

Tax Aspects of Corporate Mergers and Acquisitions

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The following outline is intended to acquaint the reader with some of the more important income tax aspects of merger and acquisition transactions. As with any summary, most of the general statements which follow are subject to numerous exceptions and qualifications. For example, the tax consequences of a transaction may vary significantly if one or more of the parties is a member of a consolidated group, an S corporation, a foreign corporation, or a tax-exempt organization. You should rely on a more comprehensive treatise for complete and detailed information on this subject.¹

As a matter of terminology, the parties to the transactions described in this outline are identified as follows:

“P” means the purchasing or acquiring corporation;

“S” means a wholly-owned corporate subsidiary of P; and

“T” means the acquired corporation, or “target”.

I. TAXABLE SALE OF STOCK

1.1. In this transaction, P purchases all of T’s stock directly from T’s shareholders, in consideration of cash, notes, or some other taxable consideration (or a combination thereof). As a result, T becomes a wholly-owned subsidiary of P.

¹ See generally, Ginsburg & Levin, Mergers, Acquisitions, and Buyouts (2006); Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (7th ed. 2002); Freund, Anatomy of a Merger (1975); Philips & Rothman, 770-3rd T.M., Structuring Corporation Acquisitions - Tax Aspects (2004); Kling & Nugent-Simon, Negotiated Acquisitions of Companies, Subsidiaries and Divisions (2002).

1.2. T's shareholders recognize gain or loss on the sale of their stock, usually capital gain or loss, measured by the difference between the basis in the stock and the purchase price. Generally, individuals are taxed at a 15% rate on capital gains under current federal tax law.

1.3. T recognizes no gain or loss on the transaction and its basis in its assets remains unchanged.

1.4. T's corporate tax attributes (net operating loss carryovers, etc.) remain unchanged, but may be limited as discussed in Section XIII infra.

1.5. P takes a new tax basis in the T stock purchased from the T shareholders equal to the purchase price paid by P therefor.

1.6. A liquidation or merger of T into P following a taxable purchase of 80% or more of T's stock will ordinarily be tax free. Rev. Rul. 90-95, 1990-2 C.B. 67.

II. TAXABLE SALE OF ASSETS

2.1. In this transaction, T transfers substantially all of its assets to P, which may assume none, some, or all of T's liabilities, in consideration of the payment of cash, notes, or some other taxable consideration (or a combination thereof). After the closing, P becomes the new owner of T's assets and any assumed liabilities. T remains in existence immediately after the closing, owning the consideration received for the sale of its assets as well as any assets or liabilities excluded from the sale. T may continue in existence or may be liquidated, in which case its net assets (including the proceeds of sale) are distributed to the T shareholders.

2.2. T recognizes gain or loss on the sale of its assets, measured by the difference between its basis in those assets and the purchase price (including any liabilities assumed). This gain or loss may be capital or ordinary, depending on the nature of the assets sold. Recapture of depreciation will give rise to ordinary income. (§§1245 and 1250). Sales of §1231 assets (basically depreciable property used in a trade or business and held for more than one year) will give rise to capital gain or ordinary loss.

2.3. T's tax attributes do not carry over to P. However, T's net operating losses will be available to offset gain to T recognized on the sale.

2.4. P takes a new basis in T's assets equal to the purchase price for those assets (including assumed liabilities).

2.5. The purchase price for T's assets is allocated among those assets in accordance with §1060. See Section V infra.

2.6. T's shareholders do not recognize gain or loss unless T is liquidated.

2.7. If T is liquidated, T's shareholders will recognize gain or loss measured by the difference between their tax basis in their stock and the value of the property distributed to them. Thus, there is a "double tax" on a liquidation: a corporate level tax on the sale of assets and a shareholder level tax on the distribution of sale proceeds.

III. TAXABLE MERGERS

3.1. A merger is the combination of two corporations into one in accordance with state corporation law. Taxable merger transactions can take three basic forms:

(a) a direct merger of T into P, with P the survivor. As a result of this transaction, P succeeds to all of T's assets and liabilities and T's shareholders receive cash, notes, or other taxable consideration (or a combination thereof).

(b) a forward triangular merger of T into S (a wholly-owned corporate subsidiary of P), with S the survivor. As a result of this transaction, S succeeds to all of T's assets and liabilities and T's shareholders receive cash, notes, or other taxable consideration (or a combination thereof).

