

# ***M&A Deals – What’s New?***

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## ***Agenda***

- I. Spin-offs and Section 355
- II. Qualified small business stock
- III. Excise tax on stock buybacks
- IV. Success-based fees
- V. Other M&A considerations

## *Spin-Offs and Section 355*

### *Spin-Offs--Overview*

- **Distributing can distribute Controlled tax-free if certain requirements are met:**
  - **Statutory requirements**
    - 80% control
      - High/low voting structures
      - Control gathering
    - Distribution of control
    - Active trade or business
      - Hot dog stand?
      - Expansion doctrine
    - Not a “device” for distribution of E&P
      - Non-business assets
  - **Judicial requirements**
    - Business purpose
    - Continuity of business enterprise
    - Continuity of interest
- **ca r5]D4n.2BDC spi>>B6( 2.274 0 w s)8647.04 -0 /TT1 4**

## Comparison to Section 301 Distributions

	<b>Section 301 Distribution</b>	<b>Section 355 Spin-Off</b>
Income/Gain	<ul style="list-style-type: none"> <li>Corporate level deemed sale treatment under Section 311(b)</li> <li>Apply Section 301(c)(1) – (c)(3) to determine shareholder tax treatment (dividend to extent of Distributing's E&amp;P, reduction of Distributing's stock basis, excess capital gain)</li> <li>For internal distributions within consolidated group-deferral triggered on external distribution</li> </ul>	<ul style="list-style-type: none"> <li>Non-recognition treatment</li> </ul>
Impact on Tax Attributes	<ul style="list-style-type: none"> <li>Gain on deemed sale of target shares               <ul style="list-style-type: none"> <li>- Subpart F</li> <li>- Section 1248 or Section 964(e)</li> </ul> </li> <li>Shareholders' tax basis in Controlled shares equal to fair market value of the shares</li> </ul>	<ul style="list-style-type: none"> <li>Treas. Reg. Section 1.312-10 impact</li> <li>Treas. Reg. Section 1.367(b)-5 analysis</li> <li>Shareholders' tax basis in Controlled shares equal to a proportionate allocation of their tax basis in Distributing's shares</li> </ul>
Elective?	<ul style="list-style-type: none"> <li>No, distributions that do not meet qualifications of Section 355 transactions are treated as Section 301 distributions</li> </ul>	<ul style="list-style-type: none"> <li>No, Section 301 distributions that meet qualifications of Section 355 transactions are treated as Section 355 transactions</li> </ul>

## *Key Requirements for Tax-Free Spin-Off (cont'd)*

- **Device Test.** The spin-off must not be used principally as a device for distributing the earnings and profits of Distributing, Controlled or both
  - Failure of device test result in a fully taxable distribution to both Distributing and Distributing's stockholders
  - Facts and circumstances test, with enumerated device and non-device factors
  - Generally prohibits planned taxable sales of Distributing or Controlled
  - Any post-distribution sale (whether or not planned) is a device factor, the strength of which depends on proximity in time, strength of business purpose, etc.
  - Significant cash and other liquid assets in excess of working capital needs are evidence of device
- **Disqualified Investment Corporation.** If a majority of the value of Distributing or Controlled is attributable to investment assets, the spin-off may not be tax-free

## *Preserving the Tax-Free Spin-Off – Section 355(e)*

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### *Preserving the Tax-Free Spin-Off – Section 355(e) (cont'd)*

- **Distributing Liability.** Distributing is legally liable for the taxes under Section 355(e), but the taxes could be allocated to Cu3.1((e)-6.56l-]
- **Diligence Issu**

*Preserving the Tax-Free Spin-Off – Safe Harbors (cont'd)*

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## *Preserving the Tax-Free Spin-Off – Safe Harbors (cont'd)*

- **One-Year Safe Harbor.** A post-

## *Preserving the Tax-Free Spin-Off – Safe Harbors (cont'd)*

### *Safe Harbors Simplified*

<b><u>Timing of Substantial Negotiations</u></b>	<b><u>Safe Harbor for Post-Spin Transaction</u></b>
Never	Immediately after spin-off
More than 2 years prior to spin-off	Immediately after spin-off
Between 1 and 2 years prior to spin-off	No [substantial] negotiations for 12 months prior to and 6 months after spin-off
Less than 1 year prior to spin-off	No [substantial] negotiations for 12 months after spin-off



