I. **Introduction** - The tax consequences to the parties should always be evaluated in the purchase and sale of a corporation. The transaction may be structured as an asset acquisition or a stock acquisition, and may be taxable or tax-free. While the tax consequences of a transaction generally do not dictate the overall transaction structure, there are times when they will (e.g., in the situation where Seller may realize a substantial gain or Buyer may realize a significant benefit and is willing to pay a premium for this benefit).

This outline summarizes the following tax considerations/issues:

A. Tax Objectives of Buyer and Seller

B. Taxable Acquisitions - Stock Acquisitions and Asset Acquisitions

C. Obtaining Asset Purchase Treatment in a Stock Transaction - IRC\(^2\) §338

D. Purchase Price Allocation and Asset Basis Step-up

E. Obtaining Seller Tax Deferral

F. Tax Free Reorganizations

As referred to in this outline, unless otherwise stated, “Buyer” is a corporation, “Seller” may be a corporation but is typically an individual or group of individuals, and “Target” is a corporation.

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2 All references to “IRC” are to the Internal Revenue Code of 1986, as amended. All “Regulations” or “Treas. Regs.” references are to Title 26 of the Code of Federal Regulations promulgated under the IRC.
II. Tax Objectives of Buyer and Seller

A. Seller Objectives

1. Maximize After-Tax Proceeds - The Seller’s main objective in most transactions is to maximize its after-tax cash proceeds. To meet this objective, the transaction must be structured so that the proceeds are subject to tax only once at the lowest possible tax rate.

   a) Avoid Two Levels of Taxation on Proceeds – Asset acquisitions ordinarily result in two levels of tax; stock acquisitions generally result in only one level of tax.

   b) Proceeds Taxed at Capital Gains Rates versus Ordinary Income Rates – Gain from the sale of stock is ordinarily subject to tax at the capital gains tax rate.\(^3\) The characterization of gain realized on the sale of assets is determined on an asset-by-asset basis (e.g., gain on the sale of inventory is ordinary income; gain on the sale of goodwill is capital gain).

      (1) Corporate Seller - Corporations are subject to a maximum capital gains tax rate and ordinary income tax rate of 35% for US federal income tax purposes; thus the characterization of the gain from the corporate Seller’s perspective should have no real tax impact.\(^4\) However, if Seller has a capital loss carryforward that will expire, and it will likely not generate any other capital gain prior to the expiration, the capital loss carryforward can be used to offset the capital gain, which could have a real tax impact.

      (2) Individual Seller - For US federal income tax purposes, individuals are subject to a capital gains tax rate of 15%, while the ordinary income tax rate can be as high as 35%.\(^5\) Through 2010, qualifying dividends (from domestic corporations and certain foreign corporations) are subject to a reduced tax rate of 15% as well, though historically dividends are more typically taxed at full ordinary rates. Thus, in the case of an individual Seller whether the transaction results in capital gains or ordinary income may significantly impact the shareholder’s after-tax proceeds.

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\(^3\) Gain from the sale of stock would be taxed at ordinary income rates if the stock were inventory in the hands of Seller (e.g., Seller is a dealer in securities).

\(^4\) See IRC §11.

\(^5\) See IRC §1(h) and 1(i). The capital gains tax rate may be higher than 15% depending upon the type of property. The 15% rate is scheduled to expire at the end of 2010; unless extended, the rate will increase to 20%.
c)  *State Taxes* - In addition to federal income taxes, the proceeds may be subject to state and local income and non-income taxes (e.g., sales of assets in New York may be subject to a sales and use tax). Tax rates vary from state to state (as do local tax rates) and depending upon the state, the tax exposure could be significant (e.g., corporate income tax rate in California and New York is 8.84% and 7.5%, respectively).

2.  **Tax Deferral Transaction** - The transaction may be structured so that Seller can defer payment of tax on the gain to another year. Anytime a taxpayer can push income into a later year and postpone payment of a tax, the taxpayer will realize an economic benefit. In a typical tax deferral transaction, Seller receives a portion of (or all of) the consideration from Buyer in notes or stock.

3.  **Potential Disallowed Loss** - If a corporate Seller realizes a loss on the sale of stock of certain corporate subsidiaries, the loss may be disallowed (i.e., Seller can not take a deduction for US federal income tax purposes). The loss disallowance rules apply to losses recognized by a corporate Seller on the sale of stock of a corporate subsidiary of which it owns at least 80% of the vote and value.

### B. Buyer Objectives

1.  **Minimize Post-Acquisition Taxes** – Buyer wishes to maximize basis in Target’s assets. Generally, only in an asset acquisition (or a deemed asset acquisition under IRC §338) does Buyer get a step-up in the basis of Target’s assets. In a straight stock acquisition, Buyer takes a carryover basis in Target’s assets.

   a)  *Maximize Depreciation and Amortization Deductions* - If a transaction is structured so that a Buyer can “step-up” the basis in Target’s fixed and intangible assets to fair market value, Buyer obtains additional depreciation and amortization deductions.

   b)  *Minimize Gain on Subsequent Disposition* - A step-up in Target’s assets would also result in a reduction in the amount of taxable gain realized on a subsequent disposition of unwanted assets.

   c)  *Debt Push-Down Strategy* - To minimize state and foreign income taxes, if there is indebtedness on the books of Target or Buyer (or one of its subsidiaries), Buyer may consider a debt “push-down,” thereby creating additional interest deductions for its tax paying subsidiaries.

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6 See Treasury Regulation §1.337(d).
Each state and foreign country has its own set of rules regarding indebtedness and interest deductions. Before a debt “push-down” strategy is implemented, the rules pertaining to indebtedness and interest deductibility for each jurisdiction should be reviewed.

2. **Recovery of Purchase Price** - By allocating the purchase price over Target’s assets, Buyer recovers the purchase price through sales of inventory and depreciation and amortization deductions. A Buyer can allocate purchase price only in an asset (or deemed asset) acquisition. In a stock acquisition, purchase price is only allocated to Buyer’s basis in Target stock; Target stock is not an amortizable asset.\(^7\)

3. **Facilitate Integration of Target** - If the Buyer intends to integrate Target or Target’s assets into its own business, it will want to structure the deal so that it may efficiently do this.

   a) **Example** – Target operates business A, which is similar to Buyer’s business B. In acquiring business A (whether Buyer acquired the stock of Target or Target’s assets), Buyer would want to structure the acquisition so that it could easily integrate Target’s business A into its business B.

### III. Taxable Acquisitions – Stock Acquisitions and Asset Acquisitions

**A. Straight Stock Acquisition** - In a straight stock acquisition Buyer acquires the stock of Target in exchange for consideration (e.g., cash, stock, other property).

1. **Seller’s Gain/Loss** - Seller realizes capital gain or loss on the sale of Target stock equal to the difference between its adjusted basis in Target stock and the amount paid by the Buyer.\(^8\) In a straight stock acquisition, gain is taxed only once at the shareholder level.

   a) **Example** - Assume Seller, an individual, intends to sell Target stock for $100. The Seller has a $40 basis in Target stock. Capital gains are taxed at a 15% rate.\(^9\)

       (1) If Seller sells Target stock to Buyer, Seller will realize a gain of $60 and recognize a $9 tax liability.

       (2) Seller has after-tax proceeds of $91.

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\(^7\) IRC §197(e)(1).

\(^8\) IRC §1001.

\(^9\) Unless otherwise indicated, tax rates are federal only. But bear in mind that state tax rates, which vary from state to state, must be considered as well.
b) **State Income Tax** - Gain is ordinarily subject to tax only in the state where Seller is a resident.

2. **Buyer’s Basis**

   a) **Target Stock** - In a straight stock acquisition, Buyer’s basis in Target stock is equal to the amount paid to Seller (including cash, notes and the fair market value of property).  

   b) **Target’s Assets and Tax Attributes** - Buyer takes a carryover basis in Target’s assets and tax attributes (i.e., Buyer inherits Target’s basis in its assets, net operating losses and earnings and profits). Buyer generally can use Target’s pre-acquisition tax attributes (e.g., net operating losses and tax credits) to offset future taxable income. However, utilization of these tax attributes will be limited.

   (1) **Due Diligence** – The tax due diligence process should include procedures to quantify Target’s net operating losses and tax credit carryforwards and identify any limitations to which the tax attributes are currently subject.