(c) a reverse triangular merger of S into T, with T the survivor. As a result of this transaction, T becomes a wholly-owned subsidiary of P and T's shareholders receive cash, notes, or other taxable consideration (or a combination thereof).

3.2. A direct taxable merger will be treated as a taxable sale of assets by T to P, followed by a liquidation of T. Rev. Rul. 69-6, 1969-1 C.B. 104. The tax consequences to the parties will be as described under "Taxable Sale of Assets" supra.

3.3. A forward triangular merger will be treated as a taxable sale of assets by T to S, followed by the liquidation of T. The tax consequences will be as described under "Taxable Sale of Assets" supra.

3.4. A reverse triangular merger, on the other hand, will be treated as a sale of stock by T's shareholders to P. The tax consequences to the parties will be as described under "Taxable Sale of Stock" supra.

IV. DEEMED ASSET SALES UNDER SECTION 338

4.1. If P purchases the stock of T and makes an election under §338, the transaction is treated as a sale of assets by T to itself at fair market value. (§338(a)).

4.2. As a result, T recognizes gain or loss on the deemed sale of assets. Since P is the new shareholder of T, P (and not T's former shareholders) bears the economic detriment of the additional taxes due by T in the year of purchase.²

4.3. T will acquire a new basis in its assets equal to the purchase price plus T's liabilities, including any tax liabilities resulting from the deemed sale.

4.4. T's tax attributes do not continue, although net operating losses may be applied against any gain on the deemed sale.

4.5. T's shareholders are not affected by the election.

4.6. The benefit of a §338 election (a stepped-up basis in T's assets) comes at the cost of immediate realization of tax on the appreciation in value of those assets. Since the principal benefit of the step-up in basis is only realized over time through depreciation and amortization, there is rarely an advantage to making a §338 election.

V. ALLOCATION RULES FOR ASSET TRANSACTIONS

5.1. In an asset sale transaction, the allocation of the aggregate purchase price among T's assets is of great importance for both T and P. T would prefer to allocate as much of the price as possible to long-term capital gain items and as little as possible to ordinary income items, recapture items and short-term capital gain items. P, on the other hand, would prefer to allocate as much as possible to inventory or items recoverable by depreciation or amortization, and as little as possible to non-depreciable assets, such as land and stock.

5.2. Two statutory provisions greatly reduce the parties' flexibility in allocating purchase price: the asset allocation rules of §1060 and the rules for amortization of intangibles under §197.

² Section 338(h)(10) provides a special election pursuant to which a sale of stock of a corporation which is a member of an consolidated group is treated as though it were an asset sale followed by a liquidation of T. Unlike an ordinary 338 election, the deemed sale takes place while T is still a member of the affiliated group and the economic consequences of the tax on the appreciated value of T's assets falls on T's shareholder, rather than on P. The benefit of this election has been extended by regulation to S corporations as well. Treas. Reg. §1.338(h)(10) - 1(c)(1).

Section 1060

5.3. Section 1060 prescribes the so-called “residual method” for the allocation of purchase price in a taxable asset acquisition.³ Under that method, the amount of the purchase price (including assumed liabilities) is allocated in accordance with the following priorities:

- (a) First, to cash and demand deposits (Class I assets);
- (b) Second, to actively traded personal property (such as securities), foreign currency, and certificates of deposit (Class II assets), in an amount equal to their fair market value;
- (c) Third, to assets that the taxpayer marks to market for income tax purposes (Class III assets), in like manner;
- (d) Fourth, to stock in trade or inventory of the taxpayer (Class IV assets);
- (f) Fifth, to all other assets not included in the other classes (Class V assets);
- (g) Sixth, to all Section 197 assets except goodwill and going concern value (Class VI assets); and
- (h) the balance to intangible assets in the nature of goodwill and going concern value (Class VII assets).

5.4. Form 8594 must be filed by each party to the transaction with its tax return for the year of sale.

Section 197

5.5. Under §197, an amortization deduction is allowed for the capitalized cost of certain types of purchased intangibles, including goodwill, going concern value, workforce in place, books and records, customer lists, licenses, permits, franchises and trademarks. A §197 intangible must be amortized over a 15-year period.

5.6. Section 197 reduces the importance to P of limiting the allocation of purchase price to goodwill and going concern value. In fact, P would now prefer to allocate more of the purchase price to goodwill rather than to depreciable assets with recovery periods greater than 15 years, such as real property.

³ Section 1060(a) adopts the price allocation regulations under §338(b)(5). Treas. Reg., §§1.338-6(b) and 1.1060-1(c), T.D. 8940, 66 Fed. Reg. 9925 (Feb. 13, 2001).

