M&A and Financings Trends

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Contingent Value Rights—In General

Distributed Event-Based CVRs

Distributed CVRs—Tax Issues on Receipt

Distributed CVRs—Tax Issues on Receipt, cont'd

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Distributed CVRs—Tax Issues on Receipt, cont'd

- *Stephens v. Commissioner*, 60 T.C. 1004 (1973), aff'd per curiam, 506 F.2d 1400 (6th Cir. 1974) (contractual obligation to make future payments did not constitute a corporate distribution of its own obligation)
- *Vinnell v. Comm'r*, 52 T.C. 934, 944 (1969) (contractual obligation to make payments over 10-year period was not distribution of obligation taxable as money or property distribution in year contract was made, but merely evidence of obligation to pay amount over period of years)
- FAA 20055202F (when obligation was distributed, it was not made unqualifiedly subject to recipient's demand for payment, but was contingent both with respect to amount and timing of payment; distribution of contingent obligation disregarded)
- Public disclosures generally treat distributed CVRs as distribution of property
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Distributed CVRs—Tax Issues on Payment

- **Tax consequences if CVRs are treated as promises to pay future distributions**
- **To acquirer stockholders**--Distribution of CVRs is ignored and future payments are treated as dividends under Sectiod Sder1 -4.7(s)e h719.C219.C219.C ι

Distributed CVRs—Tax Issues on Payment, cont'd

- **Tax consequences to acquirer stockholders if CVRs are**

Distributed CVRs—Tax Issues on Payment, cont'd

- **Tax consequences to <u>acquirer</u> if CVRs are treated as distribution of property in <u>closed transaction</u>**
- Should be similar to distribution of a debt obligation. No gain or loss under Section 311. E&P reduced by fair market value of CVR. Section 312(a)(2). Nondeductible distribution
- Compare impact on E&P of distributions of other types of property, where recognized Section 311(b) gain increases, and FMV of distributed property decreases, E&P
- Payments in excess of CVR's original FMV should be treated as payments on a contract, and should reduce E&P as payments are made
  - Are payments in excess of original fair market value deductible by issuer? Payments of distributions on stock would not have been deductible
  - Or required to be capitalized under Section 263 as a cost of acquisition of target? Treas. Reg. § 1.263-5

Distributed CVRs—Tax Issues on Payment, cont'd

- **Tax consequences if CVRs are treated as distribution of property in <u>open transaction</u>**
- Generally, open transaction doctrine applies only if there is no reasonably ascertainable FMV, which in government's view is only in "rare and extraordinary" cases. Treas. Reg. § § 1.1001-1(a), (g)(2)(ii), 15A.453-1(d)(2)(iii)
- *Burnet v. Logan*, 283 U.S. 404 (1931)
- Might a different standard apply where there is no sale or exchange, but instead a distribution?

Distributed CVRs—Tax Issues on Payment, cont'd

- **Cash equivalency doctrine?**
  - Cash method taxpayers should not be taxed on non-cash, non-negotiable instruments (i.e., even if reasonably ascertainable value)
  - Rejected by IRS (Treas. Reg. §15a.453-1(d)(2)(i)); 9th Circuit (*Warren Jones Co. v. Comm'r*, 524 F.2d 788 (9th Cir. 1975)); Court of Claims (*Campbell v. U.S.*, 661 F. 2d 209 (Ct. Cl. 1981))
  - Expanded availability of installment sale reporting may make cash equivalency doctrine a less sympathetic case, but there is no installment sale treatment for distributions
  - Still viable outside sale or exchange context?
- If open transaction doctrine applies, payments would be taxable distributions as they were made, similar to tax consequences where CVRs were treated as mere promises to make future distributions
- E&P as of distribution of CVR (under relation back theory) or as of payment?

