TAXES

Tax Geek Tuesday: Tax Planning For Mergers And Acquisitions, Part II

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Last week, in Part I of the epic mini-series that is this edition of Tax Geek Tuesday, we addressed *taxable* mergers and acquisitions. As promised, today we will take on the *tax-free reorganization* provisions of Section 368 in the same nauseating detail; addressing the statutory requirements for all forms of tax-free reorganizations, the consequences to both buyer and seller, and the pros and cons of the different structuring options.

Before we dive into Section 368, however, we need to reintroduce the case study we worked with last week. As you may remember, we used the following definitions:

- T is the target corporation; the one being acquired. For our purposes, T is a C corporation.
- A is an individual who owns 100% of the outstanding stock of T.

- P is the purchasing, acquiring entity, either directly or through a subsidiary. Both P and any subsidiary will be a C corporation.
- Newco is a subsidiary of P and the purchasing or acquiring entity (rather than P) where the acquisition of T is made by a newly formed entity. Newco is a C corporation.
- S is a subsidiary of P and the purchasing or acquiring entity (rather than P) where the acquisition of T is made by an existing subsidiary. S is a C corporation.

Then, we addressed the following fact pattern:

- A, the sole shareholder of T, desires to sell the business of T.
- P is looking to expand into the T line of business and has expressed interest in acquiring T.

- Relevant facts of T include:
    - Fair market value of the TOTAL T assets: $1,000,000

- Fair market value of the T hard assets: $600,000
- Fair market value of the T self-created intangible assets, i.e., goodwill: $400,000
- T's tax basis of its assets: $400,000
- A's basis in the T stock: $400,000

Last week, we broke down the consequences to A, T, and P if P either (1) bought A's T stock for $1,000,000; (2) bought T's assets for $1,000,000, or (3) bought A's T stock, and assuming a change in facts that permitted a Section 338(h)(10) election be made, did in fact make such an election.

But what if A, T, and P are determined to make P's acquisition of the T business tax efficient for A and T? How can the parties structure the transaction so as to minimize any gain recognized by A and T?

We'll get to that, but first, let's gain an understanding of why a tax-free reorganization is permitted by statute. **Why Does Section 368 Exist?**

If you own a building with a tax basis of $400,000 and a fair market value of $1,000,000 and you sell the building for $1,000,000 cash, you recognize $600,000 of gain. Why? Because you have "cashed out" of your investment in the building by turning it into $1,000,000 of cash.

What if, however, you didn't sell your building, but rather traded it for another building worth $1,000,000. Absent a rule to the contrary, the IRS would simply tax you on your ascension to wealth; after all, you have traded property with a basis of $400,000 for other property worth $1,000,000, which would generally trigger taxable gain under Section 1001.

Of course, there *is* such a rule to the contrary -- the "like-kind exchange" rule of Section 1031, or as it's commonly referred to in tax parlance, Section 1031 exchanges. Under Section 1031, if you trade property with a basis of $400,000 and value of $1,000,000 for property of equal value that is of "like-kind," the general rule of Section 1001 is trumped, and the $600,000 of gain inherent in the relinquished property is not recognized.

The gain is not excluded or exempted, it is merely *deferred*. This deferral is created from a mechanical perspective by giving you, as the transferor, the same $400,000 basis in the replacement property that you had in the relinquished property. This way, if you subsequently sell the replacement building for its value of $1,000,000, you will recognize the $600,000 of gain at that time. Section 1031 exists because in the eyes of the IRS, if you are merely trading your property for substantially equivalent property, then you have not "cashed out;" rather, you have merely changed the *form* of your investment in the original building to an investment in the replacement building. As a result, the IRS is willing to throw you a bone and allow you to defer recognizing any gain until you eventually *do* cash out of your investment.

What does any of this have to do with mergers and acquisitions? Well, Section 368 exists for the same reason Section 1031 exists. If A sells T for cash, A has certainly "cashed out" of his investment in T. The business of T is now owned and operated only by P and its historical shareholders, meaning A has washed his hands of his interest in T, and should be taxed accordingly.

But what if instead, A sells T – either its stock or assets – to P in exchange solely for P stock? In that scenario, after the transaction A will continue to own an interest in the business of T, only instead of owning it directly, A will own the interest through its stock ownership in P. This is e*xactly* like a Section 1031 exchange, as A has not cashed out of his investment in T; rather, he has merely changed the *form* of his investment in T. While he once owned the T business directly, A now owns T through his continuing stock ownership in P.

