# Analyst Considerations of a Taxable Stock Purchase M&A Structure

*Robert F. Reilly, CPA*

*Valuation analysts (analysts) may serve as financial advisers to the parties of merger and acquisition (M&A) transactions. And, analysts may be asked to opine on the fairness of the M&A transaction price and/or structure. Such analysts are not necessarily income tax experts. However, analysts should consider the taxation aspects of the transaction structure in their financial advice or transaction fairness opinions.*

## Introduction

Valuation analysts (analysts) are often called on to:

1. value merger and acquisition (M&A) candidates and
2. opine on the price and structure of M&A transactions.

In such engagements, analysts often serve as pre-deal financial advisors to one or more sets of transaction participants.

And, such analysts are often called on to issue transactional fairness opinions to their clients. These opinions often encompass the relative and/or absolute fairness of the deal price and the deal structure.

In addition, analysts are often asked to analyze completed M&A transactions after the fact. These engagements often involve forensic analysis related to dissenting shareholder appraisal rights actions.

Related to such tort litigation claims, analysts are often asked to opine on both the fairness of the deal price and the fairness of the deal structure to the dissenting noncontrolling shareholders.

Analysts do not need to be either investment bankers or income tax experts to perform such transaction fairness analyses. However, analysts do need to understand alternative M&A transaction structures and the impact of transactional structuring on the target company value.

Most acquisitions of larger companies are structured as nontaxable stock acquisitions. Stock acquisitions usually involve the acquirer taking a carryover tax basis in the acquired company assets. This statement is true even if the acquirer paid a substantial price premium for the target company stock.

It is possible to structure a stock acquisition as a taxable stock purchase transaction. However, there are numerous tax complexities related to this taxable stock acquisition deal structure. This discussion summarizes some of the tax benefits—and some of the tax complexities—associated with a taxable stock purchase deal structure.

Although the analyst is not expected to be the transaction income tax adviser, the analyst opining on the deal price fairness to any of the deal participants should be generally aware of these transaction structure considerations.

## Transaction Structure Considerations on Target Company Value

It is unusual for the transaction participants to structure a target company stock acquisition (versus an asset acquisition) as a taxable acquisition.

Of course, in the taxable acquisition of the target company assets, the corporate acquirer enjoys the expected future income tax benefit associated with the step-up in the depreciable basis of the acquired

assets. The depreciable basis of the acquired assets will equal the purchase price that the corporate acquirer paid for the total bundle of assets.

In contrast, in the nontaxable acquisition of the target company stock, the corporate acquirer receives a carryover tax basis of the acquired assets. That is, typically, the acquirer continues to depreciate the seller's tax basis in the target company assets—regardless of the amount of the purchase price premium that the corporate acquirer paid for the target stock.

In the typical company stock acquisition transaction, the corporate acquirer will assume all of the known (including both recorded and contingent) liabilities of the acquired company.

In addition, in the stock acquisition, the corporate acquirer will assume all of the unknown liabilities of the acquired company. These unknown liabilities would include any liabilities related to pre-acquisition date events for which no claim was made against the target company as of the acquisition date.

However, after assuming the "cost" of both these known and unknown liabilities related to the stock acquisition, the corporate stock acquirer would not receive the benefit of the step-up in the depreciable basis of the target company assets for federal income tax purposes.

Accordingly, the acquirer incurs the "cost" of the assumed liabilities in the target company purchase price. But, because the transaction is nontaxable, the acquirer does not receive the benefit of increased depreciation expense related to the revalued target company assets.

Therefore, without the tax benefit of the step-up in the depreciable basis of the acquired assets, why would the acquirer structure the stock acquisition as a taxable transaction?

## Stock Acquisition Treated as an Asset Acquisition

Some years ago, there was a trend away from acquisitions structured as asset purchase transactions to acquisitions structured as stock purchase transactions. Many years ago, these stock transactions were often treated as asset purchases for federal income tax purposes.

