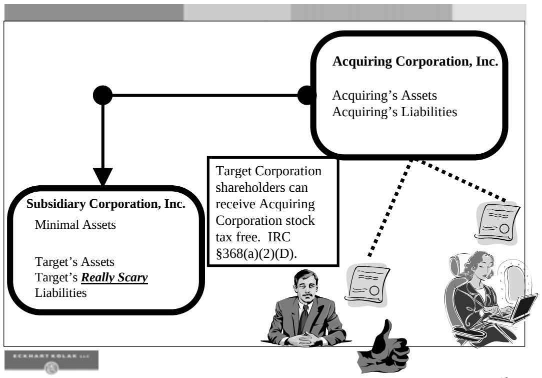
Type A Forward Triangular Merger



Type A Forward Triangular Merger



Type A Forward Triangular Merger

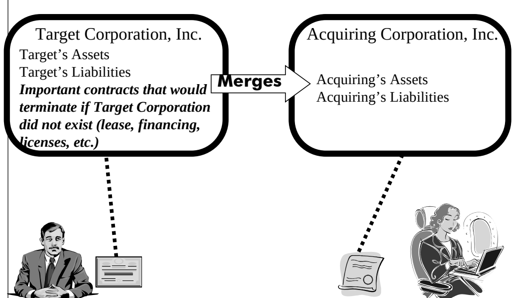


Type A Forward Triangular Merger Take-Away

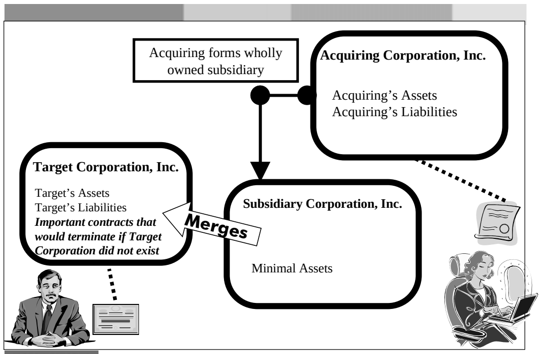
If your Target Corporation contains liabilities that you want to keep out of the Acquiring Corporation…

…have the Acquiring Corporation form a subsidiary, and merge the Target Corporation into the subsidiary, thereby isolating the Target Corporation's liabilities in the subsidiary.

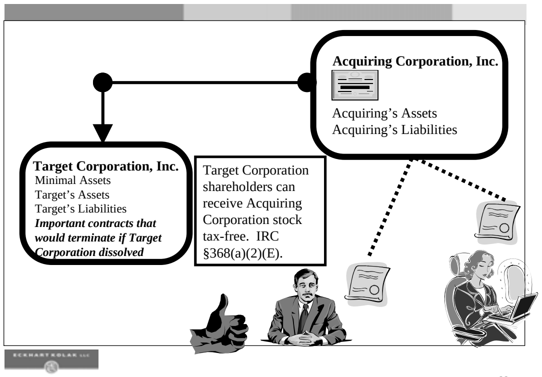
Type A Reverse Triangular Merger



Type A Reverse Triangular Merger



Type A Reverse Triangular Merger

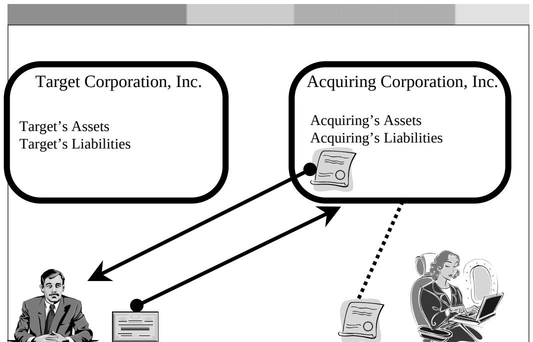


Type A Reverse Triangular Merger Take-Away

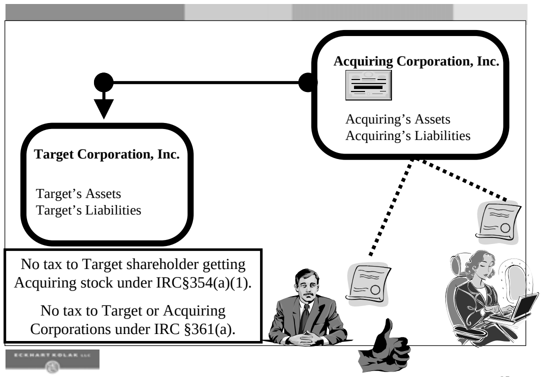
If your Target Corporation has important contracts that would be terminated if the Target Corporation did not exist…