And *that* is why Section 368 exists and why, as discussed last week, if A wishes to fit the deal under one of the tax-free reorganization provisions, A MUST receive as consideration primarily stock of P. Only by receiving stock in P has A continued his investment in T, and should he be entitled to nonrecognition of gain. Just as with Section 1031, however, any gain inherent in the business of T is not excluded or exempt by virtue of A fitting the transaction within Section 368; rather, the gain is merely *deferred* by giving A a substituted basis in the P stock received.

Types of Tax-Free Reorganization

Today, we will focus on the five "acquisitive tax-free reorganizations" of Section 368. They are called this because, well…they are the means by which P can "acquire" T. The acquisitive reorganizations are to be differentiated from "divisive transactions," which permit an existing business to split into multiple parts on a tax-free basis and are largely found in Sections 368(a)(1)(D) and 355.

The acquisitive reorganizations we'll cover are:

- Section 368(a)(1)(A): merger
- Section 368(a)(2)(D): forward triangular merger
- Section 368(a)(1)(C): acquisition of target assets with stock of acquirer
- Section 368(a)(1)(B): acquisition of target stock with stock of acquirer
- Section 368(a)(2)(E): reverse triangular merger

Tax Consequences of a Tax-Free Reorganization, In General

We have established that if A receives only P stock in exchange for the business of T, the transaction will qualify as a tax-free reorganization. The basic consequences to T, A, and P are as follows:

To Target (T):

- Does not recognize gain to the extent it receives stock in P.
- T recognizes gain to the extent of any cash boot received, unless T distributes the boot to its shareholders as part of the plan. (more on the impact of cash boot shortly). Since T must liquidate in every asset-type acquisition (A, C, and (a)(2)(D)), T generally never recognizes gain.

To selling shareholder (A):

- Section 354: no gain if only stock received.
- Section 356: if cash is received, the cash is taxed, but only to the extent of the total realized gain on the transaction. (This is the boot within gain rule, to be discusses shortly. I promise).
- Any gain is generally capital.

To buyer (P):

- No gain or loss on the issuance of stock under Section 1032.
- In all asset-transfer tax-free reorganizations (A, C, (a)(2)(D)), attributes (NOLs) of T carry over to P under Section 381

Any gain inherent in the T stock or T assets is not excluded, it is merely deferred, so that when A eventually sells the P stock – or P sells the T assets – the appreciation inherent in the T business at the time of sale will be triggered. Section 368 accomplishes this from a mechanical perspective by providing for the following:

To selling shareholder (A):

- A takes a basis in the P stock equal to A's basis in the T stock surrendered plus any gain recognized less boot received. This ensures that if A sells the P stock, the pre-transaction gain will be triggered.

To buyer (P):

- P takes a "carryover" basis in any assets acquired from T in an "A," forward triangular merger, or "C" reorganization. This basis is increased by any gain recognized by T. As indicated above, however, T will almost never recognize gain, even when boot is issued. P's basis in the T assets is <u>not</u> increased by any gain recognized by A under Section 356.
- When P acquires the T stock in a "B" reorganization, P takes a basis in the stock equal to A's basis in the T stock.

Partially Taxable Tax-Free Reorganizations

Just because a transaction qualifies as a tax-free reorganization doesn't mean it's a *tax-free* reorganization, ya' know what I mean? No? OK, then get ready for more words.As discussed above, the IRS allows for a tax-free transaction because A has continued his investment in T in another form by taking back stock in P. But what if A receives both stock in P *and* cash in the deal? In that situation, A has cashed out of his investment to the extent he received cash, and should be taxed accordingly.

As we will soon see, certain options on the Section 368 menu allow for A to receive *both* stock of P and cash in the deal and still have the transaction qualify as a tax-free transaction. But make no mistake, even though the transaction fits within the purview of Section 368, A will be required to recognize gain to the extent of any cash received. That is why I say a transaction can be a tax-free reorganization without being a *tax-free* reorganization.

This partial taxation of a transaction is generally called the "boot within gain" rule. Rather than illustrate how the rule works at this point in the discussion, however, I find that it is more useful if we save it until we are actually working through the transaction types.

Choosing A Tax-Free Transaction

Last week, I explained that choosing a taxable M&A structure is largely a process of elimination. That principle extends equally to the five types of tax-free reorganizations we will discuss today. As you will notice as we address the differing options, each of the five structuring alternatives addresses a specific problem presented by the other four; thus, if we identify our client's specific tax and non-tax goals and characteristics, the ideal tax-free reorganization type typically reveals itself.

Basic Requirements for a Tax-Free Reorganization

In order to use the provisions of Section 368, all of the players must qualify as "parties to the reorganization." In order to do so, the entities involved must all be C or S corporations; thus, partnerships and LLCs – aside from single member LLCs owned entirely by an S or C corporation – may *not* participate in a tax-free reorganization. As a result, if a corporation acquires the assets or ownership interests of a partnership in exchange solely for buyer stock, the transaction will nonetheless be fully taxable to the selling partnership or partners (unless it qualifies as a tax-free transfer to a corporation under Section 351), with the amount realized equal to the fair market value of the buyer's stock.