VI. COVENANTS NOT TO COMPETE AND CONSULTING AGREEMENTS

6.1. Purchasers of corporate assets or stock frequently attempt to allocate a portion of the consideration for the sale of the business to covenants not to compete, consulting agreements, or similar compensatory arrangements for T's shareholders.

6.2. The purchasers' motivation is often to convert a payment for nondepreciable stock (in a stock deal) or for assets depreciable over a long recovery period (in an asset deal) into a currently deductible payment. The seller may resist this allocation since those payments constitute ordinary income rather than capital gain.

6.3. Section 197, discussed under "Allocation Rules for Asset Transactions" *supra*, requires that non-competition payments be capitalized and amortized over a 15 year term. This period is considerably longer than the term of most non-compete agreements, which defined the amortization period under prior law.

6.4. To the extent that payments by P or T for consulting services are reasonable in amount, they are deductible over the life of the agreement. If such payments are unreasonable in amount, they will be recharacterized as (i) part of the purchase price of the acquired stock (in a stock deal) or (ii) part of the purchase price of the acquired assets (in an assets deal). In the latter case, the amount so recharacterized may be allocated to depreciable or nondepreciable assets, including goodwill and covenants not to compete amortizable under §197.

VII. INSTALLMENT SALES

7.1. Under §453, a taxpayer who sells property and receives payment after the close of the taxable year of sale may report gain or loss under the installment method. The installment method is automatic, unless the taxpayer opts out of the method by electing to recognize the entire gain or loss in the year of sale.

7.2. Under the installment method, a pro rata portion of the gain from a deferred payment transaction is recognized over the payment period. Example: A sells his stock in T (a closely-held corporation) to P for a \$500,000 note payable as to principal in five annual installments of \$100,000. A's basis in the stock is \$200,000; he therefore has a \$300,000 gain. A will report one-fifth of the gain (\$60,000) each year.

7.3. The balance of the deferred gain or loss must be recognized upon the sale or other disposition of the installment obligation. Example: Assume the facts of the previous example. After receiving the first \$100,000 installment of principal, A sells the promissory note for \$400,000. A will recognize the deferred \$240,000 in gain (\$60,000 times 4) in the year of disposition of the note. (§453B). A foreclosure of a security interest in stock or other personal property is treated as a sale or disposition of the installment obligation, even if the seller "takes back" the property in satisfaction of the obligation.

7.4. Generally, where a portion of the purchase price is contingent (for example, on the future success of the business sold), the seller must assume that the maximum proceeds will accrue, and allocate basis *pro rata* accordingly across tax years. This usually bunches gains in early years and so results in minimum deferral.

7.5. Installment sale treatment is not available for dealers in property or for inventory items. (§453(b)).

7.6. Installment sale treatment is not available if the installment obligation received is payable on demand or is a readily marketable security. (§453(f)(4)).

7.7. The installment method may be used by a selling shareholder of corporate stock, unless the stock is traded on an established securities market. (§452(k)).

7.8. The installment method may be used by T in a taxable asset sale, provided that T is a cash basis taxpayer and does not liquidate. However, installment sale treatment will not apply to the sale of inventory or marketable securities or to the extent of depreciation recapture. (§453(b)(2); §453(l)(1); §453 (k)(2); and §453 (i)).

7.9. If T sells its assets for an installment obligation and then liquidates, it will recognize gain in the same manner as if it had elected out of the installment method. However, T's cash basis shareholders may report their gain on the liquidation on the installment method if the liquidation occurs within 12 months. (§453(h)). This is an exception to the general rule that receipt of an obligation of a person other than the purchaser does not qualify for installment sale treatment.

7.10. Special rules apply to installment sales to related parties who dispose of the property within two years following the sale. (§453(e)).

7.11. Section 453A requires the recognition of income on the pledge of certain installment obligations.

VIII. INTEREST ON ACQUISITION INDEBTEDNESS

8.1. Section 279 limits the interest deductions on "corporate acquisition indebtedness" in excess of \$5,000,000 per year. This amount is reduced by interest on certain other acquisition debt incurred after 1967.

8.2. "Corporate acquisition indebtedness" is convertible subordinated debt incurred for the purpose of an acquisition, if the issuing corporation's debt-to-equity ratio exceeds 2:1 or if its average earnings for the past three years are less than three times the annual interest paid or incurred.