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10 IRC §1012 and §1001(b).
11 See IRC §382, §383 and Treas. Regs. §1.1502-21. For IRC §382 and also §383 purposes, the limitation is determined by multiplying the stock value of Target immediately before the acquisition by the applicable federal rate (published monthly). Going forward the pre-acquisition NOLs and tax credits may only be used to offset post-acquisition taxable income up to the IRC §382 limitation. For example, assume on the day that Buyer acquires Target stock Target has a NOL carryforward of $100. Applying the rules of IRC §382, an IRC §382 limitation of $30 is calculated. If in a year subsequent to Buyer’s acquisition, Target generates $40 of income, only $30 of its $100 NOL carryforward could be used to offset this taxable income. For Treas. Regs. §1.1502-21 purposes, if Target will join Buyer’s consolidated US tax filing, Target’s losses generated prior to joining Buyer’s consolidated group may only be used to offset future taxable income generated by Target, and not income generated by Buyer or other members of its consolidated group. Treas. Regs. §1.1502-21 does not apply if Buyer’s acquisition of Target stock also results in an IRC §382 limitation.
3. **Historical Tax Liability** – Target, and indirectly Buyer, is liable for all pre-acquisition federal and state income and non-income tax liabilities (e.g., sales and use, payroll) and all other liabilities of the Target.

   a) **Due Diligence** - In a stock acquisition, the tax due diligence process should include procedures to identify and quantify any income and non-income tax exposures.

   b) **Indemnifications** - Buyer may seek an indemnification from Seller against all pre-acquisition tax liabilities by including such provisions in the acquisition documents.

   c) **Consolidated Tax Liability** - In addition, if Target filed its pre-acquisition federal income tax return as part of a consolidated group, Target may be liable for all pre-acquisition federal tax liabilities of any entity included in that filing.\(^{12}\)

      (1) Liability resulting from this provision is less of an issue where Seller is financially strong. If Seller is not financially strong, due diligence on every entity in Seller’s consolidated filing may be warranted to assess all exposures that Target (and indirectly Buyer) could be liable for.

      (2) An indemnification provision should be crafted so that Buyer has recourse against the Seller for tax liabilities that Target may be responsible for that relate to the operations of other members of the consolidated group.

**B. Taxable Asset Acquisition** - In an asset acquisition, Buyer acquires Target’s assets directly from Target in exchange for consideration. Target then distributes the consideration (net of tax) to Seller in liquidation.

   a) **Taxable Consideration** - Taxable consideration includes the amount paid by Buyer (e.g., cash, notes, fair market value of other property given to the seller) plus the liabilities of Target that Buyer is assuming (e.g. accounts and notes payable).\(^{13}\)

2. **Proceeds Subject to Two Levels of Tax** - In an asset acquisition, the proceeds are subject to tax twice.

   a) **First Level** - Target is taxed on the gain realized (i.e., the amount by which the taxable consideration exceeds Target’s adjusted basis in the assets sold).\(^{14}\) As Target is a corporation ordinary income and capital

\(^{12}\) Treas. Regs. §1.1502-6.
gains are taxed at the same tax rate, the characterization of the gain should not have a tax impact.\footnote{15}

b) \textit{Second Level} - Seller is taxed on the gain it recognizes (i.e., the excess of the consideration distributed to it by Target over Seller’s adjusted basis in Target stock).\footnote{16}

\begin{itemize}
  \item[(1)] The amount of taxable consideration realized by Target may not be the same as the amount realized by Seller. Ordinarily, the amount of consideration distributed by Target to Seller is net of any tax due by Target.
  \item[(2)] Gain recognized by Seller in liquidation of subsidiary stock generally is subject to the capital gains tax.
\end{itemize}

3. \textbf{Example}

a) Assume Seller, an individual, intends to sell Target assets for $100. Target has an adjusted basis in its assets of $30. Seller has a basis of $40 in Target stock. The corporate tax rate on capital gains and ordinary income is 35%. The individual capital gains tax rate is 15%.

\begin{itemize}
  \item[(1)] If Buyer acquires all of Target’s assets for $100 (and does not assume any Target liabilities), Target will recognize a gain of $70 and incur a tax liability of $24.50.
  \item[(2)] After payment of its tax liability, in a liquidating distribution, Target distributes $75.50 ($100 proceeds less $24.50 tax liability) to Seller. As a result of the liquidating distribution, Seller recognizes gain of $35.50, resulting in a tax liability of $5.30.
  \item[(3)] Seller has after-tax proceeds of $70.20.
\end{itemize}

\footnote{13} IRC §1012. \footnote{14} IRC §1001. Target recognizes loss if the amount of taxable consideration is less than its adjusted basis in the assets sold. \footnote{15} Except in the situation where capital losses are available to offset capital gain. Additionally, note that gain on the sale of depreciable fixed assets (e.g., building, machinery and equipment) might be treated as ordinary income to the extent of depreciation recapture under IRC §1245 and §1250. \footnote{16} IRC §1001. The Seller may recognize a loss if the liquidating distribution is less than its adjusted basis in Target stock.
b) In the example from the Stock Acquisition section, Seller had $81 of after-tax proceeds, while in this example Seller only has $70.20 of proceeds.

4. **Buyer’s Basis** – In an asset acquisition Buyer’s resulting basis in each of Target’s assets is equal to the fair market value of each asset on the date of acquisition.\(^{17}\)

   a) **Step-up/Step-down in Asset Basis** - If the fair market value of the assets is greater than Target’s adjusted basis, the assets are “stepped up.” If the fair market value of the assets is less than Target’s adjusted basis, the assets are “stepped down.”

   b) **Asset Tax Life** - In an asset acquisition, Buyer gets a “fresh start” at depreciating/amortizing Target’s fixed assets and intangibles (i.e., in the year of the acquisition, the depreciable/amortizable life starts over from year 1). The basis used for the depreciation/amortization calculation is the fair market value on the date Buyer acquires it.

   (1) **Example** - Assume Target has an asset with a five-year tax life. This asset is acquired after Target has taken three years of depreciation deductions. In the year of the acquisition the depreciation deduction is the amount calculated using the appropriate depreciation method beginning in year one, and the depreciable basis is the fair market value of the asset on the date of acquisition. From Buyer’s perspective, the three years that Target depreciated this asset are ignored.

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\(^{17}\) IRC §1060 referring to IRC §338(b)(5).
5. **Cost/Benefit Analysis** – Due to the double tax, the present value of the benefit that Buyer will realize by acquiring Target’s assets will never exceed the additional cost associated with an asset acquisition.\(^{18}\) Only in unusual circumstances will Buyer want to incur the additional cost (i.e., Target has net operating losses that Buyer can use).

6. **Historic Tax Liabilities** – Generally, Buyer is not liable for any pre-acquisition federal or state income tax liabilities of Target for periods prior to the acquisition. The Buyer may be responsible for pre-acquisition non-income tax liabilities (e.g., sales and use taxes). The Buyer may seek to include an indemnification from the Seller for pre-acquisition non-income taxes that Target may remain liable for (e.g., sales and use taxes).

   a) **Due Diligence** - In an asset acquisition, ordinarily the tax due diligence process is limited to reviewing the federal and state non-income tax exposure items that may exist (e.g., payroll tax, sales and use tax).

**C. Taxable Asset Acquisitions – Avoiding Double Taxation**

1. As noted above, due to the prohibitive costs, asset acquisitions are unusual. However, there are some situations where double taxation may be avoided and structuring the transaction as an asset acquisition is feasible.

2. **Divisions and 80% owned subsidiaries**

   a) **Divisions** - A division is operated by the Seller and not through an entity separate from the Seller. Thus, in a disposition of a division, the Seller will be treated as selling division assets directly to Buyer and the only level of taxation is at the Seller level.

      (1) **Limited Liability Company ("LLC")** – Generally, single member LLCs are treated as entities disregarded from their owners.\(^{19}\) For US federal income tax purposes, the LLC’s operations and transactions are treated as occurring by the Seller. Thus, where a LLC has sold its assets, the Seller will be treated as selling the assets directly to Buyer and the only level of taxation is at the Seller level.

      (2) **State Income Taxes** - Not all state and local jurisdictions recognize a LLC as an entity disregarded from its owner (e.g., Texas). During the tax due diligence process, state tax

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\(^{18}\) The present value of the benefit is determined by calculating the present value of additional depreciation and amortization deductions that the Buyer will obtain in an asset acquisition.

\(^{19}\) Treas. Regs. §301.7701-1 and –3. LLCs may elect to be taxed as corporations for US federal (and some state) income tax purposes. If the LLC makes such an election, the LLC will be treated as a corporate entity separate from Seller, and a disposition of its assets will be subject to the same tax consequences discussed in the previous section.
consequences should be evaluated to quantify the state and local tax exposure, if any.

b) **80% Owned Subsidiaries** - A distribution in liquidation of a domestic subsidiary to its domestic corporate shareholder is not taxable if the corporate shareholder owns at least 80% (vote and value) of the stock of the liquidating subsidiary.\(^{20}\) Thus, in such cases, only the gain on the sale of assets, and not on the disposition of the stock, is taken into account.