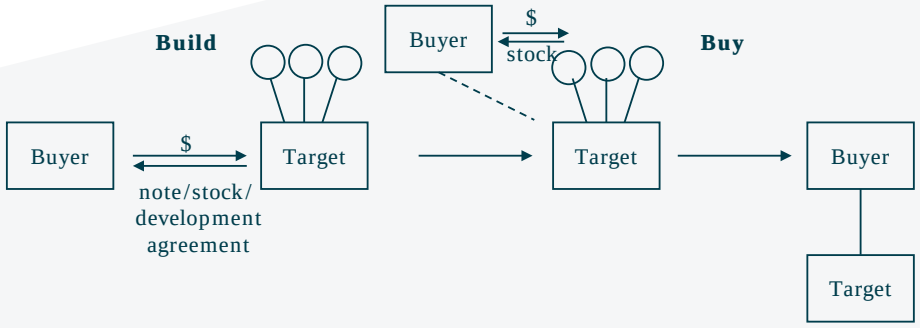
Recent Trends in M&A Transactions: Build-to-Buy Transactions

Build-to-Buy Transactions

- Potential buyer provides financing ("builds") Target and has the option to acquire ("buy") the Target in the future
- Possible structures:
  - Option / Merger Transaction

    Build: note (convertible or straight debt), preferred stock financing, development agreement

    Buy: Option to acquire Target using a fully executed merger agreement, which option Buyer can elect to exercise and close the merger. Buyer acquires Target by consummating merger.



Build-to-

Detailed Tax Treatment – Option / Merger - Seller

- Tax Treatment of the “Build”: Depends on the Transaction Structure
  - Note
  - Preferred Stock
  - Development Agreement: Taxable income deferred revenue, mismatch
- Tax Treatment of Option Issued to Stockholders:
  - Not taxable until the transaction closes
  - Additional proceeds if the acquisition happens; short-term capital gain upon lapse
- Tax Treatment of the “Buy”:
  - Generally capital gain treatment when closes

Detailed Tax Treatment – Option / Merger - Buyer

- Tax Treatment of the “Build”: Depends on the Transaction Structure
  - Note
  - Preferred Stock
  - Development Agreement: Taxable income deferred revenue, mismatch
- Tax Treatment of Option:
  - Who is selling the option?
    - Company?
    - Stockholders:
      - Not taxable until the transaction closes
      - d11

Detailed Tax Treatment – Warrant - Seller

- Tax Treatment of the Warrant: Section 1032 states "[n]o gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option...to buy or sell its stock (including treasury stock)."
  - Under Section 1032, the amount allocated to the fair market value (FMV) of the warrant is not taxable.
  - Amending the certificate of incorporation should generally be treated as a tax-free recapitalization to the stockholders for U.S. federal income tax purposes.
  - The company should not recognize any gain or income upon exercise of the warrant or lapse of the warrant unexercised.
  - Amounts treated as allocable to an option written by the stockholders, if any, could be taxable to the stockholders in the recapitalization or upon exercise of the option (as additional proceeds) or lapse of the option (as short-term capital gains).
  - The buyer presumably would have basis in the warrant, which would be added to the basis in its stock of the company if the warrant is exercised. If the warrant lapses, the buyer presumably would be entitled to a capital loss.

“S corporation” Target – First Step “F reorganization”

- The shareholders of an existing “S corporation” target (OpCo) contribute the

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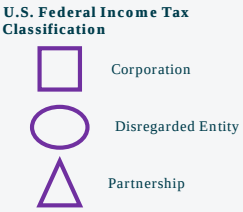
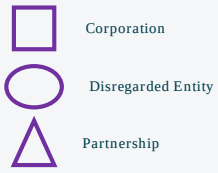
  OpCo

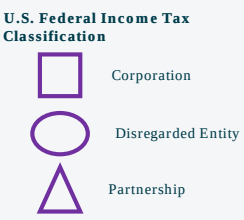


“S corporation” Target –

“C corporation” Target – First Step “F reorganization”



“C corporation” Target – Second Step Acquisition



Seller Considerations: Eligibility for QSBS (Section 1202 Gain Exclusion)

Qualified Business—Active Business Requirement

Active Business Requirement

At least 80 percent (by value) of assets are used by the corporation in the active conduct of 1 or more qualified trades or businesses.

Qualified Trade or Business means any trade or business except:

- Services in the fields of **health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services**, or any trade or business where the principal asset is the reputation or skill of 1 or more employees;
- Banking, insurance, financing, leasing, investing, or similar business;
- Any farming business;
- Businesses involving the production or extraction of products that qualify for depletion under Secs. 613 or 613A (e.g., mining, drilling); and
- Operating a hotel, motel, restaurant, or similar business

Qualified Trade or Business – PLR 202221006

Facts:

IRS considered whether a C corporation that operated pharmacies was engaged in a qualified trade or business as defined in section 1202(e)(3).