8.3. Section 163 denies the interest deduction for payments on an "applicable high yield debt obligation" (AHYDO), which generally is a high-interest debt with greater than a 5-

year maturity generating “significant original issue discount;” this occurs usually where payments in kind (PIK) are allowed to defer cash payments of interests. Section 163 also denies the deduction for certain types of convertible debt, *i.e.*, debt payable in equity of the issuer.

IX. TAX-FREE REORGANIZATIONS

9.1. Section 368 describes certain transactions which qualify as tax-free “reorganizations.” These include the following common acquisition techniques:

- (a) a statutory merger, or “A” reorganization (§368(a)(1)(A)), including:
 - (i) a forward triangular merger (§368(a)(2)(D)); and
 - (ii) a reverse triangular merger (§368(a)(2)(E)).
- (b) an acquisition of stock for voting stock, or “B” reorganization (§368(a)(1)(B)); and
- (c) an acquisition of assets for voting stock, or “C” reorganization (§368(a)(1)(C)).

9.2. Section 368 contains specific definitional requirements which must be met in order for a transaction to qualify as a “reorganization”.

9.3. Generally, a corporation may merge into a “disregarded entity” (single-member limited liability company, or a qualified subsidiary of a REITs or S corporation) under specified circumstances and still qualify as a tax-free “A” or “C” reorganization. Treas. Reg., § 1.368-2.

9.4. In addition to these statutory requirements, the courts have imposed several judicially-created requirements: continuity of interest, continuity of business enterprise and business purpose.

Continuity of Interest

9.3. The continuity of interest doctrine requires that in a reorganization, the shareholders of the acquired corporation retain some significant equity participation in the combined enterprise after the closing of the transaction. Treas. Reg. §1.368-2(a), codifying a line of U.S. Supreme Court cases commencing with Pinellas Ice & Cold Storage Co. v. Comm’r, 287 U.S. 462 (1933).

9.4. The continuity of interest doctrine deals primarily with the type of consideration received by the T shareholders. An acquisition in which the T shareholders receive only cash or debt obligations of T will not satisfy the continuity of interest requirement; the T shareholders must receive some kind of equity security in P.

9.5. Moreover, a “substantial portion” of the consideration received by the T shareholders must be equity securities. Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935). The IRS requires for tax ruling purposes that a least 50% of the total value of T’s equity securities be acquired in consideration of equity securities of P. Rev. Proc. 77-37, 1977-2 C.B. 568, §3.02. However, the IRS issued regulations in September, 2005 include an example in which only 40% of the value of the target was for consideration in the form of equity, and the COI requirement was deemed to be satisfied. Treas. Regs., §1.368-1(e)(2)(v), *Example 1*. In contrast, the regulations clearly indicate that 15% continuity is insufficient. Treas. Regs. §1.368-1(e)(7), *Ex. 6*. These more recent regulations seem more in line with the traditional case law.⁴

9.6. Sales of P stock immediately after the acquisition could, under the step transaction doctrine, be deemed the receipt of cash by the T shareholders. For example, assume that immediately following a statutory merger of T into P, T’s sole shareholder, by prearrangement, sells all of the P stock acquired by him in the merger. Under the regulations, dispositions of P stock following the merger (even if prearranged) do not adversely affect continuity of interest unless the purchaser of the stock is P or a related person. Treas. Reg. §1.368-1(e), Example 1(i).

9.7. Likewise, sales of P stock immediately prior to the reorganization do not adversely affect continuity of interest unless the consideration for the stock comes from P or a related person. Treas. Reg. §1.368-1(e), Example 1(ii).

9.8. On the other hand, the IRS regards redemptions by T of its stock in connection with a reorganization as cash received in the reorganization, whether the source of funds is T or P. Regulations also provide that continuity of interest is compromised by an “extraordinary distribution” to shareholders made by T prior to a reorganization. Treas. Reg. §1.368-1(e)(1); *see also* Treas. Reg., §1.368-1(e)(7), Example 4.

9.9. Where target shareholders receive both money and stock in the acquiring corporation for their interest in target, valuations are made as of the last business day before there is a binding contract (or tender offer) to effect the reorganization. This “signing date rule” is to allay concerns that otherwise eligible reorganizations could fail because of a decline in the acquirer’s stock value between offer and closing. Temp. Reg. § 1.368-1T(e)(2); T.D. 9316 (March 19, 2007).

9.10. Neither the COI requirements nor the COBE requirements (discussed below) apply to “E” and “F” reorganizations. T.D. 9182 (Feb. 25, 2005).