3. **Partnerships**\(^{21}\)

a) **Taxation of Partnership Operations** - Subchapter K of the IRC governs the taxation of partnerships and partners, and provides, in essence, that a partnership is not an entity subject to tax.\(^{22}\) Instead, the operations (e.g., income, deductions, losses) of the partnership flow through to the partner who is then subject to tax on these operations.\(^{23}\) Partnership income and gain is taxable to the partner whether or not the partnership actually distributes cash or other property to the partner.

   (1) Characterization of partnership items is determined at the partnership level and is taxed by the partner accordingly (e.g., sales from partnership inventory are taxed at ordinary income rates to the partner).

   (2) The tax characterization of gain realized by the partnership upon the disposition of its assets is determined on an asset-by-asset basis. Gain realized from the sale of “hot assets” (e.g., appreciated inventories and accounts receivable) is taxed at ordinary rates.\(^{24}\)

b) **Allocation of Partnership Items** - Income, deductions, credits, gains and losses are allocated to the partners based upon the partnership agreement. Where the partnership agreement is silent on the allocation method, these items are allocated in accordance with each partner’s interest in the partnership.\(^{25}\)

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\(^{20}\) See IRC §332. This rule is also applicable to a LLC that has elected to be treated as a corporation for US income tax purposes.

\(^{21}\) Including LLCs with more than one owner that have not elected to be treated as corporations for US income tax purposes.

\(^{22}\) IRC §§701 et seq.

\(^{23}\) IRC §701. A partner's ability to deduct partnership losses is limited to the partner’s basis in its partnership interest; however, this basis includes not only the cash and the basis of any property that it contributes to the partnership but also its allocable share of partnership liabilities. IRC §752.

\(^{24}\) IRC §751.

\(^{25}\) IRC §704.
(1) The partnership agreement can provide for an allocation method that is not in accordance with the partner’s interest in the partnership (e.g., an 80% partner may be allocated 100% of the deductions and losses). The Regulations provide for complex rules and requirements that must be met in order for a special allocation to be respected. 26

(2) A partner’s basis in its partnership interest is increased by income and gain allocated to it, and decreased by deductions and losses allocated to it.

c) Example - Assume Target is a partnership and it sells its assets 27 for $100. Target has an adjusted basis in its assets of $30. Two corporations own Target; each partner owns 50% of Target and has a basis of $10 in their respective partnership interests. Partnership items are allocated based on each partner’s partnership interest. Capital gains and ordinary income are taxed at 35%.

(1) If Buyer acquires all of Target’s assets for $100 (and does not assume any Target liabilities), Target recognizes a capital gain of $70. Target is not an entity subject to taxation, and passes the $70 of gain through to its partners.

(2) Each partner is allocated $35 of gain, which increases each partner’s basis to $45.

(3) Target distributes the $100 of proceeds to the partners in liquidation of the partnership. Each partner’s gain related to this distribution is $5 ($50 of proceeds less $45 of adjusted basis).

(4) As a result of the asset disposition and the liquidation of the partnership, each partner recognizes $40 of gain ($35 of gain from the asset disposition and $5 of gain from the partnership liquidation) and incurs a tax liability of $14.

(5) The partners’ aggregate after-tax proceeds are $72.

d) Historic Tax Liabilities - Generally, an incoming partner is not subject to pre-acquisition income tax liabilities related to the operations of the partnership. However, the incoming partner may be subject to pre-acquisition non-income liabilities (e.g., sales and use tax).

26 Treas. Regs. §1.704-1.
27 All of the assets are capital assets; the partnership has no hot assets.
(1) **Due diligence** – The due diligence process should focus on potential non-income tax liability exposures that the incoming partner may be liable for.

e) **IRC §754 Election** – A tax basis step-up can be obtained even on a purchase of an interest in a partnership. Buyer can get a “step-up” or “step-down” in the adjusted basis of its allocable share of partnership assets if an IRC §754 election is in effect when it acquires its interest in the partnership.28

(1) A partnership makes the IRC §754 election by filing the appropriate form with the IRS. Once made, the election is effective on all subsequent sales and exchanges of partnership interest until the election is terminated (e.g., with permission by the IRS or by a termination (technical or actual) of the partnership).29

(2) Whether an IRC §754 election is in effect should be confirmed during the due diligence process.

4. **S Corporations**

   a) **Taxation of S Corporations** - Subchapter S of the IRC,30 exempts electing corporations from the corporate income tax by taxing the shareholder(s) on the corporate income, whether or not distributed, under a conduit or pass-through regime similar to partnerships.31

   (1) Income, losses, deductions, and credits retain their corporate-level character when allocated to the S corporation's shareholder(s) on a per-share, per-day basis and are treated by the shareholder(s) as if attributable directly to the source from which they were generated.32 Income and gain items increase a shareholder’s basis in its S corporation stock and deduction and loss items decrease this basis.33

   (2) Unlike partnerships where special allocations are allowed, the S corporation’s operations must be allocated in accordance with the shareholder’s stock interest. For example, if the shareholder

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28 See IRC §743 and §755.
29 Treas. Reg. §1.754-1(c).
30 IRC §1361, et seq.
31 IRC §1363(a). Under § 1363(a), S corporations are not subject to income taxes except for the tax on built-in gains and the special tax on excess passive investment income imposed by §§ 1374 and 1375, respectively.
32 See IRC §1366 and §1377(a)(1).
33 IRC §1367(a)(1).
owns 80% of the S corporation, it is allocated 80% of the income, deductions, losses, and credits generated by the S corporation.

b) Typical Transaction Steps - The steps involved in the acquisition of assets from an S corporation are the same as the acquisition of assets from a C corporation. The Buyer acquires the assets from Target in exchange for consideration. Target then distributes the proceeds to its shareholder, in a liquidating distribution.

c) Example - Assume Target is an S corporation with a $30 basis in its assets (all assets are capital assets). S corporation will sell its assets for $100. Shareholder, an individual, owns 100% of S corporation and has a $10 basis in its S corporation stock prior to the asset sale. The capital gains tax rate is 15%.

(1) As a result of selling the assets, S corporation realizes $70 of gain.

(2) The gain is passed through to shareholder; the shareholder includes the $70 capital gain on its tax return. Additionally, the shareholder’s basis is increased to $80 as a result of the S corporation’s gain allocated to it.

(3) S corporation distributes the $100 proceeds to shareholder in liquidation. Shareholder will recognize gain of $20 ($100 proceeds less $80 adjusted basis) on this liquidating distribution.34

(4) As a result of the sale of S corporation assets and the liquidating distribution, shareholder recognizes an aggregate capital gain on its tax return of $90 ($70 allocated by S corporation and $20 as a result of the liquidating distribution) and recognizes a tax liability of $13.50 ($90 gain at a 15% capital gain tax rate). Shareholder’s after-tax proceeds are $86.50.

d) Requirements - Not every corporation is eligible to elect S corporation status. For example, to be an S corporation, the entity must be a domestic corporation with one class of stock and can have no more than 75 domestic individual (as well as certain trusts and estates) shareholders. If a corporation meets all the requirements, it must file the appropriate form with the IRS.35

34 IRC §331.
35 See IRC §1361 and §1362(a). The IRS will generally send an acknowledgement to the corporation.
(1) **Due Diligence** - The S corporation election, as well as the IRS acknowledgement, should be reviewed to ensure that the S corporation election was properly filed.

(a) In addition, all requirements to be an S corporation should be reviewed (e.g., historical shareholders, prior new issuances of stock) to confirm that the S corporation election was not involuntarily terminated.\(^{36}\)

e) **Historic Tax Liabilities** - Generally, a new shareholder is not subject to pre-acquisition income tax liabilities related to the operations of the S corporation. However, Target remains subject to pre-acquisition non-income tax liabilities (e.g., sales and use tax).

(1) **Due diligence** – The due diligence process should focus on potential non-income tax liability exposures that the new shareholder may be liable for.

f) **IRC §1374 Built-in Gains Tax** - S corporations incur a corporate level tax to the extent of built-in gains.

(1) If S corporation was a C corporation at any time within the prior 10 years, any gain realized on the transaction will be subject to an entity level tax (at the highest corporate rate), as well as a shareholder level tax, if the gain is attributed to appreciated assets that the S corporation held on the day that the C corporation converted to S corporate status. This is referred to as a “built-in gains” tax.\(^{37}\)

(a) In addition to converting in the prior 10 years, the corporation must have had a net unrealized built in gain (“NUBIG”) on the date of the conversion from C corporation status to S corporation status.

(b) The amount of gain subject to the built-in gains tax is calculated in accordance with complex tax rules located in the IRC and Regulations.

(c) If the S corporation was a C corporation in the prior 10 years, and the S corporation had a NUBIG on the date of conversion, if it can establish that the appreciation was not

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\(^{36}\) See IRC §1362(d). Involuntary termination may also occur if the S corporation generates a certain amount of passive income each year for three consecutive years. See IRC §1362(d)(3).