The factor that will most influence which of the five types of acquisitive reorganizations is available to A and P is the requirement that A receive stock in P as part of the transaction. The five structuring alternatives require varying degrees of stock of P be issued to T and A (giggles), with the required stock as a percentage of total consideration ranging from 100% in the most conservative option to 40% in the most liberal.

Because of this need for stock consideration – which has been described by the courts as the "continuity of interest requirement" -- the single biggest client goal a tax advisor must unearth before recommending a tax-free reorganization alternative is just how much cash A insists in receiving in the transaction. As the percentage of cash climbs, you will find that more alternatives are eliminated from consideration.

Aside from the continuity of interest requirement, there are two other judicial doctrines that have been established by the courts. First, the reorganization must have a business purpose. In addition, there is a "continuity of business enterprise" doctrine, which requires that the historical business of T be continued by P after the transaction.

The Five Acquisitive Reorganizations

Thus concludes our 3,000 words of M&A foreplay. Now, let's dive in to each of the five types of acquisitive tax-free reorganizations. For each option, we'll discuss the basic requirements, analyze the tax consequences, highlight the specific problem the particular reorganization is intended to address, and lastly, point out the pros and cons of each alternative relative to the others.

Section 368(a)(1)(A): "A" reorganization

In a so-called “A reorganization,” T merges into P under state law, with T going out of existence and P surviving. While the merger happens instantly under operation of state law, a tax fiction is created whereby T is deemed to transfer all of its assets and liabilities at the time of merger to P in exchange for P stock and (potentially) cash. T is then deemed to liquidate by distributing out the P stock and cash to A in exchange for A’s T stock. Thus, when the transaction is complete, P owns the T assets directly, and A owns an interest in P courtesy of the P stock it received in the transaction.

An “A” reorganization looks like so:

Problem “A” Reorganization is Designed to Address

In order to qualify as a tax-free reorganization, A must receive stock in P as part of the consideration. As we will see shortly, the majority of the five acquisitive reorganization options only permit a minimal amount of cash to go from P to A. The “A” reorganization – and it’s close cousin, the forward triangular merger of Section 368(a)(2)(D) – are the exceptions to the general rule, and are the only options for A to receive significant cash from P yet have the transaction continue to qualify under Section 368.

Under current regulations, A may receive up to 60% of the total consideration form P in the form of cash. There is no other tax-free reorganization – aside from the aforementioned forward triangular merger – that offers nearly this level of cash to change hands. As a result, if a selling client desires significant cash in the deal but hopes to defer gain on any stock consideration received, an "A" reorganization should be at the top of your list, and truthfully, may well be your only option.

Boot Within Gain Rule

This is the ideal time to illustrate the boot within gain rule that will apply to all tax-free reorganizations that permit some level of cash consideration.Using our facts, assume that T merges into P under state law, with A receiving *solely* stock in P worth $1,000,000. Because T and A (giggles) have received only P stock, the transaction qualifies as a tax-free merger under Section 368(a)(1)(A). T will recognize none of the $600,000 of gain inherent in its assets, nor will A recognize the $600,000 of gain inherent in the T stock. To ensure that the gain is merely deferred, however, A will take a basis in the P stock received equal to A’s $400,000 basis in the P stock, so that if A turns around the next day and sells the P stock for its value of $1,000,000, the deferred gain of $600,000 will be recognized.

What if instead, T merges into P and A receives $700,000 of P stock and $300,000 of cash? The transaction *still* qualifies as a tax-free reorganization, because A has received only 30% of the total consideration in cash, and as previously discussed, A may receive up to 60% cash in an A reorganization.

While the merger continues to qualify as a tax-free reorganization, it will not be a *tax-free* reorganization. This is because A must recognize gain related to the cash received. The rule works as follows:

- T recognizes no gain. Even though T received cash in the deal, T is protected from gain by Section 356 because T is required to immediately liquidate and distribute the cash to A.
- A must recognize gain under the "boot within gain" rule. A recognizes gain equal to the <u>lesser of:</u>
  - The cash received, or
  - The amount of gain inherent in the T stock.

In our example, A will recognize gain equal to the <u>lesser of:</u>

- The cash received of $300,000, or

- The amount of gain inherent in the T stock of $600,000 ($1,000,000 fair market value less $400,000 basis).