The taxpayer's pharmacists filled prescription orders received from physicians and its other employees coordinated the insurance coverage with respect to such orders. The taxpayer's employees were never involved in diagnosing medical issues or recommending any treatment or drug to individuals.

IRS considered whether the taxpayer was involved in the performance of (i) services in the field of health or (ii) services where

Qualified Trade or Business – PLR 202221006

Ruling:

IRS noted that any interaction between the taxpayer's employees and

Qualified Trade or Business – PLR 202114002

Facts:

IRS considered whether a corporate taxpayer's business was qualified trade or business under Sec. 1202(e).

The taxpayer was commonly referred to as an insurance agent or an insurance broker.

The taxpayer sold insurance using two different models: (1) direct sales on behalf of insurance companies that require the taxpayer to also perform a variety of additional administrative functions, and (2) sales on behalf of insurance wholesalers as an intermediary for a commission.

IRS focused primarily on whether the corporation was engaged in the business of "brokerage services" as listed in Sec. 1202(e)(3).

Qualified Trade or Business – PLR 202114002

Ruling:

IRS ruled that the taxpayer's "direct appointments" business model was not brokerage services and therefore was a qualified trade or business

The taxpayer used more than 80% of its assets in the direct appointments business, and therefor satisfied the qualified trade or business element of the active business requirement

IRS reasoned that the taxpayer did not serve as a mere intermediary for insurance companies in its direct appointments business and referred to the dictionary definition of "broker" that defines the term as:

- "one who acts as an intermediary: such as a: an agent who arranges marriages b: an agent who negotiates contracts of purchase and sale (as of real estate, commodities, or securities)"

IRS further reasoned that, with respect to the direct appointments business model, the taxpayer's contracts with insurance companies required the taxpayer to perform administrative services beyond those that would be performed by a mere intermediary facilitating a transaction between two parties

Qualified Trade or Business – CCA 202204007

Facts:

The C corporation operated a website and certain other limited services (e.g., building and hosting websites for certain lessors used for leasing such lessors' facilities)

The website was used by lessees to reserve certain facilities listed by lessors on the website at prices specified by such lessor

The lessors paid the corporation both (i) a periodic fee for listing facilities on the

Qualified Trade or Business – CCA 202204007

Ruling:

IRS considered the definition of the term "brokerage services" in Secs. 6025, 448, and 199A and in the dictionary

IRS concluded that Sec. 6045, and the regulations thereunder, provides that the term "broker" is broad enough to apply to the website operations of the corporation in the CCA

Further, IRS considered Sec. 199A, and the fact that Sec. 199A references Sec. 1202(e)(3)(A) with respect to what trades or businesses are specified trades or businesses

> **IRS noted that Reg. 1.199A-5(b)(2)(x) expressly provides that for purposes of Sec. 199A(d)(2) and Reg. 1.199A-5(b)(1)(ix) only**, the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities, as defined in Sec. 475(c)(2), for a commission or fee, including stock brokers and other similar professionals but does not include services by real estate agents and brokers, or insurance agents and brokers

Next, IRS considered the meaning of the term "brokerage services" based on various dictionary definitions

Ultimately, IRS concluded that the corporation should be classified as a broker **based on the common dictionary meaning of the term and the definition of the term for purposes of Sec. 6045**. Thus, IRS disregarded the definition of brokerage services in Reg. 1.199-5(b)(2)(x) notwithstanding the fact that Sec. 199A(d)(2)(A) references Sec. 1202(e)(3)(A)

- ***Facts***
  - Taxpayer developed a **proprietary tool to perform certain medical tests**
  - Taxpayer's employees analyze the results of the tests and prepare laboratory **reports for healthcare providers**
  - Those laboratory reports **do not diagnose or recommend treatment**, and the Taxpayer does not discuss diagnosis or treatment with patients or with the healthcare providers who commission the tests
  - Taxpayer's employees are well educated and include a physician, ae

- ***Ruling***
  - Noting the

QSBS: Other Current Issues

- Amortization of R&D expenses: Section 174 now requires research and experimental expenditures to be amortized rather than deducted
- $50 million gross assets test: Cash plus *aggregate adjusted basis* of other property
- Partnership subsidiaries
  - Corporate subsidiary rule: > 50% ownership
  - COBE: ≥ 33% or ≥ 20% if manager
  - Aggregate theory of ownership