⁴ See John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935) (37.5% continuity found acceptable) and Miller v. Comm’r, 84 F.2d 415 (6th Cir. 1936) (25% continuity found acceptable). As discussed *infra*, the statutory requirements for B and C reorganizations mandate that those transactions be “solely for voting stock;” this statutory continuity of interest requirement obviously supersedes the more generous judicial limitation.

Continuity of Business Enterprise

9.11. The continuity of business enterprise doctrine requires that the acquiring corporation continue to carry on a line of the acquired corporation's business or use a significant portion of the assets of the acquired corporation in another business. Treas. Reg. §1.368-1(d)(2).

9.12. For example, if immediately following a merger of T into P, P terminates all of T's business operations and disposes of all of T's assets, the transaction will not qualify as a tax-free reorganization. However, if P terminates all of T's business operations but uses T's assets in a different line of business, the transaction will satisfy the continuity of business enterprise doctrine.

9.13. The fact that P "drops down" T's assets into a subsidiary does not adversely affect the continuity of T's business enterprise. Treas. Reg., §§ 1.368-1(d)(4) and (d)(5).

9.14. Post-acquisition transfers of assets among members of a "qualified group" of corporations or to partnerships in which members of the qualified group have a significant interest or "active and substantial" management functions, will not violate the continuity of business enterprise rule. Treas. Reg. §1.368-1(d)(4).

Business Purpose

9.15. The business purpose doctrine states that a transaction will qualify as a reorganization only if it is undertaken for reasons germane to the business of a corporation which is a party to the reorganization. Treas. Reg. §1.368-2(g).

9.16. The purpose of this requirement is apparently to exclude transactions entered into exclusively for tax purposes without a non-tax business rationale. As such, it reflects a codification of the famous doctrine of Gregory v. Helvering, 293 U.S. 465 (1935), that in tax law substance will control over form.

X. TAX-FREE MERGERS

10.1. An "A" reorganization is defined in §368(a)(1)(A) as "a statutory merger or consolidation." An A reorganization is the most flexible of the three basic forms of reorganization.

10.2. An A reorganization is the only form which permits a significant amount of cash, notes or other taxable consideration ("boot") to be paid to the T shareholders without disqualifying the transaction as a tax-free reorganization.

10.3. For example, if P acquires T in a statutory merger under which P pays T's shareholders up to 50% in cash or other taxable "boot" in addition to P equity securities, the transaction will qualify as a tax-free A reorganization (although T's shareholders may recognize taxable gain on the receipt of boot, as discussed below).

10.4. In an A reorganization, T's shareholders do not recognize gain except with respect to the receipt of boot.⁵

10.5. In contrast, no loss is recognized on the exchange of T stock, unless the shareholder receives no stock or securities of P, but only boot. (§ 356(c)).

10.6. The basis of the P stock in the hands of the former T shareholder will be equal to his basis in the T stock surrendered, decreased by the amount of boot received and increased by the amount of gain recognized. (§358(a)).

10.7. Generally speaking, T will not recognize any gain or loss on either the transfer of its assets to P, or the distribution to its shareholders of the proceeds of that transfer. (§361). This is true even though T may be deemed to have transferred assets to P for consideration which includes boot taxable to its shareholders.

10.8. P's basis in the assets acquired in the merger transaction will be equal to T's basis in those assets, increased by the amount of gain (if any) recognized by T as a result of the transaction. (§362(b)).

10.9. T's tax attributes will carry over to P, subject to the limitations discussed in Section XIII infra.

10.10. Warrants are generally not treated as boot in a tax-free reorganization. Treas. Reg. §354-(e); Rev. Rul. 98-10, 1998-10 I.R.B. 11.

10.11. Certain types of preferred stock are to be treated as boot in a tax free reorganization (§354(a)(2)(C)). Nonqualifying preferred stock is generally stock which is not entitled to vote, is limited and preferred as to dividends, and does not participate in corporate growth to any significant extent, but only if any one of the following four tests is met: (i) the holder has a right to put the stock to the issuer or a related party (ii) the issuer or a related party is obligated to redeem or buy back the stock, (iii) the issuer or a related party has an option to redeem or buy back the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (iv) the dividend rate is based on interest rates, commodity prices, or similar indices.