Thus, even though the transaction as a whole fits the requirement of Section 368(a)(1)(A) and qualifies as a tax-free reorganization, A will recognize $300,000 of gain pursuant to the boot within gain rule.

Things change with drastic results, however, if A receives so much cash as to totally remove the transaction from the ambit of Section 368.

Assume A has a basis in the T stock of only $100,000 rather than $400,000, so that the gain inherent in the T stock is $900,000. Assume further that T merges into P, with T receiving $700,000 of cash and $300,000 of P stock, and immediately liquidates as required and distributes the cash and stock to A.

You might be tempted to apply the boot within gain rule, and take the position that A recognizes gain to the extent of the lesser of:

- Cash received of $700,000, or
- Total gain inherent in the T stock of $900,000, or $700,000.

This would be a rather large mistake, however. Because T has received 70% ($700,000/$1,000,000) of the consideration in the form of cash, the transaction no longer qualifies as a tax-free reorganization under Section 368(a)(1)(A), as the 60% cap on cash consideration has been exceeded. Thus, the entire transaction is a taxable one. As a result, T recognizes gain for the difference between the basis of its assets and the total consideration received, which includes both the $700,000 of cash and the $300,000 of P stock. Then, upon the liquidation of T, A will recognize gain a second time, for the excess of the $1,000,000 of consideration (less the corporate tax liability) less A's $100,000 basis in the T stock.

As you can see, there is a cliff effect to an A reorganization whereby receiving 60% of the consideration in cash means that only the cash will potentially be taxable, while receiving 61% of the consideration will make the <u>entire transaction taxable.</u> This principle applies equally to the remaining four types of acquisitive tax-free reorganizations.

Pros and Cons of A Section 368(a)(1)(A) Reorganization

Pros:

- It is the most flexible structure in terms of allowing for cash consideration, as up to 60% of the total consideration can be paid in cash.
- There is no requirement that T transfer "substantially all" of its assets to P in the merger. Thus, T can dispose of assets unwanted by P prior to the merger.
- P is not required to issue voting stock.

Cons

- P generally assumes ALL liabilities of T (but there is a new ability to have T merge into SMLLC owned by P).
- Must get approval from P and T shareholders.

<u>**Forward Triangular Merger Under Section 368(a)(2)(D)**</u>

Section 368(a)(2)(D) allows for a variation of a straight A reorganization. Instead of T merging directly into P, in a "forward triangular merger," T merges into a wholly-owned subsidiary of P, with the subsidiary surviving. The subsidiary may be existing (S) or newly-formed (Newco).

Despite the fact that T is merging into a subsidiary of P, T must receive <u>P stock</u>, rather than stock in the subsidiary. In fact, if T receives even one share of S or Newco stock, the entire transaction will fall outside the ambit of Section 368(a)(2)(D) and will be treated as a taxable transaction. A clean forward triangular merger looks like this:

A forward triangular merger allows for the same flexibility in terms of consideration as a straight merger. Thus, T may receive up to 60% of the consideration in the form of cash, provided the other 40% of the consideration is P stock. Of course, if cash is received, A will recognize gain under the "boot within gain" rule as discussed above.

There is one quirk that separates a forward triangular merger from a straight "A" reorganization. In a forward triangular merger, the surviving corporation must acquire "substantially all" of the assets of T. This is generally defined as 70% of the gross assets of T or 90% of the net assets under Rev. Proc. 77-37. The effect of this rule is to limit T's ability to distribute or otherwise dispose of assets that are unwanted by P and S (says it fast and giggles uncontrollably).

Problem the "Forward Triangular Merger" is Designed to Address

If the same mix of cash and stock is permitted, and if T goes out of existence in either a straight "A" reorganization or a forward triangular merger, why the need for the additional structuring option under Section 368(a)(2)(D)?

There are two reasons, really. First, one of the primary downsides of a straight merger is that all of the liabilities of T become liabilities of P by operation of state law. By merging T into a subsidiary of P, the liabilities can be isolated in a separate legal entity and kept away from the business activities of P.

There is also a less obvious, but equally important reason for a forward triangular merger. If T wants to merge into P, P will generally be required to receive approval from all of the

P shareholders. Depending on how many shareholders P has, this may be a major hurdle and hassle.

By having T instead merge into a subsidiary of P, P no longer needs to receive the approval of its shareholders. Instead, the surviving subsidiary – whether it be an S or Newco – must receive the approval of *its* shareholder. And who might that be? P, which will obviously give its approval.

As a result, you should consider a forward triangular merger when your selling client needs to receive cash in the deal, but the purchasing corporation is wary of receiving shareholder approval for a straight merger under Section 368(a)(1)(A).