\(^{37}\) See IRC §1374. A principal purpose of the built in gains tax was to prevent a C corporation (and its shareholders) from circumventing the entity level tax on the disposition of appreciated property by electing S corporation status and subsequently disposing of the asset.
generated during the period that it operated as a C corporation or that it did not own the asset while it was a C corporation, the gain will not be subject to the built in gains tax.

(d) Due Diligence - During the tax due diligence process, if the Buyer is an eligible shareholder and intends to continue operating Target as a S corporation, and the S corporation was converted from a C corporation in the prior 10 years, the amount of built-in gains, if any, should be confirmed.

IV. Obtaining Asset Purchase Treatment in a Stock Transaction – IRC §338

A. General Rule - IRC §338 provides that if a Buyer acquires Target stock and makes an election in connection with this stock acquisition, for US federal income tax purposes the transaction will be treated as an asset acquisition.

1. Transaction Steps - The statute provides that in the event of an IRC §338 election, Target is first treated as having sold all of its assets in a single transaction at fair market value as of the acquisition date. Target is then treated as a separate and distinct “new” corporation that purchased all the “old” Target assets as of the beginning of the day immediately following the acquisition date.38

2. IRC §338 Elections - IRC §338 provides for two elections (i) IRC §338(g) election and (ii) IRC §338(h)(10) election.

38 IRC §338(a).
B. IRC §338(g) Election - An IRC §338(g) election is a unilateral election made by Buyer. As this election is unilateral, asset acquisition treatment is only with respect to Buyer; Seller is still treated as selling stock of Target.

1. **Tax Treatment**

   a) **Seller (Stock Acquisition Treatment)** – Gain or loss is calculated as the difference between the purchase price (consideration received from Buyer) and Seller’s adjusted basis in Target stock (same as in a straight stock sale).

   b) **Buyer (Asset Acquisition Treatment)** - Buyer adjusts its basis in Target’s assets to fair market value (i.e., the “step-up” or “step-down”).

   c) **Target (Asset Acquisition Treatment)** – Gain or loss will be recognized to the extent of any difference between the taxable consideration and Target’s adjusted basis in its assets. Tax will be due on any gain recognized.

      (1) As the owner of Target, Buyer presumably has the responsibility for the tax liability recognized by Target.

   d) An IRC §338(g) transaction is applicable if the Target is a foreign or domestic corporation. Because the proceeds are subject to full double taxation, this election is rarely used in the acquisition of a domestic target.

C. IRC §338(h)(10) - An IRC §338(h)(10) election is a bilateral election that results in asset acquisition treatment to all parties (e.g., Seller, Buyer and Target).

1. An IRC §338(h)(10) election has the same impact as a straight taxable asset acquisition, in that Target is treated as selling assets to Buyer and subsequently distributing, in a liquidating distribution, the net proceeds to Seller.

2. The IRC §338(h)(10) election is available in certain instances where double taxation is generally avoided - when Target is an 80% owned domestic subsidiary, and where Target is an S corporation.

3. **Feasibility of Election** - In determining whether an IRC §338(h)(10) election is feasible, the overall additional costs and benefits associated with the election should be calculated and compared to the gain (or loss) that would be recognized in a straight stock acquisition. Seller will often expect Buyer to compensate it (i.e., via increased purchase price) for the additional tax that will be due as a result of the election.
D. General Requirements for IRC §338 Elections - The following is a list of some of the requirements needed to make an IRC §338 election.

1. Buyer must be a corporation.

2. Target must be a corporation. Target can be either a C corporation or an S corporation. The election is not applicable to partnerships or limited liability companies.

3. The acquisition must be a qualified stock purchase. To be a qualified stock purchase the Buyer must acquire at least 80% of Target’s stock during a 12-month period in a taxable transaction.\(^{39}\)

4. The election must be filed timely. In the case of an IRC §338(h)(10) election, both the Buyer and Seller must file the appropriate form.

5. In the case of an IRC §338(h)(10) election, Buyer and Seller must each agree to the election.

E. If made, an IRC §338 election is applicable to only one specific entity and for one specific transaction. Thus, in a single acquisition in which a Buyer acquires the stock of several corporations, a separate IRC §338(h)(10) or (g) election must be made for each corporation that is acquired and for which the Buyer intends to step-up the basis.

F. IRC §1374 Built-in Gains Tax - If an IRC §338 election is made on an S corporation Target, any built-in-gain as a result of the S corporation once being a C corporation that has not yet been recognized is currently triggered.

   1. Due Diligence - During the due diligence process if Target is an S corporation and Buyer intends to make an IRC §338 election, the amount of federal and state built-in gains tax that may be triggered should be quantified.

G. State Taxes - Generally, all states recognize the IRC §338 elections. However, some states may require a separate filing. During the due diligence process, state tax considerations should be evaluated so that any state income tax exposure may be quantified.

V. Purchase Price Allocation and Asset Basis Step-up

A. Purchase Price Allocation and Asset Basis Step-up - In either a straight asset acquisition or a deemed asset acquisition as a result of an IRC §338 election purchase price is allocated among Target’s assets. The allocation is done according to asset class and based upon the fair market value of each asset on the date of the acquisition. Asset

\(^{39}\) IRC §338(h)(1).
basis is stepped up, if the fair market value of the asset is greater than Target’s adjusted basis.

**B. Method of Allocation** - Purchase price is first allocated to Class I assets, then to Class II assets, then to Class III assets, and so on, until purchase price has been fully allocated. 40

**C. Seven Asset Classes Used to Allocate Purchase Price** 41

1. Class I assets include cash, savings accounts and checking accounts.

2. Class II assets include publicly traded stock (not stock of subsidiaries or affiliates), US government securities, certificate of deposits, and foreign currency.

3. Class III assets include assets that are marked to market annually such as accounts receivable and certain debt instruments.

4. Class IV assets are inventories.

5. Class V is a “catch all” class. It includes all other tangible assets not included in any of the other classes such as fixed assets (e.g., building, land, office equipment) and stock of subsidiaries and affiliates.

6. Class VI includes intangibles as defined in IRC §197 except for goodwill and going concern (e.g., covenants not to compete, customer lists, trademarks).

7. Class VII includes IRC §197 tax-deductible goodwill and going concern.

**D. IRC §197** – Provides that a taxpayer is entitled to an amortization deduction over fifteen years for any “amortizable IRC §197 intangible.” 42

1. IRC §197 assets are described in the IRC and the Regulations. In general an IRC §197 asset includes goodwill, going concern value, trademarks, covenant not to compete, a governmental license or permit, and customer lists. 43

2. Some common intangibles that are not an IRC §197 asset include an interest in a corporation, partnership or limited liability company, and certain copyrights and patents not acquired in connection with the acquisition of a trade or business (i.e., self created copyrights and patents). 44

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40 See IRC §1060 and Treas. Regs. §1.338-6.
41 Treas. Regs. §1.338-6(b)(2).
42 IRC §197(a).
43 See IRC §197 and Treas. Regs. §1.197-2.
44 See IRC §197(e) and Treas. Regs. §1.197-2(c).
3. The IRC §197 rules apply to IRC §197 intangibles that were acquired after August 10, 1993 (or July 25, 1991 if a valid retroactive election has been made).

E. IRC §197 Anti-churning Rules

1. Rules designed to prevent taxpayers from converting Pre-§197 non-amortizable intangibles into amortizable IRC §197 assets without changing the ultimate owner. Prior to IRC §197, goodwill and going concern value were not amortizable assets.

2. A Buyer may have an anti-churning problem if Target has non-amortizable goodwill and Seller retains at least a 20% interest in Target.

3. These rules have the effect of disqualifying the intangible as an IRC §197 asset and disallowing any amortization deductions.

VI. Obtaining Seller Tax Deferral

A. To the extent that a Seller is able to defer the recognition of gain, it may be able to defer the corresponding tax payment. As mentioned above, there is an economic value to deferring payment of tax to a later period.

1. Example - Assume Seller realizes a $10 capital gain. If Seller pays tax currently on this capital gain, it will have $7.50 to reinvest ($10 proceeds less $2.50 in tax at a 25% state and federal income tax rate).

   a) If instead, the Seller could defer paying tax on the gain for 10 years and invested the $2.50 of tax it would earn an additional $2.40 of return. The economic benefit of deferral realized by Seller is $1.22, which is the present value of the return of $2.40.

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45 IRC §197(f).

46 $2.40 is the future value of the income stream. Assuming a 7% interest rate compounded annually.

