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Tax Strategies and Key Tax Issues in Selling a Business, Part 2

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Tax Strategies and Rollover Equity When Selling a Business

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Rollover and Deferred Sale Strategies Historic Perspective

- Traditional acquisition structure for a closely held business?
 - Purchase and sale of 100% of all outstanding equity.
 - Often combined with:
 - A non-compete agreement,
 - A consulting contract, and/or
 - A short-term note or similar installment payment (e.g., 1-to-3 years).
 - Perhaps structured as a taxable or tax-free merger.



Rollover and Deferred Sale Strategies Current Market Developments

- Impact of private equity funds (“PEF”) and recent constraint in capital markets:
 - Liquidity gap (debt and equity), and
 - Valuation gap.
- Resultant increase in rollover and deferred sale strategies. Frequently used to:
 - Bridge liquidity and valuation gaps, and
 - Align economic interests of existing owners and new investors.
- Restricts ability of business owners to extract full value at time of sale.



Rollover and Deferred Sale Strategies Resulting Legal Challenges

- Results in greater deal complexity. Transactions often include both a sale component and a joint venture component:
 - Typical purchase and sale agreement, including representations, warranties, covenants, and indemnifications, plus
 - Employment and non-compete agreements, plus
 - Joint venture agreement with negotiated terms for board representation, appointment and removal of officers, majority and “super-majority” voting rights, dilution rights (including future equity issuances of options and warrants), buy-sell agreements, rights of first refusal, and tag-along and drag-along rights.



Rollover and Deferred Sale Strategies Resulting Tax Challenges

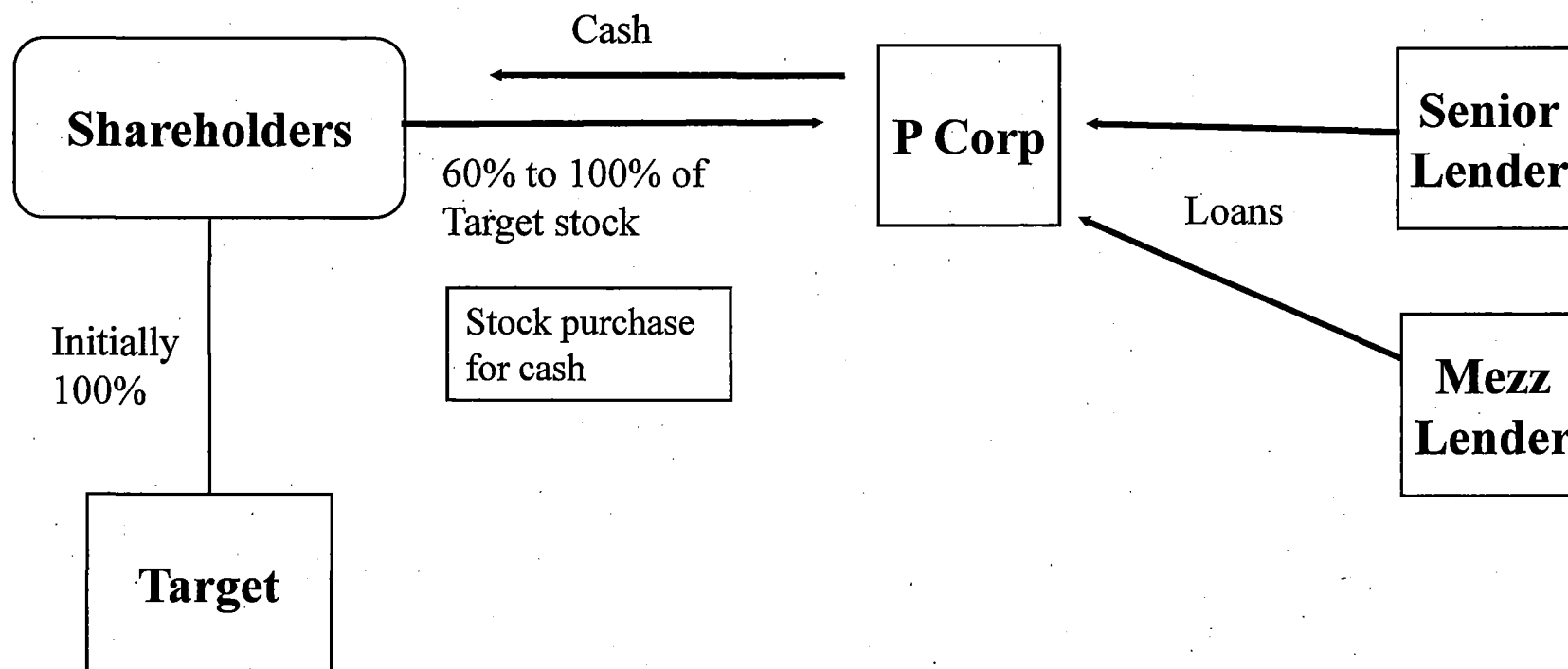
- Typical tax objectives:
 - Minimize any corporate level tax imposed on Target.
 - Maximize ability of Shareholders to enjoy long term capital gain.
 - Create depreciable & amortizable step-up in Target's assets to benefit Buyer.
- Typical sale strategies:
 - Qualify for an IRC § 338(h)(10) election.
 - Create deemed sale of Target assets (Rev. Rul. 99-5)
 - Structure sale as a forward triangular merger with asset sale equivalence.
- Corporate rollover strategies impair ability to achieve these objectives.
- Consider alternative usage of LLCs.
 - LLC and partnership structures significantly improve “deal flexibility”, but
 - Partnership tax rules add a level of complexity – and require additional up-front planning.