Inflation Reduction Act and M&A

The Inflation Reduction Act ("IRA")

- IRS Funding Increase
- Corporate AMT
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IRS Funding Increase

Overview

The Act increases IRS funding by $76.6 billion, including approximately

- $46.6 billion for tax enforcement activities,
- $25.3 billion for operations support,
- $4.75 billion for upgrading technology and business systems services, and
- $3.2 billion for taxpayers services

These additional funds would be disbursed over 10 years, during which the Congressional Budget Office estimates the increases in funding for enforcement activities will bring in nearly $204 billion in lost revenues

The IRS Commissioner stated the additional funding for enforcement activities will focus on large corporations and global high-net worth taxpayer

IRS Funding Increase (cont.)

- The reason provided for the funding boost is to help the IRS operationally
- The ultimate impact of this increase in resources is unclear
- Increased scrutiny of large M&A tax structuring?

Corporate Alternative Minimum Tax (cont.)

"Applicable Corporation" (i.e., corporations subject to the CAMT)

Applicable corporation generally means a corporation that meets the AFSI test in a preceding year, beginning in 2022

AFSI test, in general:

- Average AFSI (excluding NOL carryovers) over three tax years ending with the relevant tax year (e.g., 2022) exceeds $1 billion (excluding certain AFSI adjustments)
- Test based on years in existence if in existence for less than three years
- AFSI annualized for short tax years

Two-part AFSI test for corporations with foreign parent

- Three-year average AFSI (excluding certain adjustments) of all members of the group exceed $1 billion AND
- Three-year average AFSI of U.S. members of the group, U.S. trades of business of foreign group members that are not subsidiaries of U.S. members, and foreign subsidiaries of U.S. members exceed $100 million

Corporate Alternative Minimum Tax (cont.)

Applicable Corporation – Aggregation Rule

- ***Solely to determine if a corporation is an applicable corporation, AFSI is***

Corporate Alternative Minimum Tax (cont.)

Adjusted Financial Statement Income (AFSI)

- **Net income or loss of a corporation on corporation's applicable financial statement (AFS) (generally, an audited GAAP or IFRS statement) for the tax year, with adjustments**
- **Adjustments (In General)**
  - For financial statement and federal income tax reporting years that do not coincide
  - For an AFS for a group of entities that includes entities that are not subject to US taxation
  - For corporations filing a consolidated return, AFSI of the group takes into account only items on the AFS that are properly allocated to members of the group.

Corporate Alternative Minimum Tax (cont.)

AFSI - Adjustments (cont.)

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Corporate Alternative Minimum Tax (cont.)

AFSI - Adjustments (cont.)

Corporate Alternative Minimum Tax (cont.)

General Business Credit and Minimum Tax Credit

- Amends the general business credit limit so that credits are not limited by tentative minimum tax; taxpayers may utilize their general business credits against both regular tax liability and the CAMT up to approximately 75% of the combined tax
- Paying the CAMT in a year generates a minimum tax credit, which may be carried forward indefinitely and applied against regular tax in future years (to the extent regular tax plus BEAT exceeds CAMT)

Corporate Alternative Minimum Tax (cont.)

Stock Buyback Excise Tax

Section 4501 imposes a 1% excise tax on certain repurchases of corporate stock

- Tax only applies to repurchases that exceed issuances
- Effective for stock repurchases occurring after December 31, 2022
- Applies to repurchases by a covered corporation
- The tax is not deductible
- The value of repurchases is reduced by the value of any shares issued by the corporation during the year

Stock Buyback Excise Tax (cont.)

M&A Considerations

Broad language of the provision potentially could impact a range of corporate transactions that do not appear to involve stock repurchases as that term commonly is understood

- For example, in a merger involving cash consideration, payments of cash to the target's shareholders might be viewed as repurchases to the extent those payments are funded out of the target's existing cash resources or with the proceeds of debt that is incurred or assumed by the target in the transaction

Stock Buyback Excise Tax (cont.)

M&A Considerations (cont.)

- Other transactions that potentially also could be impacted include
  - (1) payments of cash or other "boot" to target shareholders in partially tax-free reorganizations,
  - (2) certain acquisition transactions, including leveraged buy-out transactions, in which cash is sourced or funded out of cash of the target corporations or debt proceeds that the target corporation assumes,
  - 5