…have the Acquiring Corporation form a subsidiary, and merge the subsidiary into the Target Corporation, with the Target Corporation as the surviving corporation.

Type B Stock-for-Stock Reorganization



Type B Stock-for-Stock Reorganization



Type B Stock-for-Stock Reorganization – 9 Requirements

- ✓ The target entity must be considered a corporation for federal tax purposes. Reg. §1.368-2(b)(1)(i)(B).
- ✓ The acquiring entity must be considered a corporation for federal tax purposes. Reg. §1.368-2(b)(1)(i)(B).
- ✓ There must be a plan of reorganization. Reg. §1.368-1(c).
- ✓ Continuity of shareholder interest must be maintained. Reg. §1.368-1(e)(1)(i).
- ✓ Continuity of business enterprise must exist. Reg. §1.368-1(d)(1).
- ✓ A business purpose for the reorganization must exist. Reg. §1.368-1(c).
- ✓ Reporting and record keeping requirements must be met. Reg. §1.368-3T.

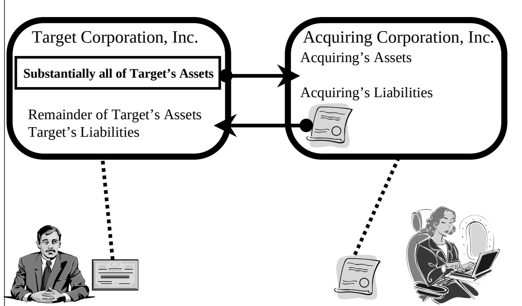
Type B Stock-for-Stock Reorganization – 9 Requirements

- ✓ The acquiring corporation must acquire control of the target corporation, meaning at least 80% of the voting power and 80% of each class of the target corporation's stock. IRC §368(a)(1)(B), 368(c).
- ✓ The target corporation shareholders must receive ***only voting stock*** in the acquiring corporation. IRC §368(a)(1)(B). No boot is allowed!

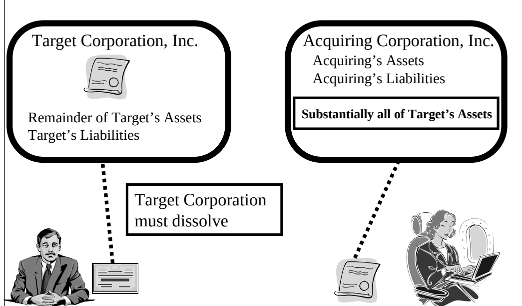
Why Use a Type B Stock-for-Stock Reorganization?

- ✓ Since there is only an exchange of stock, the Target Corporation remains unchanged – no mergers into or out of the Target Corporation.
- ✓ There is no transfer of the Target Corporation's assets which could require the consent of a third party, or trigger a termination right or default under a contract.
- ✓ Most of the above can be accomplished using a reverse triangular merger (which can include boot), so Type B stock-for-stock reorganizations are not often used.