Pursuant to an election under Internal Revenue Code Section 338(h)(10), a corporate acquirer—in conjunction with the stock seller—may elect to treat the purchase of the target company stock as an asset acquisition.

In such a transaction, the gain on the deemed asset sale is reported on the target company's con-

solidated income tax return (or reported by the shareholders of an S corporation). Section 336(e) allows for the similar income tax treatment if the corporate acquirer is not itself a corporation.

Such tax elections allow for the corporate acquirer to treat a target company stock acquisition as a target company asset purchase for federal income tax purposes. Accordingly, with such an election, the tax "benefit" of a step-up in the depreciable tax basis of the target company assets (up to the acquisition price) is achieved by the corporate acquirer.

## Reps and Warranties Protection

One reason for this trend away from asset acquisition structures is that the typical corporate acquirer legal counsel is now more comfortable in drafting contractual representations and warranties to cover any adverse effect related to the acquirer assuming unknown liabilities.

Another reason for this trend in deal structures is the common availability of "reps and warranties" insurance related to most merger and acquisition transactions.

In addition to the availability of reps and warranties protection, a stock acquisition structure simplifies the transfer of the target company's business agreements, contracts, licenses, and so forth, to the corporate acquirer.

This intangible asset transfer result is achieved because a stock acquisition structure does not

create a legal change in the ownership of these underlying contracts and rights.

## Taxable Acquisition of the Target Company Stock

However, in certain circumstances, acquisitive transactions may be structured as a taxable acquisition of target company stock without an election being made under either Section 338(h)(10) or Section 336(e). In these instances, the corporate acquirer may be a private equity firm that wants to avail itself of Section 1045 rollover treatment.

Or, the acquirer may be a not-for-profit institution that is not concerned with the potential double tax related to the taxable transaction structure.

Alternatively, the target company may have depreciated assets or other tax attributes that the corporate acquirer wishes to preserve. Or, the corporate acquirer simply cannot qualify for the election under Section 338 because the target company is a stand-alone C corporation.

Also, the target company seller may want to avail itself of the gain exclusion provisions under Section 202, or the target company seller may want to have the opportunity to accomplish a Section 1045 rollover.

Whatever the reasons are for this current trend in acquisition deal structuring, the result includes tax complexities that many transaction participants may not be familiar with. Further complicating this transaction structuring decision is the application of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) topic 820, Fair Value Measurement, for U.S. GAAP purposes.

Regardless of the deal tax structure, ASC topic 820 requires that the target company acquisition be accounted for on a fair value (and not a historical cost) accounting basis.

Therefore, the target company opening GAAP balance sheet will be presented on a fair value (equal to acquisition purchase price) basis, even if the tax balance sheet is still presented on a carryover tax basis.

## Illustrative Example of the Tax Complexities

To illustrate certain transaction structure tax complexities, let's assume that an LLC (taxed as a partnership) acquires all of the stock of a C corporation target company. Let's assume that the LLC investors make contributions to the capital of the LLC.

In turn, the LLC obtains the acquisition purchase price financing from a commercial bank. The C corporation target company is treated as the co-borrower on the acquisition financing debt.

The acquirer LLC uses the debt and equity to finance the acquisition of the C corporation target company stock. For income tax purposes, the final transaction structure is an LLC with an investment in the C corporation stock, debt, and equity.

The acquired C corporation company is an operating business that generates cash flow from its operations. The tax problem becomes: how does the acquirer LLC receive from the C corporation the amount of cash needed to amortize the acquisition indebtedness?

If the acquired C corporation distributes some of its cash flow to the LLC, then the likely tax treatment will be a taxable dividend to the LLC parent. In addition, the acquisition debt interest expense treatment will likely be that the interest expense is an investment interest expense.

Accordingly, the LLC owners:

1. would have to recognize dividend income and
2. may be limited with respect to the tax deduction of the acquisition debt interest under the Section 163 investment interest expense rules.

An additional tax complexity is that the situation may not be readily identified until it is time to start completing the acquirer's income tax returns.

