

Tax Planning For Carryover Equity Transactions: A Primer

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In acquisitive transactions, allowing the seller to obtain an equity position in the buyer (“carryover equity”), rather than simply using cash consideration, can be beneficial for both parties. A buyer can use its own equity as currency, reducing the amount of cash and other financing needed for the transaction. At the same time, using carryover equity allows a seller to participate in the upside of the acquiring company and defer at least some of the taxable gain generated by the sale.

While both corporations and partnerships can engage in acquisitive transactions using carryover equity, the requirements and the consequences differ depending on the type of entity involved. In particular, because of the differences in the tax treatment of carryover equity for corporate, as compared to partnership, transactions, use of a partnership as the acquisition vehicle can produce substantially better results for both buyer and seller.



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Corporate Transactions

For corporate acquisitions, the primary forms of equity take-back deals are tax-free reorganizations. Generally, tax-free reorganizations must satisfy the following requirements:

- (1) there must be continuity of proprietary interest (i.e., the selling shareholders must receive some carryover equity);
- (2) there must be continuity of a significant line or portion of the target’s historic business enterprise; and
- (3) there must be a bona fide business purpose for the reorganization.[1]

There may be additional requirements depending on the form of the reorganization; for example, in a type B reorganization, the only consideration permitted is voting stock of the buyer.[2]

As a result of a tax-free organization, the buyer becomes the owner of the target corporation, either through a stock or asset acquisition. The buyer finances this through the use of: (1) its own equity; and

(2) in certain types of reorganizations, other consideration, or “taxable boot,” such as cash or notes.[3]

However, even if the consideration includes cash, causing the seller to recognize some gain in the transaction, there is no step-up in the target corporation’s assets following the transaction.[4] Therefore, the buyer does not get the benefit of a higher tax basis in the target corporation assets (although the buyer makes a cash investment), resulting in a lack of additional depreciation or amortization deductions and a greater gain on any future asset sale.

Alternatively, the buyer and seller could utilize Section 351 (transfers to controlled corporations) to effectuate the corporate acquisition. In a Section 351 transaction, the buyer contributes cash and the seller contributes assets to NewCo in exchange for stock and stock and cash, respectively.[5] As in a tax-free reorganization, both parties generally receive the stock tax-free.[6] The seller is taxed on the lesser of the cash received or the economic gain realized.[7] The seller’s basis is used for stock first; accordingly, the seller generally will apply its entire basis to the equity in NewCo and will not be able to use its basis to offset cash received unless that basis exceeds the value of the carryover equity.[8] NewCo’s basis in its assets will equal the selling company’s basis in the assets transferred increased by the amount of gain recognized by the sellers on the transfer.

If the requirements of Section 351 cannot be satisfied (due to the parties’ use of an existing corporation or their inability to satisfy the control requirements), the parties could use an alternative, often utilized in real estate and umbrella partnership real estate investment trust (UPREIT) transactions.

Pursuant to the alternative transaction, the buyer and seller could engage in a transaction with exchangeable partnership shares which, coupled with a Section 754 election, would provide to the buyer — and the buyer alone — the benefit of an increased basis in the newly acquired assets. Here, the seller would contribute the business to a limited liability company, receiving exchangeable LLC interests in return. The buyer contributes cash and the LLC owners contribute LLC interests to NewCo. The buyer and the seller enter into an exchange agreement pursuant to which the seller will sell the exchangeable LLC interests to NewCo, owned 100 percent by the buyer. As the exchangeable LLC interests are sold to NewCo, NewCo will make a Section 754 election, increasing its basis (and effectively, the buyer’s basis) in the newly acquired LLC assets.

Partnership Transactions

Because of the limitations inherent in tax-free reorganizations, and even in Section 351 transactions, buyers and sellers would be advised to look outside the corporate context and to the partnership arena for alternative carryover equity transactions structures. In particular, buyers and sellers could benefit from engaging in part-sale, part-contribution partnership transactions rather than corporation reorganizations or transfers.

Generally, a partner’s contribution of property to a partnership in exchange for interests of the partnership is not a taxable event.[9] However, to the extent that the cash and other consideration received is less than the value of the property contributed, there is a deemed sale of the property to the extent of the consideration; the remainder of the property is treated as contributed to the partnership.[10]

The partner’s basis is apportioned between the sale transaction and the contribution transaction.[11] To the extent that the consideration received exceeds the basis apportioned to the sale transaction, the partner recognizes gain.[12] The partner does not recognize gain on the receipt of the partnership

interest in the contribution transaction;[13] instead, the partner's basis in the property transferred carries over and is applied to the partner's equity in the partnership.

Following the transaction, the buyer holds its partnership interest with a basis equal to the cash purchase price. The partnership holds the property with a basis equal to: (1) the portion of the consideration allocated to the sale transaction; plus (2) the contributing partner's carryover basis allocated to the contribution transaction. Generally, the economic effect of the basis rules is that there will be a significant difference between the tax basis in the property and the fair market value of the property. The resolution of the book-tax difference in the partnership has the benefit of allocating the additional depreciation and amortization deductions, largely flowing to the buyer.[14]

Because of these potentially beneficial results, M&A practitioners should consider utilizing a partnership part-sale, part-contribution structure rather than relying only on the standard corporate reorganization provisions.

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[1] I.R.C. § 368(a)(1).

[2] I.R.C. § 368(a)(1)(B).

[3] See, e.g., I.R.C. § 368(a)(1)(A), (2)(E).

[4] I.R.C. § 358(a)(1).

[5] I.R.C. § 351.

[6] I.R.C. § 351(a).

[7] I.R.C. § 351(b)(1).

[8] See I.R.C. § 358(a)(1).

[9] I.R.C. § 721.

[10] I.R.C. § 707(a)(2)(B); Treas. Reg. § 1.707-3(a)(1).

[11] Treas. Reg. § 1.707-3(f), Ex 1.

[12] I.R.C. § 707(a)(2)(B); see also Treas. Reg. § 1.707-3(f), Ex 1.

[13] I.R.C. § 721; see also Treas. Reg. § 1.707-3(f), Ex 1.

[14] I.R.C. § 704(c)(1)(A).