Typical Sale and Rollover Structures for Closely-Held Corporations

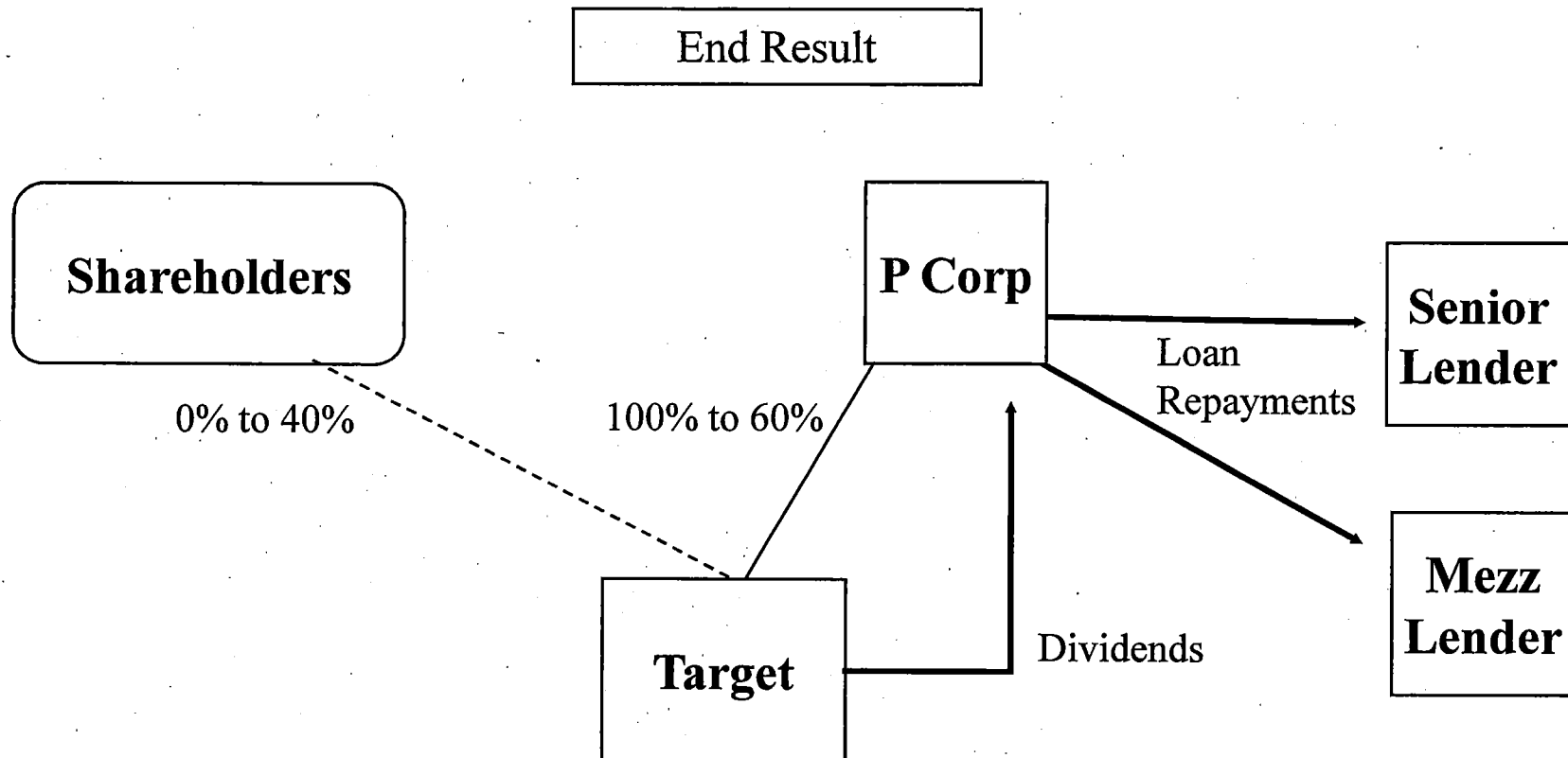


Stock Sale and Equity Rollover Example 1



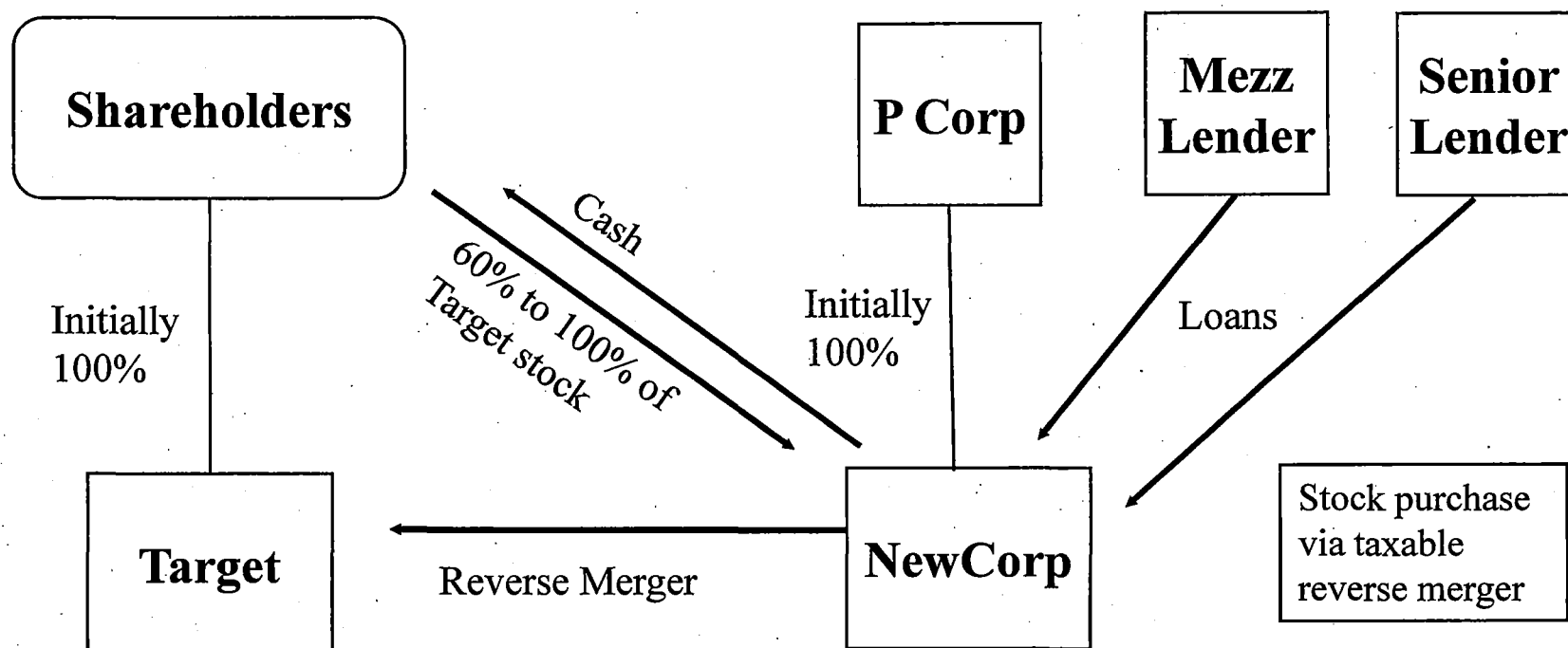


Stock Sale and Rollover Example 1 (Cont'd)





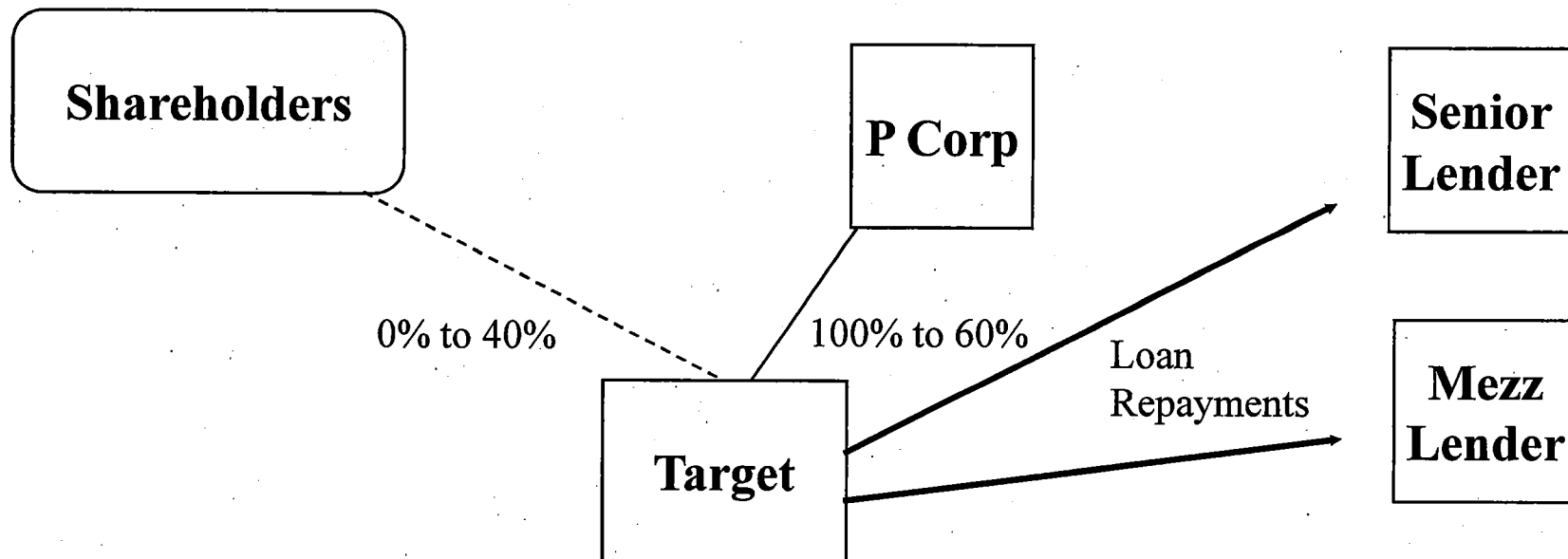
Stock Sale and Rollover Example 2





Stock Sale and Rollover Example 2 (Cont'd)

End Result





Stock Sale and Rollover

Examples 1 & 2

Tax Consequences

Tax Consequences if C Corp Target

- Capital gain to Target shareholders.
- Acquisition debt at Target post-closing in Example 2.
- No tax impact to Target (excluding IRC § 382 and similar limitations).
- Sale not eligible for IRC § 338(h)(10); no step-up in tax basis of Target's assets.
- If sale \geq 80%, Parent enjoys 100% DRD and ability to consolidate Target.
- If sale $<$ 80%, Parent has 80% DRD and no tax consolidation.
- Target shareholders fully taxed on future dividends.