Pros and Cons of A Section 368(a)(2)(D) Reorganization

Pros:

- Same availability of cash as a straight "A" reorganization.
- Liabilities of T go into S, not P.
- P no longer needs shareholder approval; rather, S needs P approval, which it will get.

Cons

- P must acquire “substantially all” of T’s assets.
- Cannot use stock of S.

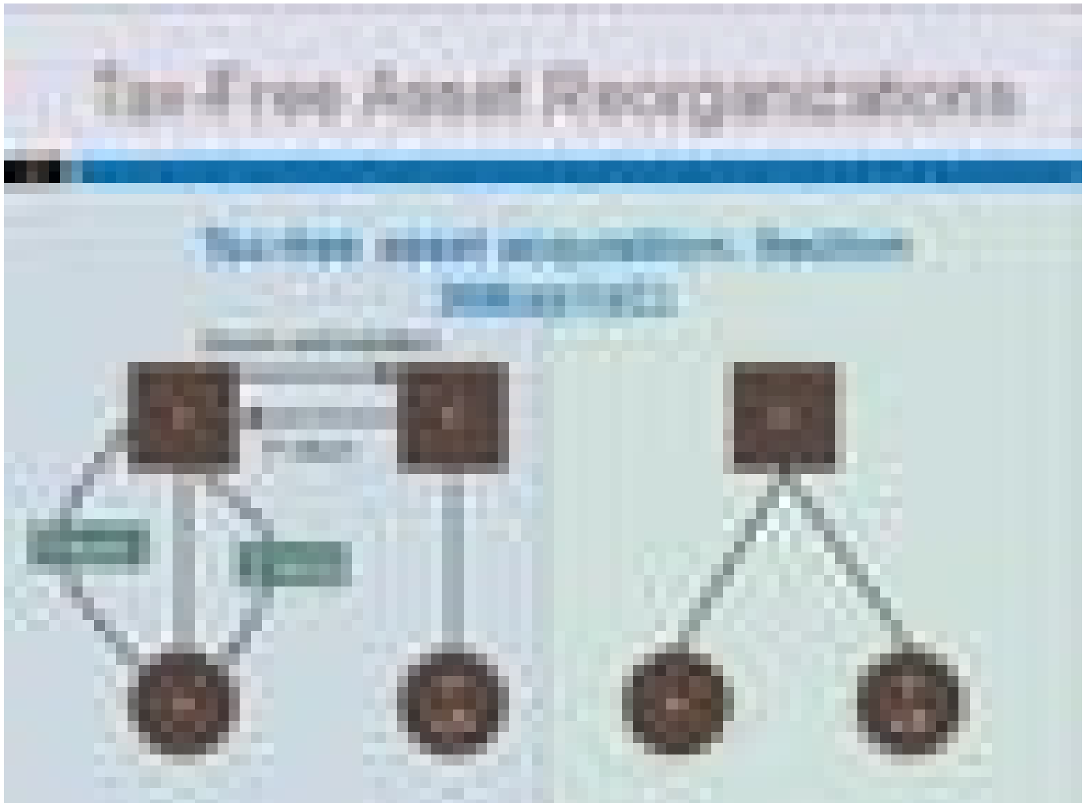
Tax-Free Asset Sale Under Section 368(a)(1)(C): "C" reorganization

Last week, we discussed in great detail the pros, cons, and consequences of a *taxable* asset acquisition. In doing so, we pointed out that the asset purchase is the buyer's structure of choice because it results in a step-up in the basis of the acquired assets.

Section 368(a)(1)(C) provides the option for P to purchase the assets of T in a *tax-free asset* acquisition. It is important to note, however, that because the transaction will be (at least partially) tax-free, the buyer does not receive the step-up in asset basis that is so attractive in a taxable acquisition. This is because – as we previously discussed – gain in a tax-free reorganization is not excluded, it is merely deferred. For this reason, in addition to A taking a substituted basis in the P stock received in the deal, P must take a carryover basis in the assets received from T. This preserves the gain inherent in the T assets so that if T subsequently sells the assets, the pre-transaction gain will be triggered.

In a "C" reorganization, T transfers its assets to P in exchange for P stock, just as in a taxable asset sale. In addition to the lack of asset basis step-up to P, however, there are three key differences in a tax-free asset sale. First, unlike in a taxable assets sale, T is required to liquidate by distributing the P stock to A. In addition, P is required to acquire "substantially all" of the assets of T, meaning T may not dispose of significant assets prior to the transaction. Lastly, in a taxable asset sale, any net operating loss of T remains with T. In a tax-free asset sale, however, Section 381 provides that a net operating loss of T carries over to P, and may be used by P subject to Section 382 limitations.