47 Assuming a discount rate of 7%.
B. Transactions giving rise to Seller tax deferral

1. **Installment Sales** - IRC §453(a) provides that Seller can defer currently remitting tax on gain to the extent that the transaction qualifies as an installment sale. If installment sale treatment is applicable, Seller recognizes gain as purchase price payments are received. Installment sales usually involve Buyer giving Seller a note as part of the consideration.48

   (1) **Example** - Assume that the overall purchase price is $100 and Seller’s basis in an asset is $30. In exchange for the asset, the Buyer will currently pay $50 in cash and will pay the additional $50 over the following five years. In year one, the Seller will recognize $35 of gain (50% of the purchase price received multiplied by $70 of total gain).

   (2) **Seller Interest Charge** - The Seller will be subject to an interest charge payable to the IRS if the face amount of the installment obligation at year-end exceeds $5 million.49 Interest will be charged on the amount of the deferred tax liability outstanding at the end of the taxable year (i.e., the amount of the gain not yet recognized multiplied by Seller’s tax rate).

   (3) **General Rules** - For a sale to be treated as an installment sale, at least one payment must be received after the close of the taxable year. If a transaction requires only one payment to be received, and that payment will not be paid until a later year, the transaction will still qualify as an installment sale.

      (a) Not all transactions are eligible for installment sale treatment. Ineligible transactions include: (i) sales of assets that result in a loss; (ii) sales of inventory; (iii) dealer dispositions of personal/real property; and (iv) sales of stock or securities traded on a market. Additionally, installment sale treatment is not available if the Target is a public corporation.

      (b) Installment sale treatment is automatic with respect to eligible transactions and if a taxpayer wishes for the installment sale rules not to apply, it must elect out of installment sale treatment. This may be the case where the taxpayer has net operating losses that will currently expire

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48 For installment sale treatment to apply, if a contingent note is used it cannot be “out of the money.” Additionally, the note cannot be publicly traded debt.
49 IRC § 453A.
and intends to use these net operating losses to offset any gain.

b) Other advantages of installments sales include providing secure paper to seller, potential interest deductions and possible basis step-up to Buyer, and flexibility on the purchase price (e.g., earn out formulas)

c) Gain is recognized immediately upon the death of the Seller.

2. Stock Consideration

a) The IRC provides for several transactions involving stock consideration that if entered into will result in the total deferral or partial deferral of tax. These transactions include the following.

(1) IRC §351 and §721 Transactions - Contributions of appreciated assets to corporations and partnerships pursuant to tax-free provisions in the IRC. Generally, if a Seller transfers certain assets to a corporation (or partnership) and receives sufficient qualified stock, the appreciation on the transferred property will not be currently taxable.

(2) Tax free reorganizations - IRC §368 also allows for the deferral of gain in a tax free reorganization. These types of transactions are discussed in detail in the following section.

b) In general, for tax free treatment both IRC §368 and IRC §351 allow Buyer to use either common stock or preferred stock.

(1) Boot - If Seller receives non-qualified preferred stock, or other property (e.g., cash), it will recognize gain only to the extent of the fair market value of the non-qualified stock or other property received. Other property and non-qualified stock is commonly referred to as “boot.”

(2) Non-Qualified Preferred Stock - Non-qualified preferred stock for purposes of IRC §351 (and IRC §368) is stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and

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50 IRC §351 (applicable to corporations) and §721 (applicable to partnerships).
51 Receipt of publicly traded stock is also acceptable.
52 IRC §361(b).
53 IRC §351(g) and §351(h)(3)(A).
(a) The holder of the preferred stock has the right to require the issuer or a related person to redeem or purchase the stock within 20 years;

(b) The issuer or a related person is required to redeem or purchase the stock within 20 years;

(c) The issuer or a related person has the right to redeem or purchase the stock within 20 years, and as of the issue date, it is more likely than not that such right will be exercised; or

(d) The dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.\(^\text{54}\)

(3) In determining what type of stock has been received, reliance should not be placed on the “name” of the stock. There are times when stock referred to as “common stock” may actually be preferred stock based upon its terms. For any Seller deferral transaction (as well as in all other areas of tax law where the type of stock is important), the terms of the stock instrument should be reviewed.

c) \textit{Potential Permanent Deferral of Gain} – The gain is permanently deferred upon Seller’s death as a result of a step-up in asset basis to fair market value afforded to beneficiaries.

**VII. Tax Free Reorganizations**

A. A tax free reorganization is a transaction usually involving two or more corporations, in which a Seller is able to exchange shares in Target or a Buyer is able to acquire Target assets, in exchange for shares in Buyer or Target without the Seller or Target currently recognizing gain or loss. Tax free reorganizations are specifically provided for in IRC §368.

1. Several different types of reorganizations are provided for in the IRC. Generally, reorganizations are referred to by a letter (e.g., B reorganization or E reorganization). The letter corresponds to the subparagraph in the IRC where the reorganization can be found (e.g., B reorganization is found at IRC §368(a)(1)(B)).

\(^{54}\) IRC §351(2)(A)(i)-(iv) and (B).
2. Ordinary, in a reorganization transaction gain is deferred. However, gain may be currently recognized to the extent that the Seller receives boot (i.e., cash, debt, non-qualified preferred stock, other property).\(^{55}\)

3. In tax free reorganization Buyer takes a carryover basis in Seller’s tax attributes (e.g., asset basis and NOLs).\(^{56}\)

B. Requirements – There are several requirements that are applicable to a majority of the various types of reorganizations.

1. General Requirements

   a) Continuity of interest\(^{57}\) – In order for continuity of interest to exist, the original owners must retain a continuing interest in the reorganized company (i.e., the Seller must receive stock as part of its consideration). For continuity of interest purposes, generally common and preferred stock is treated as equity consideration. However, IRC §351(g) non-qualified preferred stock is treated as non-equity consideration.

      (1) The relative amount of equity and non-equity consideration that the Seller must receive is unclear. The IRS considers receipt of 50% (by value) of the total consideration received to be sufficient to meet this requirement.\(^{58}\) However the Supreme Court has held that 38% is sufficient.\(^{59}\)

      (2) The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition treatment available to corporate reorganizations.

   b) Continuity of business enterprise\(^{60}\) - The acquiring corporation must continue the Target’s historic business. The fact that the acquiring corporation is in the same line of business as the Target tends to establish the requisite continuity. However this fact alone is not sufficient to establish continuity of business enterprise. If the Target has more than one line of business, continuity of business enterprise requires only that the acquiring corporation continue a “significant” line of business. This requirement is satisfied if the acquiring corporation uses a significant portion of the Target’s historic business assets in a business.

\(^{55}\) IRC §361.
\(^{56}\) IRC §381.
\(^{60}\) See generally Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶12.61[2].
c) **Plan of reorganization** - The reorganization must occur pursuant to a plan. A plan of reorganization is explicitly required by IRC §354 and §361, which grant tax free treatment to exchanges only if they are made “in pursuance of the plan of reorganization.” The function of the plan of reorganization is to separate those transactions making up the reorganization from other steps, however proximate in time, that are not part of the reorganization.

d) **Business purpose**\(^6\) - There must be a real and substantial non-federal income tax purpose for the reorganization. An acceptable business purpose should bear some relation to the business of the acquiring corporation or the Target, or to their affiliated groups. Acceptable business purposes include reduction in state income taxes, simplification of organization structure or integration of similar business lines.

2. **Additional Requirements** - In addition to the general requirements above, each type of reorganization has separate rules and requirements that must be met in order for the transaction to qualify as tax free. These rules and requirements are found in the IRC and Regulations.\(^6\) This outline will not describe each type of reorganization nor the specific requirements and conditions of each. The following is a summary of some, but not all, of the other rules/requirements:

   a) Certain reorganizations require that only voting stock of Buyer be used (e.g., B reorganization and C reorganization).

   b) Acquisition of “control” of Target stock or “substantially all” of Target’s assets are requirements of several types of reorganizations (e.g., B reorganization requires Buyer to control at least 80% of the voting power and at least 80% of the nonvoting stock of Target; C reorganization requires Buyer to acquire “substantially all” of Target assets).

   c) Boot is permitted in some types of reorganizations (e.g., A reorganization), but not in all.

C. **A Reorganization – IRC §368(a)(1)(A)**

   1. The most common and flexible of the acquisitive reorganizations is the A reorganization, which is a statutory merger or consolidation pursuant to U.S. state corporate law. A merger typically involves the acquiring corporation acquiring the assets and the liabilities of another corporation pursuant to state law. Target

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\(^6\) See Treas. Regs. §1.368-1 and –2.
\(^6\) See IRC §368 and the corresponding Treas. Regs.
disappears as a legal entity and Target’s shareholders and creditors become shareholders and creditors of the acquiring corporation.

2. An A reorganization is the most flexible as long as the continuity of interest threshold is met.
   a) It allows for stock issued to Seller to be common or preferred and voting or non-voting.
   b) It also allows for securities, cash and other property to be used. An A reorganization allows for a significant amount of boot without disqualifying the transaction as a tax-free reorganization.