⁵ Each T shareholder will recognize gain equal to the lesser of (i) the amount of gain realized in the transaction (i.e., the amount of appreciation in value of his stock) or (ii) the value of the boot received. Example: P and T merge, with P as the survivor. P issues for each share of T stock, \$100 in P stock plus \$50 in cash. X, the owner of one share of T, has an \$80 basis in his T stock. X will recognize gain of \$50 (the value of the \$50 in boot received being less than the potential gain of \$70). Y, another owner of one T share, has a basis of \$130. Y will recognize gain of \$20 (the potential gain of \$20 being less than the \$50 in boot received). (§§354(a), 356(a)).

Triangular Mergers

10.12. Under §368(a)(2)(D), a forward triangular merger qualifies as a reorganization only if substantially all of the assets of T are acquired by S in consideration of P stock. No S stock may be used as merger consideration.

10.13. Under §368(a)(2)(E), a reverse triangular merger qualifies as a reorganization only if (i) after the merger, T owns substantially all of the assets of S and T; and (ii) the T shareholders exchange at least 80% of T's stock for P voting stock. In other words, the primary merger consideration must be P voting stock (non-voting stock will not do) and no more than 20% of the merger consideration may be other consideration.

10.14. In Rev. Rul. 2001-25, 2001-22 I.R.B. 1291, the IRS ruled that the “substantially all” test for a reverse triangular merger was satisfied even though T sold half of its assets prior to the merger. Since the proceeds of those assets were retained by T, it continued to own substantially all of its assets.

10.15. In Rev. Rul. 2001-46, 2001-42 I.R.B. 321, S merged into T, with the T shareholders receiving P stock and cash constituting more than 20% of the merger consideration. Even though this merger would not qualify as tax-free under §368(a)(2)(E), a subsequent merger of T into P pursuant to an integrated plan, was held sufficient to regard the entire transaction as a single merger of T into P, which qualified for “A” reorganization treatment.

XI. TAX-FREE EXCHANGES OF STOCK

11.1. A “B” reorganization is defined in §368(a)(1)(B) as “the acquisition by one corporation, in exchange solely for all or a part of its voting stock ... of stock of another corporation, if immediately after the acquisition, the acquiring corporation has control of such other corporation”

11.2. “Control” is defined in §368(c) as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote plus at least 80% of the total number of shares of all other classes of stock of the corporation.

11.3. In a B reorganization, the sole consideration that can be used is voting stock of either the acquiring corporation or its parent, but not both. Any other consideration (“boot”) destroys the tax-free nature of the transaction.

11.4. If P acquires all of T's stock solely for P voting stock, the transaction will qualify as a B reorganization. Likewise, if S acquires all of T's stock solely for voting stock of P or S (but not both) the transaction will qualify as a B reorganization.

11.5. In a B reorganization, T's shareholders do not recognize gain or loss on the exchange. Rather, each T shareholder takes a substituted basis in his P stock equal to his basis in

the T stock surrendered. Any gain on appreciation in value of the T stock is therefore deferred until a later sale or taxable disposition of the P stock.

11.6. T's basis in its assets is unchanged; P may not elect to step up the basis in those assets under §338.

11.7. T recognizes no gain or loss on the transaction and generally retains its tax attributes subject to the limitations discussed in Section XIII infra.

11.8. P's basis in the T stock acquired in the transaction is equal to the basis of that stock in the hands of the T shareholders. Query: how does P determine its carryover basis if T's stock is publicly traded and held by hundreds of strangers?

11.9. Since the existence of even a slight amount of "boot" will destroy a B reorganization, great care must be used in structuring the transaction:

(a) Purchases by P of T shares as a part of the same plan of acquisition are forbidden, even if the purchased shares constitute less than 20% of T's shares. Heverly v. Comm'r, 621 F.2d 1227 (3d Cir. 1980); Chapman v. Comm'r, 618 F.2d. 856 (1st Cir. 1980); Rev. Rul. 85-139, 1985-2 C.B. 123; Rev. Rul. 75-123, 1975-1 C.B. 115.

(b) However, T may redeem up to 50% of its stock prior to the reorganization without destroying its tax-free nature, so long as the cash for the redemption does not come from P. Rev. Rul. 55-440, 1955-2 C.B. 226; Rev. Rul. 75-360, 1975-2 C.B. 110; Rev. Rul. 68-285, 1968-1 C.B. 147.

(c) Cash paid to T shareholders in lieu of fractional shares will not violate the solely for voting stock rule. Rev. Rul. 66-365, 1966-2 C.B. 116.