An asset sale under Section 368(a)(1)(C) looks like this:



The statute provides that P may acquire the T assets by paying up to 20% of the total consideration in cash, with the remaining 80% required to be paid in P stock. The statute further provides that in computing this 20% boot limitation, any liabilities of T that are assumed by P are generally *not* considered cash boot. Here's where things get tricky.

Liabilities of T are not considered cash boot <u>only if no actual cash boot is paid.</u> This means that if P acquires T solely for P stock, and T has liabilities that exceed 20% of its asset value, the liabilities will not constitute boot and the transaction will satisfy Section 368(a)(1)(C).

If, however, P pays even $1 of cash to T in the deal, then <u>all of the T liabilities</u> assumed by P are considered cash boot. Thus, if T's liabilities exceed 20% of its asset value, P may not even issue a single dollar of cash boot, because if it does, the liabilities will be added to the cash and the total boot will exceed the 20% limit.

This treatment of T liabilities as cash boot when actual cash boot is paid effectively eliminates the ability for A to receive any cash in a tax-free transaction, because T's liabilities will typically approach or exceed 20% of its asset value. This inability for A to receive cash, when coupled with P's inability to achieve a step-up in basis, makes "C" reorganizations largely unattractive in most scenarios.

Problem the "C" Reorganization is Designed to Address

With such obvious drawbacks of a "C" reorganization when compared to a tax-free merger, it raises the question of why A, T and P would consider this tax-free version of an asset sale?

One positive of a "C" acquisition is that unlike a state-law merger, the same level of shareholder approval is not required. In addition, while all liabilities of T automatically become liabilities of P upon a merger, in a "C" reorganization, P may pick and choose the liabilities it is willing to assume.

Pros and Cons of A Section 368(a)(1)(C) Reorganization

Pros:

- Doesn't require same level of shareholder approval as merger.

- Can leave some liabilities behind.

Cons:

- From a practical perspective, can't really get cash out.
- T must liquidate.
- Buyer does not get a step up in asset basis.

Tax-Free Stock Sale Under Section 368(a)(1)(B): "B" reorganization

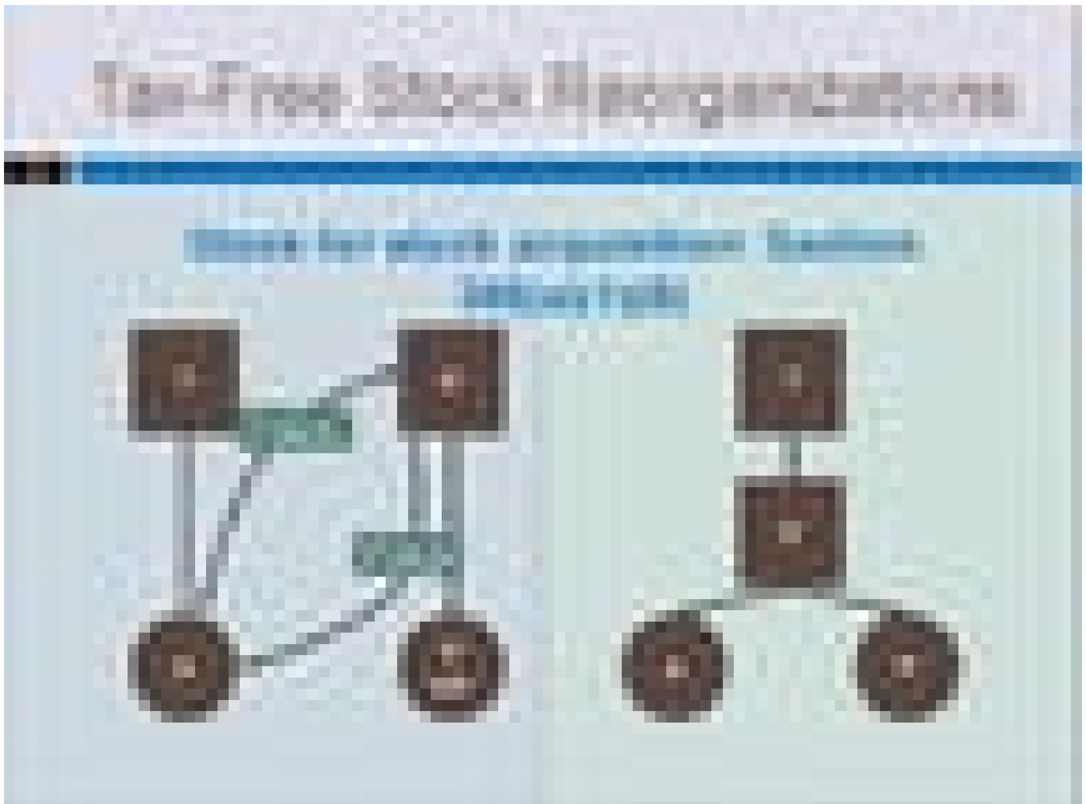
The statute also provides a tax-free version of a stock sale. Just as in a taxable stock sale, in a "B" reorganization, the transaction takes place directly between A and P. A transfers the stock to P in exchange for P stock, and T becomes a wholly-owned subsidiary of P. Immediately after the transaction, P must own 80% of the vote and value of the T stock.