VIII. Tax-Free “Incorporations” under Section 351

A. Requirements

1. Section 351 provides nonrecognition treatment for transferors of property to a corporation solely in exchange for stock of the transferee corporation, provided the transferors as a group control the transferee corporation immediately after the transfer.

2. Control is generally defined under Section 368(c) as 80% of the voting power and 80% of each class of nonvoting stock.

3. As in the case of reorganizations, a transferor recognizes taxable gain to the extent of any “boot” (cash or other nonqualifying consideration) received.
I. CHOOSING THE APPROPRIATE LEGAL STRUCTURE FOR THE ACQUISITION

A. Stock Purchase – the acquirer purchases 100% of the target company’s outstanding stock directly from the target company’s stockholders

1. Requires unanimous “approval” of the target company’s stockholders; all target company stockholders must sign the acquisition agreement

2. The target company becomes a wholly-owned subsidiary of the acquirer

3. Because the target company becomes a subsidiary of the acquirer, the acquirer indirectly assumes responsibility for all of the target company’s liabilities to third parties, including unknown liabilities

4. There is no direct assignment of the target company’s contracts or governmental permits; this may reduce the likelihood that third-party consents will have to be obtained (although some contracts and permits may require third-party consents with respect to a change of control of the target company)

5. For federal income tax purposes, the target company’s stockholders generally have capital gains with respect to the sale of their stock; and,
generally speaking, the adjusted basis of the assets held by the target company is not “stepped up”

B. **Purchase of Assets** – the acquirer purchases some or all of the target company’s assets from the target company, and may assume certain specified liabilities of the target company –

1. Requires approval of the holders of at least a majority of the outstanding target company shares (assuming the transaction involves the sale of all or “substantially all” of the target company’s assets); under the corporation laws of some states, target company stockholders who do not vote in favor of the transaction may have statutory “appraisal” or “dissenters,” rights, allowing them to demand and receive the appraised value of their target company shares in cash

2. The acquirer does not assume responsibility for the target company’s known or unknown liabilities, except to the extent they are expressly assumed by the acquirer (or are imposed upon the acquirer by law); the acquirer may “leave behind” unwanted liabilities

3. “Bulk transfer” laws may apply where a major part of the target company’s inventory or equipment is being transferred (which may require advance notification of the target company’s creditors and, under the laws of some states, payment of proceeds from the transaction to the target company’s creditors)

4. If the target company is financially distressed, transfers for less than reasonably equivalent value may present fraudulent transfer issues under federal bankruptcy or state laws

5. An assignment of the target company’s contracts and governmental permits may require third-party and governmental consents; certain governmental permits may be non-assignable

6. Sales or other transfer taxes may be payable with respect to the assets transferred to the acquirer (although some states have sales tax exemptions for “casual and isolated sales” or sales made for resale)

7. For federal income tax purposes, the acquirer gets a “step up” in the basis of the assets acquired; however, the target company’s stockholders may be subject to “double level” income tax liability if the proceeds of the sale of the assets are distributed by the target company to its stockholders
C. Merger

1. Types of mergers
   a. “Straight” forward merger – the target company merges directly into the acquirer
   b. “Forward subsidiary” merger – the target company merges into a newly-formed subsidiary of the acquirer
   c. “Reverse subsidiary” merger – a newly-formed subsidiary of the acquirer merges into the target company; the target company becomes a wholly-owned subsidiary of the acquirer
   d. Other types of mergers

2. Requires approval of the holders of at least a majority of the outstanding target company shares (and, in certain cases involving a “straight” forward merger or the issuance of stock by the acquirer, approval of the holders of at least a majority of the outstanding shares of the acquirer); the target company’s stockholders (and in certain cases, the stockholders of the acquirer) who do not vote in favor of the merger may have statutory “appraisal” or “dissenters’” rights, allowing them to demand and receive the appraised value of their shares in cash

3. The acquirer assumes responsibility (directly in a “straight” forward merger and indirectly in a “forward subsidiary” or “reverse subsidiary” merger) for all of the target company’s liabilities to third parties, including unknown liabilities

4. There is a direct assignment of the target company’s contracts and governmental permits to the acquirer in a “straight” forward merger and to the acquirer’s newly-formed subsidiary in a “forward subsidiary” merger (which may increase the likelihood that third-party or governmental consents will have to be obtained); there is no such direct assignment in a “reverse subsidiary” merger (which may reduce the likelihood that third-party or governmental consents will have to be obtained)

5. As a general matter, the federal income tax consequences of a “straight” forward or a “forward subsidiary” merger are similar to those of a purchase of assets; and the federal income tax consequences of a “reverse subsidiary” merger are similar to those of a stock purchase
II. BASIC CHRONOLOGY OF AN ACQUISITION TRANSACTION

A. Confidentiality agreement

B. Letter of intent

C. Pre-acquisition (“due diligence”) review

D. Preparation by the acquirer of draft of definitive acquisition agreement, and negotiation between the sellers (or the target company) and the acquirer; preparation by the sellers (or the target company) of disclosure schedules

E. Signing of definitive acquisition agreement

F. Satisfaction of closing conditions (e.g., governmental permits and third party consents, “bring-down” of representations and warranties)

G. Closing

H. Post-closing period – payments under promissory notes, “earn out” provisions, employment or consulting agreements and non-competition agreements; claims for indemnification

III. CONFIDENTIALITY AGREEMENTS

A. Generally, the first agreement signed in an acquisition transaction

B. The acquirer wishes to obtain certain information about the target company to evaluate whether or not to make offer to acquire assets or stock of the target company (and, perhaps, to allow the acquirer’s lenders to determine whether to finance the acquisition)

C. The target company wishes to protect confidentiality of trade secrets and other confidential information disclosed to the acquirer; the acquirer may want protection as well if it discloses its trade secrets or confidential information to the target company (or to stockholders of the target company), where, for example, acquirer will be issuing stock or a promissory note in the acquisition; the parties (and especially the target company) may also want to maintain confidentiality of the potential transaction

1. Uniform Trade Secrets Act - requires reasonable measures to protect trade secrets
   a. Confidentiality agreements help to demonstrate these reasonable efforts
   b. Information furnished should be stamped “Confidential”
2. Confidentiality agreement may also be needed to protect non-trade secret confidential information

D. Definition of “confidential information” is very important – should cover “trade secrets,” “know-how” and “other confidential information” concerning the business and affairs of disclosing party and should set forth a detailed (but not exclusive) list of trade secrets, know-how and other confidential information being protected

E. Restrictions on use and disclosure of confidential information

1. Use by recipient only to evaluate a negotiated acquisition transaction

2. Disclosure by recipient to only those representatives of recipient (such as directors, officers, employees, consultants, legal counsel, accountants and financial advisors) and potential lenders who:
   a. have a need to know such information in evaluating the acquisition transaction; and
   b. are informed by recipient of confidential nature of information (or, better yet, who actually sign confidentiality agreement)

3. Obligation of recipient to ensure (or at least use best efforts to ensure) confidential treatment by representatives of recipient

4. Some agreements will further restrict disclosure of particularly sensitive materials (e.g., permit disclosure only to those representatives of recipient who do not have operational responsibilities)

F. Exceptions to recipient’s confidential treatment obligations – confidential information of disclosing party that:

1. becomes generally available to the public other than as a result of disclosure by recipient or its representatives

2. becomes available to recipient on non-confidential basis prior to its disclosure by disclosing party

3. recipient receives from third party not bound by any confidentiality obligation

4. is independently developed by recipient (this exception entails difficult proof problems for disclosing party)
G. Confidential information that recipient is legally compelled to disclose
   1. Recipient should be required to give prompt notice to disclosing party so that disclosing party may seek protective order or other remedy
   2. Recipient should be permitted to disclose only that portion of the confidential information that it is legally compelled to disclose

H. Covenant by recipient not to solicit for employment (or employ) any (or certain) of the disclosing party’s employees for a stated period of time

I. Non-competition covenants – recipient generally resists giving such covenants; also present unlawful restraint of trade issues

J. Acquisitions in which the acquirer and the target company are competitors
   1. Particularly sensitive to the target company, as a business matter
   2. May present issues for both parties under antitrust laws if acquisition is not consummated (or, in some cases, prior to closing)
   3. May necessitate “phased” disclosure, with the most competitively sensitive information being disclosed only upon or shortly before closing (and not to sales, marketing or production personnel)

K. Special considerations in acquisitions of public companies
   1. Standstill agreements
   2. Failed negotiated transactions that turn into tender offers – tension between confidentiality covenants and duty under securities laws to publicly disclose material non-public information