*Extracting Value or Reallocating Liabilities in a Spin-*





## *Extracting Value or Reallocating Liabilities in a Spin-Off (cont'd)*

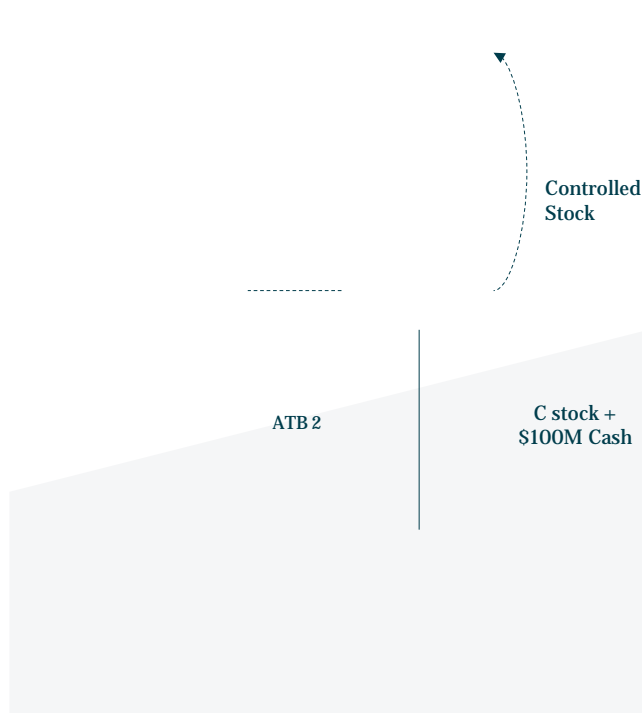
- Cash distributions to Distributing and liability assumptions by Controlled are subject to additional limitations:
  - Basis limitation – For the cash distribution or liability assumption by Controlled to be tax-free to Distributing, amount of cash distributed/liabilities assumed cannot exceed Distributing's basis in its Controlled stock (if Controlled is a preexisting

## *Extracting Value or Reallocating Liabilities in a Spin-Off (cont'd)*

### *Example 1: Cash Distribution, Boot Purge*

## Extracting Value or Reallocating Liabilities in a Spin-Off (cont'd)

### Example 2: Boot Purge



- **Facts:** Distributing is engaged in two lines of business, ATB1 and ATB2, each of which is actively conducted. ATB2 has basis of \$100M, FMV of \$400M
- **Step 1:** Controlled issues debt to unrelated creditor
- **Step 2:** Distributing contributes ATB 2 to Controlled in exchange for \$300M of Controlled stock and \$100M cash;
- **Step 3:** Distributing distributes Controlled stock to Distributing's shareholders and repays existing Creditor \$100M cash.

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## Extracting Value or Reallocating Liabilities in a Spin-Off (cont'd)

### Example 3: Liability Assumption

- Distributing recognizes gain on contributed assets if liabilities assumed by Controlled exceed basis in contributed assets.
- Gain is recognized under Section 357(c) rather than as an ELA under consolidated return rules. Treas. Reg. § 1.1502-80(d)(1) (as would be the case in absence of

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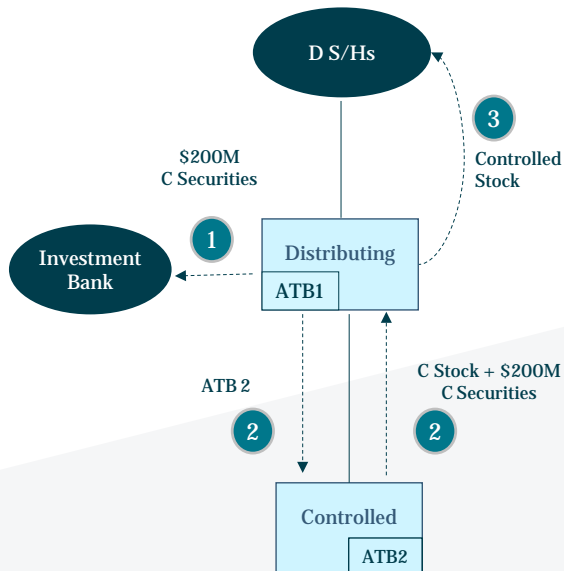
## Extracting Value or Reallocating Liabilities in a Spin-Off (cont'd)