Tax Consequences if S Corp Target

- If sale $<$ 80%, tax result same as C Corp.
- But, if sale \geq 80%, significant difference if election made under IRC § 338(h)(10).
 - P Corp obtains FMV basis in Target's assets.
 - No carryover of tax attributes.
 - Target shareholders still pay tax on 100% of Target's BIG – even if only 80% of Target stock is sold.
- In all cases, Target treated as if it sold its assets and liquidated. Will trigger residual IRC § 1374 corporate tax and affect amount and character of gain to Target shareholders.



Rollover and Deferred Sale Strategies Using Partnerships



Rollover and Deferred Sale Strategies: Using Partnerships to Effect Asset Sale Treatment

- Opportunity: Prior to sale, consider converting corporate entity into an LLC, or transferring Target's assets & liabilities to an LLC.
- Caution: There are extremely significant (and potentially expensive) tax issues that must be considered before conversion, including:
 - Income tax effects to corporation and its shareholders upon conversion, and
 - Impact of IRC § 197 anti-churning rules on basis step-up.



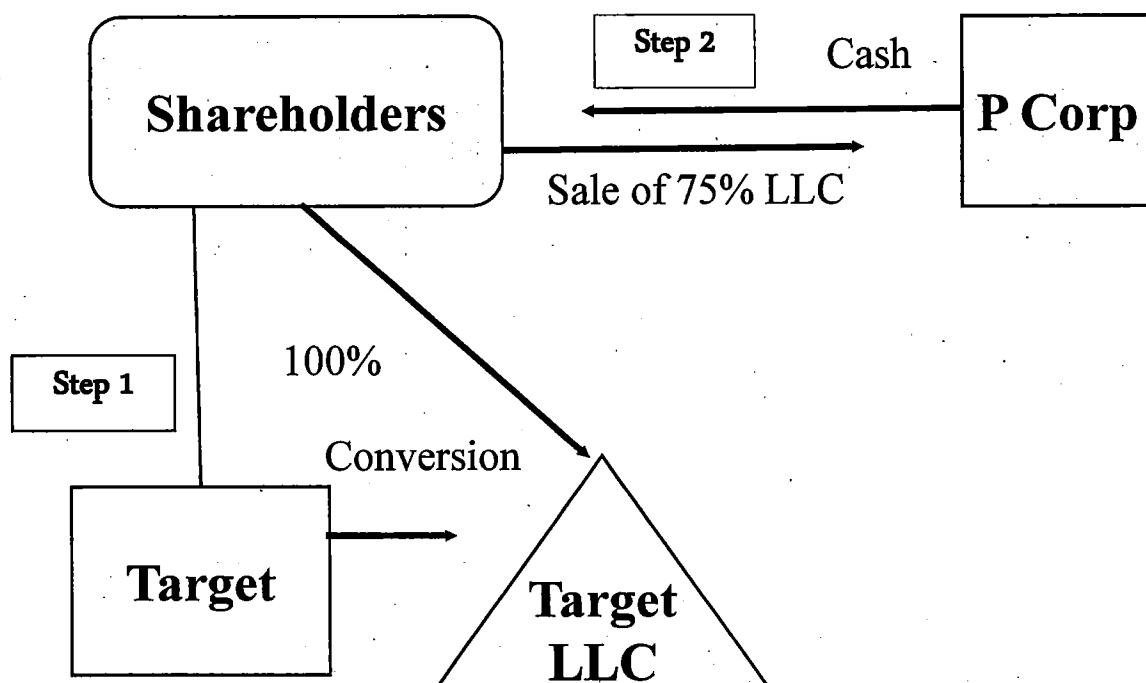
Rollover and Deferred Sale Strategies: Using Partnerships to Effect Asset Sale Treatment

- Conversion of a corporation into an LLC:
 - Usually treated for tax purposes as a taxable sale of the corporation's assets followed by a liquidation. *See* IRC §§ 331, 332, 336, 337.
 - If entity is a closely-held C corporation, results in double taxation (*i.e.*, tax both at corporate and shareholder levels).
 - If entity is an S corporation, results generally in single taxation (*i.e.*, tax at shareholder level).
 - Certain S corporations will be subject to corporate tax, (*e.g.*, S corps that converted from C corp status within 5 to 7 years of liquidation). *See* IRC § 1374.
- Exception for LLCs conversions that qualify as tax-free reorganizations.