L. Return (or destruction) of confidential information if acquisition not consummated

IV. USING LETTERS OF INTENT IN BUSINESS ACQUISITIONS

A. Basic characteristics of a letter of intent (also referred to as an “agreement in principle,” “memorandum of understanding” or “heads of agreement”)
   1. The provisions setting forth the terms of the acquisition are generally non-binding
   2. Expectation that letter of intent will ultimately be replaced by a definitive acquisition agreement
B. Hazards of using a fully binding letter of intent – if the parties are unable to negotiate a definitive acquisition agreement on their own, a court could be called upon to fill in the missing terms

C. Why use a letter of intent (instead of proceeding directly to a definitive acquisition agreement)?
   1. Provides the acquirer with an opportunity to get certain binding provisions into place at an early stage (such as a “no-shop” provision and a provision regarding control of publicity)
   2. May facilitate compliance with regulatory requirements (such as the Hart-Scott-Rodino Antitrust Improvements Act)
   3. May facilitate dealings with third parties (such as potential lenders)
   4. Provides a useful framework for subsequent negotiations; makes subsequent negotiations more focused
   5. May be treated by the parties as creating a “moral” obligation, even if not legally binding

D. Potential disadvantages of using a letter of intent
   1. Securities law disclosure issues
   2. Practical difficulty of keeping a signed letter of intent confidential
   3. Risk that a court may find that a letter of intent creates a duty to negotiate in good faith or other binding obligations, even where the parties did not intend to be bound
   4. Possibility that the preparation and negotiation of a letter of intent may delay the ultimate execution of a definitive acquisition agreement and may result in extra expense
   5. May place one of the parties at a disadvantage in negotiating the acquisition agreement

E. Use of term sheets – a term sheet offers some of the advantages of a letter of intent (such as providing a useful framework for future negotiations); however, because a term sheet is typically not signed by the parties, it does not provide the acquirer with the opportunity to put binding provisions (such as a “no-shop” provision) into place, and it does not enable the parties to make Hart-Scott-Rodino Act filings
V. ARCHITECTURE OF THE DEFINITIVE ACQUISITION AGREEMENT

A. Introductory provisions – names of parties, recitals, definitions

B. Description of what is being sold (especially important in asset acquisitions); and, in asset acquisitions, description of what liabilities are being assumed

C. Purchase price; payment of purchase price; and, in asset acquisitions, allocation of purchase price

D. Sellers’ (or target company’s) representations and warranties

E. Acquirer’s representations and warranties

F. Sellers’ (or target company’s) pre-closing covenants

G. Acquirer’s pre-closing covenants

H. Closing
   1. When and where
   2. Conditions precedent to sellers’ (or target company’s) obligation to close
   3. Conditions precedent to acquirer’s obligation to close
   4. Deliveries at closing
      a. by sellers (or target company)
      b. by acquirer

I. Termination of agreement

J. Indemnification provisions
   1. In favor of acquirer
   2. In favor of sellers (or target company)
   3. Time limitations on asserting claims for indemnification
   4. Monetary thresholds and limitations on indemnification claims
   5. Procedural issues with respect to indemnification claims (including provisions relating to defense of third-party claims)

K. Other post-closing covenants of the parties

L. General or “miscellaneous” provisions
VI. PRICING ISSUES IN BUSINESS ACQUISITIONS

A. Dollar amount of purchase price – various possible formulations

1. Fixed dollar amount

2. Fixed dollar amount, subject to adjustment after the closing based on a post-closing audit of the target company’s closing date financial statements – e.g., “$50,000,000 plus or minus the amount by which the stockholders’ equity of the target company as of the closing date is greater or less than $35,000,000”; sometimes, working capital-based adjustments or other adjustments are used

3. “Earn out” formula – e.g., $20,000,000 plus an “earn out” equal to 20% of the amount by which the pre-tax income of the acquired business exceeds $4,000,000 during the 12-month period following the closing; “earn outs” involve difficult drafting issues and often result in disputes

4. Other possible formulations

B. Form of consideration

1. Cash payment at closing

2. Deferred cash payments or promissory notes
   a. Timing of payments
   b. Interest rate
   c. “Set off” rights – ability of the acquirer to deduct indemnification payments or other amounts owing to the acquirer from amounts payable by the acquirer
   d. Security for future payments; escrow of future payments
   e. Possible availability of installment tax treatment to recipients of payments
   f. Deferred payment rights and promissory notes (as well as interests in an escrow fund) may constitute “securities” under federal and state securities laws
   g. Subordination of the acquirer’s deferred payment obligations to obligations to other creditors of the acquirer
3. Shares of the acquirer’s stock

a. Payment of the purchase price in the form of stock of the acquirer may permit the acquisition to qualify for treatment as a “tax-free” reorganization for federal income tax purposes

b. Possible pricing formulations

i) “Fixed exchange ratio” (or issuance of a fixed number of shares of the acquirer’s stock) – e.g., “at the closing, the acquirer will issue and exchange 2.6 shares of its common stock for each outstanding target company share” or “at the closing, the acquirer will issue a total of 2,000,000 shares of its common stock to the target company’s stockholders”

ii) “Fixed market value formula” (or “floating exchange ratio”) pricing, which may be used if the acquirer’s stock is publicly traded – e.g., “at the closing, the acquirer will issue $50,000,000 of its common stock to the target company’s stockholders, with the acquirer’s common stock to be valued at its average market price over the period of ten trading days preceding the closing date”

iii) Caps, floors and collars; “walk rights” tied to the level of the acquirer’s stock price

c. Because the acquirer is issuing stock, the acquirer must comply with the federal securities laws, either by registering the stock with the SEC (which may increase the time needed to close the transaction) or by relying on an exemption from registration

i) a publicly-held acquirer that contemplates using its stock to make a series of acquisitions may find it useful to file a “shelf” registration statement with the SEC

ii) among the exemptions from registration that are sometimes used in this context are the exemption provided by §4(2) of the Securities Act of 1933 (and the “safe harbor” provided by Regulation D under the Securities Act of 1933), and the exemption provided by §3(a)(10) of the Securities Act of 1933

d. State securities law issues
e. Restrictions on subsequent transfers of the shares issued by the acquirer in the acquisition

   i) Restrictions imposed under federal securities laws

   - Restrictions that will apply if the shares are issued in reliance on the §4(2) or Regulation D exemption from registration (including a possible one-year holding period)

   - Restrictions that will apply (to “affiliates” of the target company) if the shares are registered with the SEC or issued in reliance on the §3(a)(10) exemption.

   ii) Negotiated contractual restrictions

f. A vote of the acquirer’s stockholders may be required under some circumstances

4. Other forms of consideration

C. Allocation of purchase price in asset acquisitions

VII. SIGNIFICANT NON-PRICE PROVISIONS OF THE ACQUISITION AGREEMENT

A. Representations and warranties regarding the target company and its business; indemnification provisions

1. Purposes of representations and warranties –

   a. Allow the acquirer to call off the acquisition if significant inaccuracies in representations and warranties are discovered before closing

   b. Provide a basis for obtaining comprehensive information (included in disclosure schedules) regarding the target company and its business

   c. Provide a remedy to the acquirer after the closing of the acquisition in the event the target company and its business were not accurately portrayed to the acquirer; allocation of risks between the parties

2. Post-closing consequences of inaccurate representations and warranties – the acquirer is “indemnified” against the damages arising from the inaccuracies
3. Scope of representations and warranties
   a. “As is” acquisitions vs. acquisitions with comprehensive representations and warranties
   b. Certain representations may be particularly controversial – e.g., “no undisclosed liabilities” representation; representation covering “contingent” liabilities; “full disclosure” (“10b-5”) representation

4. Parties standing behind the representations and warranties
   a. All stockholders of the target company vs. less than all stockholders of the target company
   b. “Joint and several” liability vs. “proportionate” liability

5. Disclosure schedules
   a. Contain extensive information on the target company’s business; identify exceptions to the representations and warranties
   b. Must be prepared, thoroughly reviewed by the acquirer and finalized before the acquisition agreement is signed

6. Negotiated limitations on representations and warranties and related indemnification obligations
   a. Materiality qualifications
   b. “Knowledge” qualifications
      - actual vs. “constructive” knowledge
      - individuals whose knowledge is to be imputed to the target company
   c. Limitation on period of survival of representations and warranties
   d. “Basket” (deductible) or threshold
   e. Ceiling on liability
   f. Certain categories of damages not subject to indemnification (such as “consequential” damages)
   g. Other limitations

7. Security for performance of indemnification obligations – “hold back” or escrow of a portion of the purchase price; “set off” rights
8. Control of defense of third-party claims with respect to which the acquirer may seek indemnification

9. Subrogation rights of indemnifying parties

B. Acquirer’s representations and warranties – very limited in scope, if the entire purchase price is to be paid in cash at the closing; however, may be extensive if the acquirer is to issue a promissory note or stock as consideration in the transaction

C. Timing of the closing of the acquisition

1. Deferred closing – In many cases, the closing of an acquisition (i.e., the actual transfer of the target company’s stock or assets to the acquirer) does not take place until several weeks or months after the signing of the acquisition agreement. The parties use the period between signing and closing to make required governmental filings and obtain needed governmental approvals, to obtain needed contractual consents, to make arrangements for any needed stockholder meeting, to obtain any needed financing and to make preparations for the closing.