This is because, for GAAP financial accounting purposes, the parent LLC and its operating C corporation subsidiary will be considered as one reporting group—with the target company assets being reported on the consolidated (or combined) balance sheet at fair value at the time of acquisition.

## The Alternative Tax Structure

A more taxpayer-favorable result may be achieved if the acquirer LLC makes a check-the-box election to be taxed as a C corporation. Then, the acquirer LLC will further elect to file a consolidated income tax return with its acquired C corporation subsidiary. With this tax structure, the limitation of the deductions for the interest expense is avoided. However, the tax flow-through nature of the LLC structure would be given up.

Another tax structure alternative could be to create a management fee agreement between (1) the acquired operating C corporation and (2) the acquirer LLC.

Pursuant to this management agreement, enough cash flow would result from the management fee for the LLC to amortize the stock acquisition debt. However, the transaction parties should be careful not to change the economics of the deal by adding this target company management fee expense after the fact.

## Other Structuring Considerations

A further tax complexity is that, for income tax purposes in a stock purchase transaction, the C corporation assets will carry over with respect to both depreciable basis and depreciation methods. However, for GAAP financial accounting purposes, the acquired C corporation's opening balance sheet will be presented on a fair value accounting (i.e., stepped-up basis).

The corporate acquirer should be careful to ensure that both:

1. the target company historical tax depreciation schedules are maintained and
2. the acquisition accounting entries for the GAAP accounting can be unwound.

This post-transaction recordkeeping consideration is in addition to the acquirer performing a Section 384 analysis if the target company has a net operating loss or a tax credit carryforward.

The purchase of C corporation stock by an S corporation may create an additional trap for the transaction participants. This transaction structure will create the tax complexities outlined in the above LLC acquisition illustrative example. However, there will be one additional potentially negative tax consequence.

To illustrate, let's assume that an S corporation purchases the C target corporation stock for $10 million and the underlying depreciable basis of that target company's assets is $4 million.

Similar to the tax result described above, if the S corporation acquirer borrows the funds to finance the acquisition purchase price, then the interest expense will be treated as investment interest expense—if it is traced to the acquisition of the target C corporation stock. Even if the interest is tax deductible to the S corporation shareholder for federal income tax purposes, it may not be deductible for state income tax purposes.

This tax situation may encourage the transaction participants to make a QSub election under Section 1361 for the acquired C target corporation.

However, after carefully examining the consequences of a QSub election, the transaction participants may conclude that the election creates a deemed liquidation of the target company under Section 332. In a deemed liquidation of the target company into the parent corporation under Section 332, the parent takes a carryover depreciable tax basis in the target company assets as its stock basis.

Accordingly, in this particular example, the parent corporation would lose $6 million in stock tax basis when a QSub election is made.

## Summary and Conclusion

A taxable stock acquisition transaction is a potentially attractive M&A structure in order for the target company seller to pay one level of tax on the company sale—and to potentially pay no tax if Section 202 applies.

For corporate acquirers, the taxable stock acquisition structure will likely result in the easy transfer of all of the target company (1) business contracts and agreements and (2) registrations and licenses.

However, the transaction participants need effective income tax planning in order to avoid the potential negative tax consequences and complexities of a taxable stock purchase.

Valuation analysts are often called on to assess and opine on the fairness of the price and of the structure related to an M&A transaction. Such analysts may advise one or more transaction participants in a pending deal.

Or, such analysts may be engaged as valuation testifying experts in dissenting shareholder appraisal rights claims. In such engagements, the analyst also opines on the fairness of the deal price and structure—in this case, to the dissenting noncontrolling equity holders.

There are benefits and complexities associated with the taxable stock purchase transaction structure. Such issues should be considered in the fairness analysis of the M&A transaction price and structure.

Although not necessarily expected to be an income tax expert, the analyst advising any of the deal participants should be generally aware of these transaction structure considerations.

*Robert Reilly is a managing director of the firm and is resident in our Chicago office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.*