### Example 4: Debt-for-Debt Swap with Controlled Securities

- **Facts:** Distributing is engaged in two lines of business, ATB1 and ATB2, each of which is actively conducted. ATB2 has basis of \$100M, FMV of \$400M
- **Step 1:** Distributing contributes ATB 2 to Controlled in exchange for \$200M of Controlled stock, \$100Ma2(M)]Tc6FMc0Ma2(M)]Tc4Tc 0.0

## Extracting Value or Reallocating Liabilities in a Spin-Off (cont'd)

### Example 5: Intermediated Debt-for-Debt Swap



- **Facts:** Distributing is engaged in two lines of business, ATB1 and ATB2, each of which is actively conducted. ATB2 has basis of \$100M, FMV of \$400M
- **Step 1:** As part of a plan, investment bank purchases Distributing debt from creditors and holds the debt for its own account. After a sufficient period of time, investment bank enters into an agreement with Distributing to accept Controlled securities in retirement of the Distributing debt.
- **Step 2:** Distributing contributes ATB2 to Controlled in exchange for \$200M of Controlled stock and \$ 200M of Controlled securities.
- **Step 3:** Distributing distributes Controlled stock to Distributing's shareholders and repays investment bank using \$ 200M of C securities.

## *Extracting Value or Reallocating Liabilities in a Spin-Off (cont'd)*

### *Example 6: Debt-for-Equity Swap with Controlled Stock*

- Delayed share transfer may be facilitated by investment bank.
- [Within [18 months] retained shares may also be distributed to Distributing shareholders as a distribution or in exchange for shares of Distributing under Section 355. If not used to repay debt or distributed to shareholders, within five years shares will be sold.]
- Consider business purpose, contin2.4(r.2.4(nM33l)-38.2(an /T1

### *Revenue Procedure 2024-24 and Notice 2024-38*

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## *Revenue Procedure 2024-24 and Notice 2024-38 (cont'd)*

- **Areas of Study under Notice 2024-38**
  - Application of substance over form, agency, step transaction and other relevant theories to intermediated exchanges and direct issuance transactions
  - Delayed distributions versus retentions
  - Stricter scrutiny on continuing relationships
  - Solvency, continued viability of Distributing and Controlled
  - Tax consequences of post-distribution payments
  - Impact of transactions related to divisive reorganizations (e.g., RMTs) on Controlled securities
  - Re-leveraging
  - Distinction between Section 357(c) and Section 361

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## *Distinction between Section 357 and Section 361?*

- Rev. Proc. 2024-24 draws a distinction between liabilities, which include non-financial and contingent liabilities and may be assumed pursuant to Section 357, and debt, which is limited to liabilities pursuant to an instrument or contractual arrangement constituting debt for US federal income tax purposes, and may be satisfied with Section 361 consideration under Sections 361(b)(c) and (c)(3)
- Cites to legislative history of Section 361 that mentions indebtedness, although the purpose of the change in statute was to overrule *Minnesota Tea*, which included non-debt liabilities, and liabilities and indebtedness have been used interchangeably in various contexts
- Common subject matter, shared animating policies, same basis limitation, what gives?

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## *Intermediated Exchanges and Direct Issuance Transactions*

- Notice 2024-38 states that Treasury and IRS are considering the application of general principles of federal income tax law (including substance over form, agency and other relevant theories) to intermediated exchanges and direct issuance transactions
- Exchange could be recast such that, e.g., intermediary is not respected as a creditor of Distributing, or is treated as Distributing's agent, rather than acting for intermediary's own account and subject to the upside/downside of the intermediated exchange
- In that case, Distributing would not be treated as exchanging Distributing's stock for stock of Controlled, and Section 361 consideration would not apply

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## *Intermediated Exchanges*

- **Prior 5/14 Standard**
  - Investment bank buys outstanding Distributing debt from holders
  - 5 days later, IB and Distributing enter into an agreement to exchange Distributing debt for Controlled stock or securities, with
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## *Intermediated Exchanges (cont'd)*