Interestingly, P does not have to a*cquire* 80% of T in the transaction; rather, it simply must *own* at least 80% of T when the dust settles. This means that the same entities can engage in multiple "B" reorganizations. For example, P could acquire 81% of T for P stock in a transaction qualifying under Section 368(a)(1)(B). If P later acquires the remaining 19% of T stock in exchange solely for P stock, that transaction will *also* qualify as a "B" reorganization, because P owns more than 80% of T immediately after the transaction.

The hallmark of the "B" reorganization is the complete limitation on cash boot. A must receive *only* P stock; in fact, if A receives even $1 of cash in the deal, the entire transaction becomes taxable to A. This is commonly referred to as “blowing the B,” and the results are cataclysmic.

Just as in a taxable stock sale, the tax year of T terminates only if T is joining or leaving a consolidated group. If P and T do not elect to file a consolidated return – of if T was not previously part of a consolidated group – T simply files a full-year return.

A “B” reorganization and its aftermath is shown below:



In the standard M&A deal, A typically wants to sell the T stock rather than its assets to avoid double taxation and capitalize on the preferential long-term capital gains rates afforded stock sales.

Such motivations do not exist in a tax-free reorganization, however, because no gain is recognized at either the T or A level. Thus, the primary reasons A and P will choose a “B” reorganization as opposed to an “A” merger, forward triangular merger, or “C” reorganization is because certain assets of T are nontransferable. In the three asset sale-type acquisitive reorganizations, assets of T must move to P, which will often terminate key contracts or licenses. In a “B” reorganization, however, the assets of T remain owned by T; it is simply the ownership of T that shifts from A to P.

Pros and Cons of A Section 368(a)(1)(B) Reorganization

Pros

- T continues its legal existence. No need to transfer contracts.
- Liabilities of T are retained in T, not in P or S.

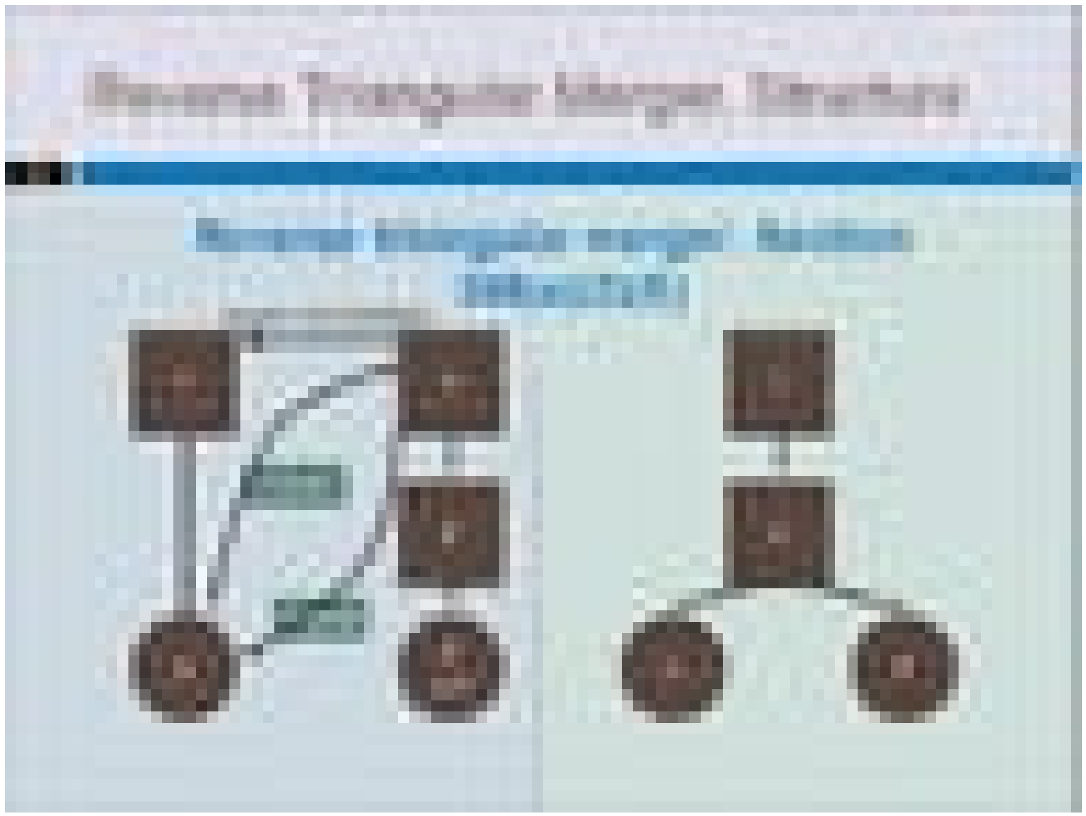
Cons

- A cannot receive ANY cash.
- P must issue voting stock.