(d) Reorganization expenses paid by P will not generally be considered as boot to the T shareholders. Rev. Rul. 73-54, 1973-1 C.B. 187.

(e) SEC registration rights given to the T shareholders will not constitute boot to the T shareholders. Rev. Rul. 67-275, 1967-2 C.B. 12.

(f) Amount paid for employment or consulting agreements will be treated as boot if unreasonable in amount. Treas. Reg. §1.356-5(b); Rev. Rul. 77-271, 1977-2 C.B. 116; Rev. Rul. 68-473, 1968-2 C.B. 191.

XII. TAX-FREE ACQUISITIONS OF ASSETS FOR STOCK

12.1. A “C” reorganization is defined in §368(a)(1)(C) as “the acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other . . . shall be disregarded.”

12.2. Section 368(a)(2)(G)(i) adds the condition that “the acquired corporation distributes the stock, securities and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization.” Thus, there is a requirement that T be liquidated in order for an asset transaction to qualify as a C reorganization.⁶

12.3. If P acquires substantially all of T’s assets (and assumes all or a part of T’s liabilities) in consideration of the issuance to T of P’s voting stock, and T thereafter liquidates, the transaction will qualify as a “C” reorganization. Likewise, if S acquires substantially all of T’s assets (and assumes all or a part of its liabilities), in consideration of S voting stock or P voting stock (but not both), and T thereafter liquidates, the transaction will so qualify.

12.4. The IRS’s present ruling position is that “substantially all” of T’s assets means 90% of the fair market value of T’s net assets and 70% of the fair market value of its gross assets. Rev. Proc. 77-37, §3.01, 1977-2 C.B. 568.

12.5. In a C reorganization, T’s shareholders do not recognize gain or loss on the distribution of P stock on T’s liquidation. Rather, each T shareholder takes a substituted basis in the P stock equal to his basis in the T stock surrendered. Any gain on the appreciation in value of the T stock is therefore deferred until a later sale or taxable disposition of the P stock.

12.6. In a C reorganization, T does not recognize gain or loss on the exchange of its assets for P stock.

12.7. P’s basis in the T assets acquired will be equal to T’s basis in those assets prior to the exchange.

12.8. T’s tax attributes will generally carry over to P, subject to the limitations discussed in Section XIII infra.

12.9. Unlike the strict “solely for voting stock” requirement applicable to B reorganizations, a limited amount of “boot” is permitted in a C reorganization. The amount of boot, plus T’s liabilities assumed by P, plus any T assets not transferred to P, must not exceed 20% of the fair market value of T’s assets. In other words, the P voting stock issued in the

⁶ The liquidation requirement may be waived by the IRS in certain very limited circumstances. §368(a)(2)(G)(ii); Rev. Proc. 89-50, 1989-2 C.B. 631, amplifying Rev. Proc. 77-37, 1977-2 C.B. 568.

transaction must be at least 80% in value of T's total assets. (§368(a)(2)(B)). The tax consequences of the receipt of boot are discussed under "Tax-Free Mergers" supra.

XIII. LIMITATIONS ON THE USE OF TAX ATTRIBUTES

13.1. Section 382 limits the deductibility of net operating loss carryforwards ("NOLs") following an "ownership change" with respect to a corporation with NOL's or net unrealized built-in losses. Section 383 contains similar limitations on carryovers of certain tax credits or capital losses.

13.2. An "ownership change" occurs where there is an increase in stock ownership of more than 50 percentage points within any three-year period by any "five-percent shareholders."

13.3. The use of the loss corporation's NOLs will be completely denied if the loss corporation does not continue its old business for a period of two years following the ownership change. (§382(e)(2)).

13.4. Generally speaking, where an ownership change occurs, the amount of NOLs available to offset income in subsequent years is limited each year to the product of the fair market value of the corporation's stock immediately before the change in ownership multiplied by the IRS's "long-term tax-exempt rate" in effect on the date of the ownership change.

13.5. Example: Assume that T has a \$1,000,000 NOL. P acquires all of T's stock for its fair market value of \$500,000 on August 1, 2007. The long-term tax exempt rate on that date was 4.50%. T would be able to use only \$22,500 of the NOL each subsequent year (\$500,000 times 4.50%).

13.6. Corporate tax attributes may also be limited by §§269, 381, 384 and the consolidated return regulations.

XIV. GOLDEN PARACHUTE PAYMENTS

14.1. Under §280G, no deduction is allowed for "excess parachute payments" paid as a result of a change in control of a corporation or a change in the ownership of a substantial portion of its assets ("change of control").