- Heightened concern if intermediated exchange is hardwired prior to, contemporaneously with or shortly after the intermediary acquires the Distributing debt
- If there is an agreement, understanding or arrangement with respect to the intermediated exchange prior to or at the same time as intermediary's acquisition of Distributing debt, taxpayer must provide information and analysis establishing that the requirements of Section 361 are satisfied (taking into account substance over form, agency, etc.)
- Service will consider the length of time between intermediary's acquisition of Distributing debt and its satisfaction with Section 361 consideration as a primary factor in determining whether form should be recast

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## *Intermediated Exchanges (cont'd)*

- End result of intermediated exchange is that Distributing has retired

## *Direct Issuance Transactions*

- Distributing issues new debt directly to intermediary for cash
- Distributing uses cash to retire outstanding debt held by unrelated third parties
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## *Direct Issuance Transactions (cont'd)*

- Should a direct issuance be treated as a sale of Controlled stock or securities?
  - Does a loan need to be outstanding for a certain period of time to be respected as debt for tax purposes?
    - Commercial paper has a term of 7 to 21 days
  - Does method of repayment using Controlled stock or securities necessitate recast from loan to sale if:
    -



## *Replacement of Distributing Debt*

- Notice 2024-38 states that Treasury and the IRS are of the view that replacement of Distributing debt that was satisfied with Section 361 consideration can be used as an artifice for increasing the debt and other liabilities of Distributing and Controlled, replicating a sale of a portion of Controlled
- Rev. Proc. 2024-24 requires representation that Distributing debt satisfied with Section 361 consideration will not be replaced with committed or anticipated borrowing
- Exceptions only for borrowings incurred in the ordinary course of business under an existing revolver unrelated to spin or resulting from an unanticipated change in circumstance unrelated to spin.
- Anti-abuse concern only?

## *Continuing Relationships*

- Notice 2024-38 indicates renewed focus on continuing relationships, especially overlapping key employees, officers and directors and contractual arrangements on non-arm's length terms, and especially if business purpose is fit and focus
- Only in the context of retention of Controlled stock or securities, or more broadly?
- Rev. Proc. 2024-24 states that the degree of continuing relationships will significantly inform the determination of whether a retention is in pursuance of a tax avoidance plan
- Retention ruling generally requires a representation that none of Distributing's directors, officers or key employees will serve as a directors, officers or key employees of Controlled while Distributing retains Controlled stock or securities
- If representation cannot be made, favorable ruling may be issued if overlap is solely to accommodate Controlled business needs, overlapping directors are a minority of Controlled's board, and overlap is for an identified limited period of time. Officers count as directors for this purpose
- New multi-factor test for retention tax avoidance purpose focuses on continuing relationships

## *Post-Distribution Payments from Controlled to Distributing*

- Notice 2024-38 states that post-distribution payments will be treated as Section 361 consideration only if the taxpayer establishes that (1) under Arrowsmith (relation-back doctrine), the character is Section 361 consideration, (2) as of the first distribution date, the FMV of Distributing's right to receive the payment(s) was not reasonably ascertainable, and (3) the payment will be properly accounted for when received
- E.g., indemnity payments, adjustment amounts, balancing payments, true-ups, earnouts, etc.
- Rev. Proc. 2024-24 requires representation that Distributing will deposit any post-distribution payment received from Controlled in a segregated account and will distribute it within 90 days after receipt to shareholders or to creditors in satisfaction of existing old and cold Distributing debt
- Most post-distribution payments are in respect of indemnities and may be made long after the spin, when there may not be any old and cold Distributing debt outstanding, or Distributing may already have paid the liability using cash on hand

## Basic Exemption

- Reduced federal income tax for non-corporate stockholders on capital gains from QSBS held for more than five years

Acquisition Date	Exclusion	Effective Max Tax Rate*	Effective Max AMT Rate	Gain Subject to 3.8% NIIT
8/11/93 – 2/17/09	50%	14%	14.98%	50%
2/18/09 – 9/27/10	75%	7%	8.47%	25%
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## Rev. Proc. 2024-3: IRS “No Rule” Policy