Tax-Free Reverse Triangular Merger Under Section 368(a)(2)(E)

At long last, we come to the final of our five acquisitive tax-free reorganizations. A reverse triangular merger is a hybrid of a an “A” merger and a “B” stock acquisition. In the transaction, P sets up a wholly-owned subsidiary, Newco. T then merges into Newco, with T surviving. In the transaction, the former T shareholders give up stock constituting control of T – meaning 80% of the vote and value – in exchange for P stock and, subject to limitation, cash.

A reverse triangular merger looks like this:



If you're particularly astute, you'll notice that the aftermath of a reverse triangular merger looks *exactly* like the end result of a “B” reorganization – T remains in existence as a subsidiary of P. Just like in a “B” reorganization, T will not file a final tax return unless it leaves or joins a consolidated group.

Problems the Reverse Triangular Merger is Designed to Address

More so than the other four reorganizations discussed today, the reverse triangular merger is designed to fix a specific problem. Assume P wants to acquire T, but an asset acquisition isn't possible because T holds nontransferable assets. That eliminates reorganizations under Sections 368(a)(1)(A), (a)(2)(D), and (a)(1)(C). P could, of course, acquire the stock of T in a "B" reorganization.

A "B" reorganization, however, does not allow A to receive even a dollar of cash. What if P needs to acquire the stock of T, but A insists on receiving at least a portion of the consideration in cash?

In a reverse triangular merger, P simply must acquire "control" – or 80% of the vote and value of T – in exchange solely for P stock. This means that P may acquire the other 20% of T stock in cash if it wishes to. Thus, as opposed to a "B" reorganization, in a reverse triangular merger, A may receive up to 20% of the total consideration in the form of cash.

A reverse triangular merger also solves an additional problem with "B" reorganizations. In a straight stock sale, P must chase down all of the shareholders of T, obtain their agreement to sell for P shares, and then complete the sale. This can be a colossal pain in the ass.

In a reverse triangular merger, however, because T is merging with S, provided the requisite amount of T shareholders agree to the merger under state law, all of the T shareholders' T stock will automatically convert into P stock in the deal. There is no need for P to deal with each individual shareholder.

It is important to note, unlike a “B” reorganization, it is impossible for the same P and T to engage in multiple reverse triangular mergers. This is because P must acquire at least 80% of T in the deal; obviously, once P has acquired 80%, it cannot do so a second time. Also note, this means that if P already owns 21% of T, it will be impossible for P to acquire the remainder of the T stock in a reverse triangular merger, because P will not be able to acquire 80% of the T stock “in the transaction.”

After the transaction, T must hold substantially all the assets of T and Newco.

Pros and Cons of A Reverse Triangular Merger

Pros

- Preserves corporate existence of T; doesn’t risk nontransferable assets.
- Unlike straight “B” reorganization, it can allow for 20% cash boot.
- P does not need to get the approval of its shareholders for Newco to merge into T.

Cons

- Must hold substantially all of T’s assets after the transaction, so no pre-transaction disposition is allowed.
- Since 80% of T must be acquired as part of the transaction, if P already owns more than 20% of the T stock, a reverse triangular merger will not be permitted.

Summary

While there are countless variations of these five acquisitive reorganizations (for example, triangular reorganizations whereby a subsidiary of P acquires T in a "B" or "C' reorganization by issuing P stock), the previous analysis should provide the necessary information for zeroing in on the right structure for you client.

Clearly, tackling an M&A project for a client is not among the easier things we'll do as tax advisors, but it is not so daunting that it should fall

Synergy (Photo credit: Mulad)

outside the scope of our services. The fact is, we hold much of the key information regarding our clients' tax and non-tax goals so as to be in the best position to advise the client whether he should -- or can -- pursue a taxable or tax-free acquisition, and if it's the latter, to identify the ideal alternative under Section 368. It is my hope that this two-part discussion helps you in that regard.

Got an idea for a Tax Geek Tuesday? Send it along to anitti@withum.com or on twitter @nittigrittytax

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