Rollover and Deferred Sale Strategies: Wrong Way?

Example 3



Transaction Steps

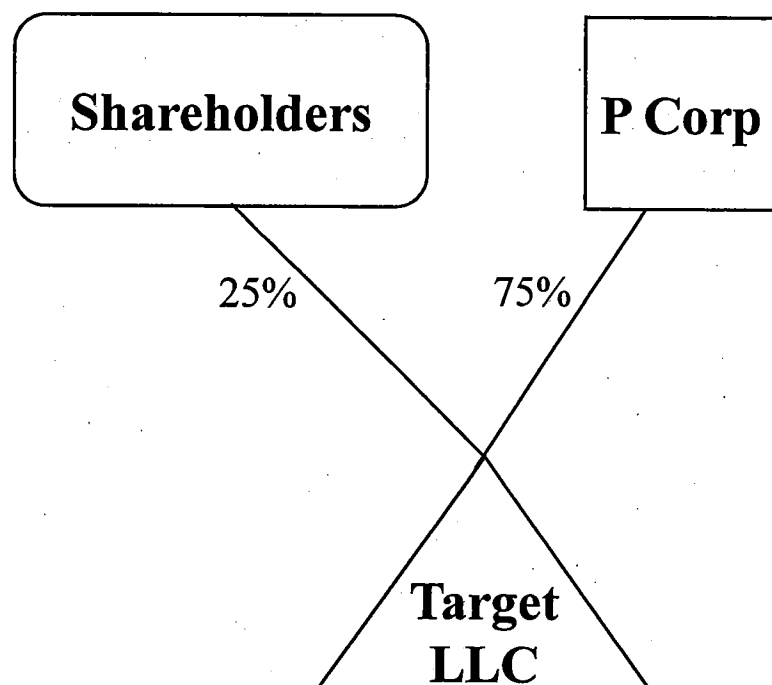
- Step 1: Conversion of Target to LLC
- Step 2: Sale of LLC membership interests



Rollover and Deferred Sale Strategies: Wrong Way?

Example 3 (Cont'd)

End Result



Tax Consequences if C Corp Target

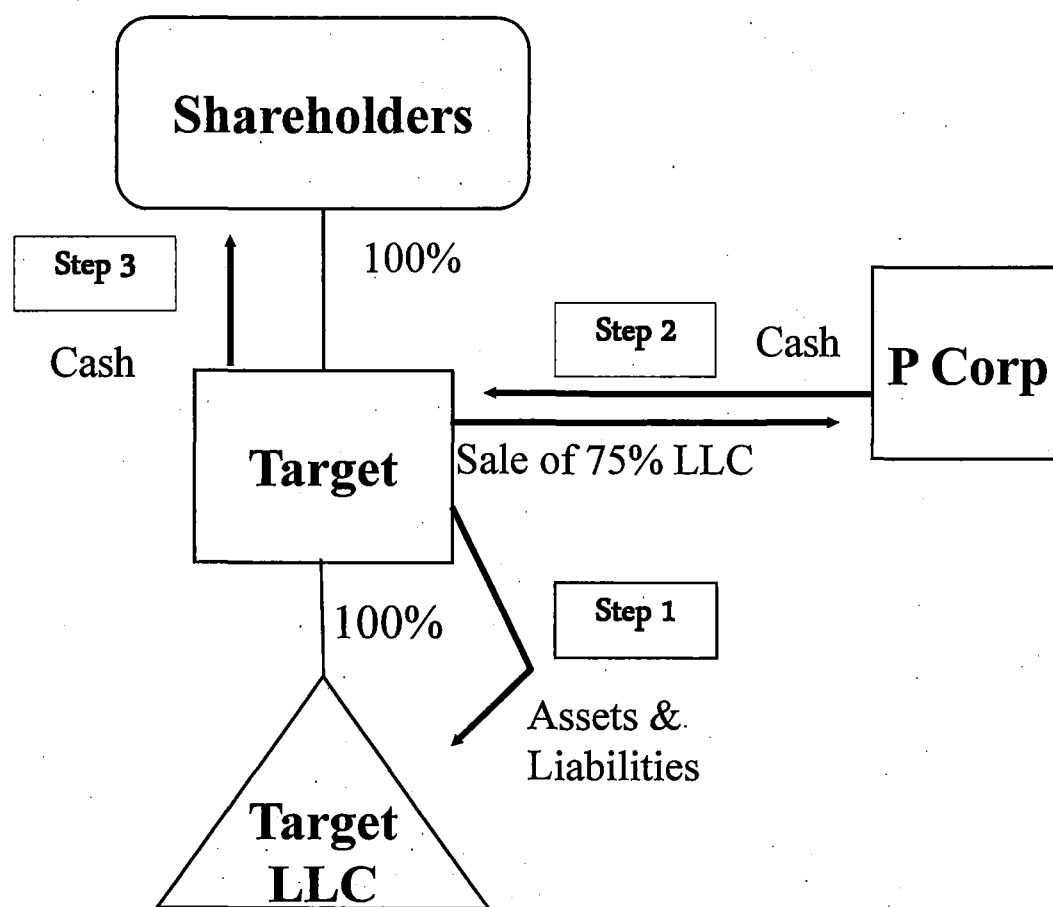
- Conversion is fully taxable.
- Same as if Target sold all its assets.
- 100% of Target's gain triggered on conversion (even though only 75% sold).
- Fully taxable both to Target and Target Shareholders.