### IRS NO RULE POLICY

- New “No Rule” Policy. In Rev. Proc. 2024-3, published on January 2, 2024, the IRS stated that it would not longer issue private letter rulings (PLRs) regarding whether a corporation meets the active business requirement under Section 1202(e).
  - The IRS had issued several taxpayer **favorable** PLRs starting in 2013, including, for example: PLR 201436001 (drug testing & manufacture), PLR 201717010 (medical testing), PLR 202114002 (insurance broker), PLR 202125004 (manufacture of healthcare products), PLR 202221006 (pharmaceutical distributor), PLR 202319013 (application services software company), PLR 202352009 (interim staffing), PLR 202342014 (data migration), and PLR 202418001 (medical testing & reports)
  - These rulings specifically addressed whether the corporation was in a *qualified* trade or business under Section 1202(e)(3). Does Rev. Proc. 2024-3 change that?
  - The IRS issued taxpayer **unfavorable** guidance in CCA 202204007 (reservations website matching lessors and lessees).

### IRS PRIORITY GUIDANCE PLAN

- IRS Priority Guidance Plan includes guidance on the Section 1202 QSBS rules described as “Guidance under §1202 regarding the exclusion of gain from the sale or exchange of qualified small business stock.”

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## IRS Exams (Audits) of QSBS Issues

1. Provide documentation regarding the sold shares, including the following: (a) Date shares were acquired, (b) cost basis of shares, (c) date shares were sold, (d) sales price of shares.
2. Provide documentation verifying the sold shares qualify for the qualified small business stock gain exclusion, including the following:
  - a. Corporation was a C-corporation from acquisition through disposition.
  - b. The shares of Corporation were original issuance stock after 8/10/93.
  - c. Corporation had **total gross assets of \$50 million or less at all times after August 9, 1993, and before it issued the stock.**
  - d. You acquired the stock at its original issue in exchange for money or other property (not including stock), or as pay for services provided to the corporation.
  - e. The corporation must have met the active business test and must have been a C-corporation during substantially all the time you held the stock. \_\_\_\_\_

## *Short Positions, Hedges and Constructive Sales*

*Consider whether gain on QSBS shares may have been triggered even if legal title to shares retained:*

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### *Short Positions and Hedges – Simultaneous “Put” and “Call”*

- Basic Facts: Holder of QSBS shares enters into an arrangement on DATE 1 with Buyer pursuant to which
  - (1) during initial 6-month period, Buyer has the right the purchase shares for \$10 per share (i.e., call right);
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## Short Positions and Hedges – Nonrecourse Loan

- Basic Facts: “Holder” of QSBS shares borrows cash from Buyer.
  - Loan is non-recourse.
  - Only collateral is the QSBS shares.
- Considerations:
  - Is this fundamentally the same as a “put” right for a fixed amount in the hands of Holder? In other words, if Holder never pays back the loan, he or she forfeits the shares but keeps the cash.
  - How important are the terms of the loan and security?
  - What if loan is only 50% of the FMV of shares pledged as collateral?
  - Does this fact pattern also implicate the Sec. 1202(j) rules?
- See, for example, *Lizzie W. Calloway v. Comm’r* 135 T.C. 3 (2010).

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## Short Positions and Hedges – Section 1202(j)

- If the taxpayer has **an offsetting short position** with respect to any qualified small business stock, the QSBS exclusion does not apply to any gain from the sale or exchange of such stock unless—
  - (A) such stock was held by the taxpayer for more than 5 years as of the first day on which there was such a short position, and
  - (B) the taxpayer elects to recognize gain as if such stock were sold on such first day for its fair market value.
- The taxpayer shall be treated as having an **offsetting short position**

## QSBS Example: Transfer of LTP interests to UTP

- Facts:
  - LTP owns stock in ABC that is treated as QSBS.
  - Individual A owns an interest in LTP. Individual A contributes his interest in LTP to UTP, an existing partnership.
- Issues:
  - General rule that QSBS contributed to a partnership is not QSBS in hands of the transferee partnership. Same rule if contribution of interest in LTP to UTP?
  - Can Individual A exclude his portion of the gain on sale allocated to him through UTP?
    - See Treas. Reg. 1.1045-1(g)(3)(iii) regarding tiered partnerships: “**...upper-tier partnership’s ownership of the lower-tier partnership is disregarded...**” (emphasis added).
    - Note risks with analogy for Section 1202 purposes to Section 1045 regulations.
  - What about Individual B? Fails continuing economic interest rule under Section 1202(g)(2)(B).