14.2. In addition, §4999(a) provides for a 20% excise tax on the recipient of any excess parachute payment.

14.3. A "parachute payment" is any payment in the nature of compensation to an officer, shareholder, or highly compensated individual contingent on a change of control if such payment exceeds three times a "base amount". The payment can include the value of stock options which vest upon a change of control.

14.4. The “base amount” is the individual’s average annual compensation for the five taxable years ending prior to the change of control.

14.5. An “excess parachute payment” is the portion of the parachute payment which exceeds the “base amount.” Example: A, the president of T, has average annual compensation of \$150,000 for the past five years. He receives a payment of \$500,000 contingent upon the acquisition of T by P. His “excess parachute payment” would be \$350,000. If A had received a \$450,000 payment, this would not be a “parachute payment” because it did not exceed three times A’s “base amount.”

14.6. The golden parachute rules do not apply to certain corporations eligible to elect S corporation status (§280G(b)(5)(A)) or to non-publicly held corporations whose shareholders approve the payment as provided in §280G(b)(5)(B).

XV. MASSACHUSETTS TAX CONSIDERATIONS

Personal Income Tax

15.1. Under Massachusetts law, gross income generally follows Federal income tax principles. G.L. c. 62, §2(a).

15.2. Federal income tax law distinguishes between ordinary income (taxable at a maximum rate of 35%) and long-term capital gain (generally taxable to individuals at a rate of 15%).

15.3. Under current Massachusetts law, earned and unearned income (including dividends and interest) as well as long-term capital gains are taxed at 5.3%. Short-term capital gains are taxed at 12%.

15.4. Accordingly, there is an incentive to recharacterize ordinary income of individuals (and S corporations) as long-term capital gain for federal (but not for Massachusetts) purposes.

15.5. Non-residents are not subject to tax on the sale of corporate stock in a Massachusetts corporation. Occasionally, Massachusetts residents will change their domicile to avoid capital gains taxation on significant transactions.

Installment Sales

15.6. If a Massachusetts taxpayer uses the installment method for Federal income tax purposes, for tax years beginning on or after January 1, 2005, the taxpayer may automatically qualify for this method for Massachusetts purposes as well, depending on the amount of Massachusetts gain for the transaction. Generally, taxpayers with Massachusetts gain of less than \$1 million must automatically follow the method of reporting for federal purposes. Taxpayers with Massachusetts gain of at least \$1 million who elect the installment method of reporting for

federal purposes have a choice between electing in or out of the Massachusetts installment method of reporting. G.L. c. 62, § 63. See Technical Information Release 04-28. Massachusetts Department of Revenue Administrative Procedure 201.

15.7. An application to use the method must be filed with the Department of Revenue prior to filing of the Massachusetts income tax return. The Department of Revenue will condition its approval of the application upon the posting of “acceptable security.”

Corporation Excise Tax

15.8. Generally speaking, Massachusetts follows Federal income tax principles in determining taxable income for purposes of the Massachusetts corporation excise tax. G.L. c. 63, §30(4).

15.9. There are special limitations on use of NOLs for Massachusetts tax purposes. G.L. c. 63, §30(5)(b).

15.10. Massachusetts also imposes a corporate level income tax on certain S corporations whose total receipts exceed \$6 million per year. G.L. c. 63, §32D(b). An asset sale may result in total receipts subject to this tax in the year of the sale.

Corporation Excise Tax Lien

15.11. A corporation must notify the Commissioner of Revenue at least five days prior to the sale of all or substantially all of its assets situated in the Commonwealth and file all tax returns necessary to determine the tax due and to become due through the date of the sale or transfer. Failure to notify the Commissioner, file returns, or pay taxes creates a lien for the Commissioner on the assets of the corporation effective immediately before the sale. G.L. c. 62C, §51.

15.12. The Commissioner will typically waive the corporation excise tax lien at the request of the corporation. G.L. c. 62C, §52. Massachusetts Department of Revenue Administrative Procedure 613.2 sets forth the procedure to be followed in such cases.

Sales Tax

15.13. A sale of a business in its entirety by the owner (other than the sale of any motor vehicle, trailer, boat or airplane included therein), is exempt from the Massachusetts sales tax as a casual or isolated sale. G.L. c. 64H, §6(c); 830 CMR 64H.6.1(1)(d). To avoid the Massachusetts sales tax on the transfer of inventory, the seller should obtain a resale certificate from the purchaser.