2. Simultaneous signing and closing – Sometimes, the parties opt to have a “simultaneous signing and closing” (i.e., to delay signing the acquisition agreement until they are ready to close the acquisition). In this situation, neither party is contractually committed (until the actual closing) to proceed with the transaction, and either party accordingly may elect to abandon the transaction for any reason prior to the closing. A number of provisions may be eliminated from the acquisition agreement if there is a “simultaneous signing and closing” – e.g., pre-closing covenants, closing conditions and termination provisions.

D. Pre-closing covenants of the target company – rules relating to the conduct of the target company’s business between signing and closing

E. Conditions to the acquirer’s obligation to consummate the acquisition (which, if not satisfied, will give the acquirer a “walk right”)

1. “Bring down” of representations and warranties regarding the target company and its business – representations and warranties must be accurate (at least in all material respects) on the closing date as if made on the closing date

2. Obtaining required contractual and governmental consents and approvals; expiration of the waiting period under the Hart-Scott–Rodino Act; obtaining “estoppel certificates” from parties to key contracts

A Basic Issues and Principles 14.
3. Litigation “out” – can be broad (e.g., giving the acquirer a “walk right” if there is any pending or threatened litigation challenging the acquisition) or narrow (e.g., giving the acquirer a “walk right” only if there is an actual injunction in effect that prohibits the acquisition)

4. Material adverse change “out”

5. Continued availability of key employees of the target company; execution by key employees of employment or consulting agreements and noncompetition agreements

6. Delivery of legal opinion by counsel for the target company

7. No exercise (or limited exercise) of statutory “appraisal” or “dissenters’” rights (if available) by target company stockholders

8. “Due diligence out” – inclusion of such an “out” will typically be resisted by the target company because of its broad scope; an acquirer with a “due diligence out” may be viewed as having received a free “option” to decide whether or not to proceed with the acquisition

9. Financing “out” – also typically resisted by the target company

10. Other conditions

F. Conditions to the obligation of the target company (or its stockholders) to close – will not necessarily mirror the conditions to the acquirer’s obligation to close

G. Payment of transaction-related expenses – e.g., sales taxes (if required to be paid) in a transaction structured as a purchase of assets; legal and accounting fees incurred by the target company and its stockholders; Hart-Scott-Rodino Act filing fee; investment banking fees

H. Other provisions – e.g., provisions relating to employees; provision contemplating payment of a termination or “break-up” fee

VIII. SPECIAL PROBLEMS POSED BY ACQUISITIONS OF DIVISIONS AND SUBSIDIARIES

A. Identification of business or assets being acquired; difficulties in dealing with “shared” intellectual property rights and other “shared” assets

B. Identification of liabilities being assumed

C. Financial statement issues (including issues arising from inter-company transactions and issues arising from unavailability of separate financial statements for the division or subsidiary being acquired)
D. Possible need for post-closing transition services agreements

E. Federal income tax issues – especially important in an acquisition of a subsidiary from a consolidated group

F. Employee benefits issues

This outline is not intended to be exhaustive. It provides only a general (and highly simplified) overview of the topics addressed, and is intended to be used in conjunction with a more comprehensive oral presentation on these topics. Accordingly, many of the principles and statements set forth in this outline are subject to exceptions and qualifications that are not specifically described in the outline. Every business acquisition is unique, and the parties to a business acquisition should always seek independent legal advice reflecting the particular circumstances of their transaction.
ILLUSTRATIVE COMPARISON OF FEDERAL INCOME TAX CONSEQUENCES OF STOCK SALE WITH FEDERAL INCOME TAX CONSEQUENCES OF ASSET SALE

ASSUMPTIONS:

- TargetCo owns a single asset - a factory worth $100,000,000, with an adjusted tax basis of $80,000,000. TargetCo's only liability is bank debt in the amount of $70,000,000.

- TargetCo's shareholders have an aggregate tax basis of $10,000,000 in the stock of TargetCo and have held the stock for more than 18 months.

ALTERNATIVE #1 (STOCK SALE):

Purchaser buys all of the outstanding stock of TargetCo from TargetCo's shareholders for $30,000,000 in cash.

<table>
<thead>
<tr>
<th>Gross Amount Realized by Shareholders</th>
<th>$30,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>less Adjusted Basis</td>
<td>($10,000,000)</td>
</tr>
<tr>
<td>Recognized Gain</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>less Tax (15% rate)</td>
<td>($3,000,000)</td>
</tr>
<tr>
<td>After-Tax Proceeds to Shareholders</td>
<td>$27,000,000</td>
</tr>
<tr>
<td>($30,000,000-$3,000,000)</td>
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</tbody>
</table>

- There is no corporate level tax.
- Purchaser retains $80,000,000 basis in factory.
**ALTERNATIVE #2 (ASSET SALE):**

Purchaser buys factory from TargetCo for $100,000,000. (Purchaser pays $30,000,000 in cash, and Purchaser assumes TargetCo’s $70,000,000 bank debt.) TargetCo distributes the net after-tax proceeds of the sale to its shareholders.

<table>
<thead>
<tr>
<th>Gross Amount Realized by TargetCo</th>
<th>$100,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>less Adjusted Basis</td>
<td>($80,000,000)</td>
</tr>
<tr>
<td>Recognized Gain</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>less Corporate Level Tax (35%)</td>
<td>($7,000,000)</td>
</tr>
<tr>
<td>After-Tax Proceeds to TargetCo</td>
<td>$23,000,000</td>
</tr>
<tr>
<td>($30,000,000-$7,000,000)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Gross Amount Distributed by TargetCo to Shareholders</th>
<th>$23,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>less Adjusted Basis</td>
<td>($10,000,000)</td>
</tr>
<tr>
<td>Recognized Gain</td>
<td>$13,000,000</td>
</tr>
<tr>
<td>less Tax (15% rate)</td>
<td>($1,950,000)</td>
</tr>
<tr>
<td>After-Tax Proceeds to Shareholders</td>
<td>$21,050,000</td>
</tr>
<tr>
<td>($23,000,000-$1,950,000)</td>
<td></td>
</tr>
</tbody>
</table>

- Shareholders receive $5,950,000 less than they would receive in a stock sale (Alternative #1).
- Purchaser gets stepped-up basis in factory of $100,000,000.
- The advantage to Purchaser of an asset sale (over a stock sale) is equivalent to the present value of up to $20,000,000 of extra depreciation deductions. These extra deductions are available in an asset sale because of the step-up in the basis of the factory from $80,000,000 to $100,000,000.
Committee on Taxation

“Where Business Law and Tax Law Meet”

The Committee on Taxation focuses on tax issues that are of concern to business lawyers. The committee doesn't aim to make business lawyers into tax experts, but tries to help business lawyers gain a basic understanding of the important tax issues that inevitably arise in their practices. The committee seeks to act as a bridge between tax law and business law, and to increase communication about tax issues among the various committees of the Section of Business Law, and between the Sections of Business Law and Taxation. While some members of the committee see themselves as tax practitioners, the majority are business lawyers whose practices demand that they remain informed of tax considerations that impact their clients.

We welcome your interest and invite you to join the committee.

Involvement

The committee operates through approximately 10 subcommittees and through joint projects with other entities of the ABA and welcomes your involvement. Writing and speaking opportunities are available if you have the interest and the time. The committee invites members’ ideas on articles and any interest in editing the committee’s e-newsletter, Tax News for the Business Lawyer. In addition, members have the opportunity to write periodic reports on developments in the law distributed via the committee’s members-only listserv and write course materials for committee programs and forums. Speaking opportunities at meetings, forums, and programs are available as well. Feel free to contact the Committee Chair or Vice-Chair for more information on how to get involved.

Knowledge and Networking

Have access right at your fingertips to materials and resources used in committee meetings throughout the year. The committee has sponsored and co-sponsored some excellent programs at Section Spring Meetings, ABA Annual Meetings, and the first annual 2008 Global Business Law Conference. Members can search the Section’s online Program Library for program materials dating back to 1999. The committee’s recently published e-newsletter, Tax News for the Business Lawyer, distributed via the members-only listserv, will keep you current on developments in tax and business law from fellow committee members.

Savings

- Discounts on Committee and Section Publications and Products found in the ABA Web Store, visit www.ababooks.org.
- Discounted Registration to Committee and Section Meetings. Section of Business Law Spring Meeting will take place in Vancouver on April 16-18, 2009.

<<< Join the committee! >>>

Committee membership is free for Section of Business Law members. For immediate enrollment in the committee or Section, log in at www.ababusinesslaw.org.