Individual A



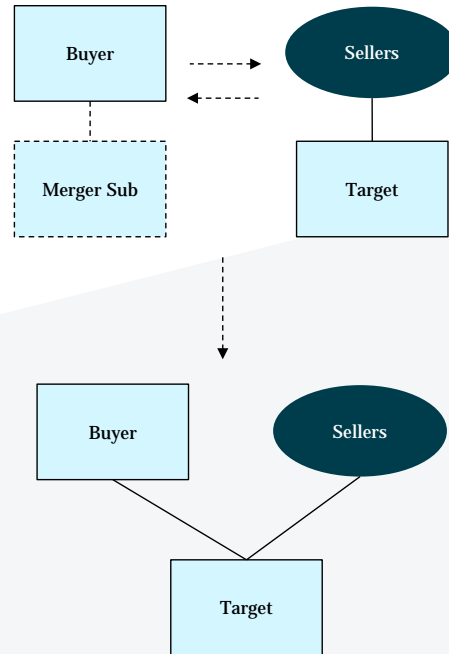
ABC  
(C Corp)



*QSBS Example: S Corporation Transfer of Business to Newco in Exchange for QSBS*

## QSBS Example: Holding Period Is Not Satisfied

- Facts:
  - Sellers own stock in Target (“**Target**”) that has a holding period of almost (but no more than) 5 years.
  - Buyer wants to purchase Target for cash.
- Alternatives:
  - Delay closing (does merely signing an agreement implicate Section 1202(j))
    - Does delaying payment work?
  - Use buyer stock – tax-free reorganization
  - Partial sale
    - Complications:
      - Put/call mechanism/ensuring certainty of final structure
      - Can Buyer consolidate?
      - QSBS eligibility requirements
- Other potential uses for deferral structure
  - Acquisition using stock consideration that doesn’t qualify as tax-free reorg
  - Acquisition by a partnership



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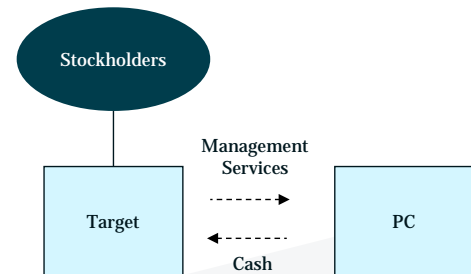
## QSBS Example: Packing and Stacking

- Facts:
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## QSBS Example: Friendly PC Structure

- Facts:
  - Target is a C-corporation.
  - Target provides management services to friendly professional corporation that employs health service providers
- Issues:
  - Is Target engaged in the business of providing “health services”?
  - Can Target include PC in its consolidated tax return?
    - Does the answer to this question impact the QSBS analysis?
      - Does the relative value of the management business versus the medical practice matter?



## *Excise Tax on Stock Buybacks*

### *Background*

- Section 4501 added by Inflation Reduction Act in August 2022.
- Imposes 1% excise tax on net amount of repurchases of corporate stock (value of stock repurchased minus value of stock issued).
- Applies to buybacks made after December 31, 2022 by publicly traded domestic corporations, some domestic subsidiaries of foreign corporations, and covered surrogate foreign corporations.
- Example exemptions:
  - Corporations with less than \$1 million in net buybacks in a tax year are exempt.
  - Dividends for tax purposes.
  - If part of a tax-free reorganization and no gain/loss is recognized on such repurchase by the shareholder by reason of such reorganization qualification.

## Guidance

- Initial guidance issued in January 2023 (Notice 2023-2).
- Proposed regulations issued in April 2024.
- Final regulations regarding procedural matters issued on June 28, 2024.
  - Generally follow proposed regulations regarding procedural matters.
  - NEW per final regulations: RICs and REITs are exempt from the requirement to file a stock repurchase excise tax return (Form 7208) due to their exemption from the tax but have to maintain records.