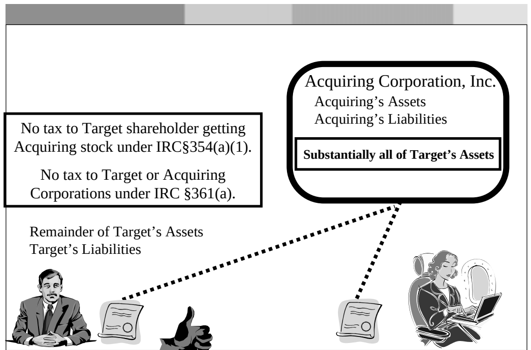
Type C Stock-for-Assets Reorganization



Type C Stock-for-Assets Reorganization



Type C Stock-for-Assets Reorganization



Type C Stock-for-Assets Reorganization – 11 Requirements

- ✓ The target entity must be considered a corporation for federal tax purposes. Reg. §1.368-2(b)(1)(i)(B).
- ✓ The acquiring entity must be considered a corporation for federal tax purposes. Reg. §1.368-2(b)(1)(i)(B).
- ✓ There must be a plan of reorganization. Reg. §1.368-1(c).
- ✓ Continuity of shareholder interest must be maintained. Reg. §1.368-1(e)(1)(i).
- ✓ Continuity of business enterprise must exist. Reg. §1.368-1(d)(1).
- ✓ A business purpose for the reorganization must exist. Reg. §1.368-1(c).
- ✓ Reporting and record keeping requirements must be met. Reg. §1.368-3T.

Type C Stock-for-Assets Reorganization – 11 Requirements

✓ The acquiring corporation must acquire substantially all of the target corporation's assets. IRC §368(a)(1)(C).

a. "Substantially all" means 90% of the fair market value of the net assets, and 70% of the fair market value of the gross assets. Rev. Proc. 77-37, 1977-2 C.B. 568 (for advance ruling purposes).

9. The acquiring corporation can assume some or all of the target corporation's liabilities. IRC §368(a)(1)(C).

✓ The target corporation shareholders can receive as consideration only ***voting stock*** in the acquiring corporation, plus up to 20% of total consideration in boot. IRC §368(a)(2)(B).

a. If the acquiring corporation assumes any liabilities of the target corporation, the assumed liabilities count towards the 20% boot limit.

11. The target corporation must liquidate after the reorganization. IRC §368.

Why Use a Type C Stock-for-Assets Reorganization?

- ✓ The acquiring corporation can pick and choose the assets of the target corporation to be acquired (but must acquire “substantially all” of the assets).
- ✓ The acquiring corporation does not have to assume any of the target corporation liabilities, but may assume some or all of them if desired. Any assumed liabilities count towards the 20% boot limit.

Two important take-aways to remember

If the buyer in your deal if paying for the target company partly (at least 40%) in the stock of the acquiring company…
…you might be able to structure the deal as a tax-free reorganization, at least with regard to the stock in the acquiring corporation being given.

Type A Mergers (including forward triangular mergers and reverse triangular mergers) are simpler to implement and have fewer traps than Type B or Type C reorganizations.

M&A Federal Tax Reference Materials

- ✓ Jeffrey S. Shamberg, *M & A Tax Basics*, in IICLE Business Law Volume IV (2005).
- ✓ Practicing Law Institute, *Acquiring or Selling the Privately Held Company* (2006) (updated each year).
- ✓ Martin T. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts* (2006).
- ✓ Fed. Tax Coordinator 2d (RIA), *Corporate Reorganizations*, ¶ F-2000 et seq. (2010).
- ✓ Barnet Phillips, *Structuring Corporate Acquisitions -- Tax Aspects*, in BNA Tax Management Portfolio, U.S. Income Series, 770-2nd (2005).

Conclusion.

Questions?

Speaker Biography.

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Ray has special expertise with purchases, sales, and mergers of businesses, and financing with debt and equity. Ray has been involved in numerous sales or purchases of businesses, and has experience with tax planning, due diligence, agreement negotiations, and closings for those transactions.

Ray also advises real estate investors on real estate transactions, including purchases, sales, leases, financing, construction, zoning, real estate taxes, and ownership planning. He has represented clients buying shopping centers, buildings in the Chicago Loop, and large tracts of vacant land.

Ray is a member of the American, Illinois State and Chicago Bar Associations. He is the former Chair of the Corporation and Business Law Committee of the Chicago Bar Association, and is Co-Chair of its Mergers and Acquisitions Subcommittee. He is a board member of Midwest Business Brokers and Intermediaries Association, and a member of the Union League Club of Chicago. He has also been an active member of Chicago Volunteer Legal Services.

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