## Ongoing Discussion Points

- Some industry groups/others argue that the so-called “funding rule” introduced in Notice 2023-2 and maintained (with some modification) in the proposed regulations should be withdrawn.
  - The “funding rule” applies the buyback tax to publicly-traded foreign-parented domestic corporations that fund “by any means” purchases or repurchases of certain foreign corporation stock if avoidance of the excise tax is a principal purpose of the funding.
  - The rule may go beyond the scope of Section 4501 and so some say it should be struck down in the courts (see, notably, the Supreme Court’s decision in *Loper Bright Enterprises Inc. v. Raimondo*, No. 22-451 (S. Ct. 2024), which requires courts to determine the “best” interpretation of statutes that aren’t clear on their face).

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## M&A

- When this tax *might* apply in a M&A:
  - Pre-positioning or post-transaction redemptions/cash outs.
  - Pre-positioning or post-transaction single entity reorganizations (E, F).
  - Transactions when US pubco stock is purchased by an affiliate of the pubco.
  - Acquisitive reorganizations with cash or other property as consideration, especially if cash originates from the target or debt is used to finance the acquisition and is assumed by the target.
- Unknown if 1% rate could be turned up/down in future.

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## *Next Steps*

- Domestic pubcos and specified affiliates of foreign pubcos should have prepared for any filing and payment obligations that were due on October 31, 2024.
- Review in respect of any planned redemptions by covered corporations or transactions that are like redemptions.

## *General Rules – Treas. Reg. Section 1.263(a)-5(a)*

- Per Treas. Reg. Section 1.263(a)-5(a), a taxpayer must capitalize an amount paid to “facilitate” a “transaction” including most acquisitions of a target’s assets or stock.
- Thus, costs attributable to a buyer’s acquisition of a target’s assets or stock are usually not deductible and instead are added to the basis of

### *Application to Success-Based Fees*

- A success-based fee is a fee “contingent on the successful closing of a transaction,” such as an investment banker’s fee.
- Such fee is paid to “facilitate” a transaction and thus is required to be capitalized.
  - “...*except to the extent* the taxpayer maintains sufficient documentation



## *Safe Harbor*

- Due to numerous IRS and taxpayer disputes over difficulties in providing this “sufficient documentation,” IRS issued Rev. Proc. 2011-29, providing a safe harbor for deducting 70% of a success-based fee paid or incurred in a so-called “covered transaction.”
- Does not apply to a non-covered transaction.
- This applies in lieu of maintaining the documentation.

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## *PLR 202308010 (released Feb. 24, 2023)*

- IRS addressed a taxpayer’s request for relief under Treas. Reg. section 301.9100

*PLR 202308010 (released Feb. 24, 2023), continued*


- Relief was denied.
  - IRS found that under the transaction agreement, the selling shareholders reduced the gross sales price by the amount of the success-based fee.
  - IRS claims that if Taxpayer deducts the success-based fee, this adjustment to the gross sales price creates a double benefit by reducing the shareholders' amount realized on the transaction and, by extension, their gain by the amount of the fee.
- *Further*, IRS concluded that a success-based fee paid to a financial adviser was a capitalizable cost incurred by the majority shareholder, a private equity fund, instead of a cost of the target (see Regs. Sec. 1.263(a)-1(e)(1)).

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*PLR 202308010 (released Feb. 24, 2023), continued*

- IRS conclusion seems to run contrary to past ruling practice and cut against the intent of Rev. Proc. 2011-29 to reduce controversy over substantiating the deductibility of success-based fees.
- Could mean a larger change in IRS policy (?).
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## *Implications*

- This area seems to be an area of IRS focus.
  - Taxpayers should carefully examine their specific facts and circumstances when determining which party to a transaction is the appropriate entity to take transaction costs into account.
  - This determination is critical to making a valid safe harbor election under Revenue Procedure 2011-
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## *Other Tax Considerations*

## *Liberty Global*

- **Economic substance doctrine: longstanding judicial doctrine applied to attack tax shelter transactions.**
- **Codified in 2010 under Code section 7701(o).**
- **District court recently rejected a transaction based on the economic substance doctrine.**

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