Tax Consequences if S Corp Target

- Conversion is fully taxable (same as C Corp).
- Target shareholders recognize tax on built-in gain.
- In certain instances, Target also can be subject to tax (e.g., IRC § 1374).

Rollover and Deferred Sale Strategies: Right Way?

Example 4



Transaction Steps

Step 1: Form new Target LLC; transfer assets & liabilities to Target LLC.

Step 2: Target sells 75% of the LLC interests to P Corp.

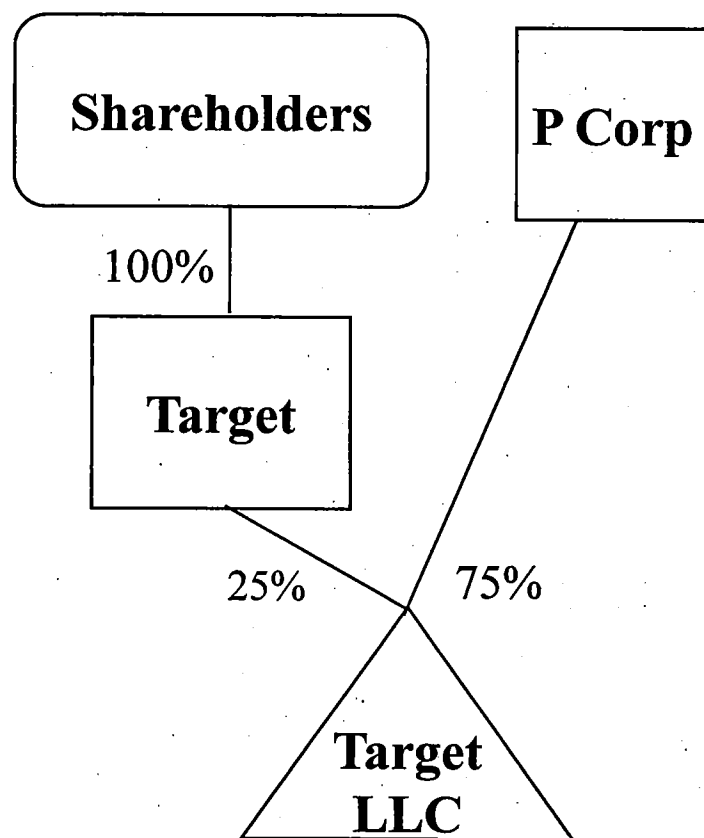
Step 3: Target distributes cash to Shareholders.



Rollover and Deferred Sale Strategies: Right Way?

Example 4 (Cont'd)

End Result



Tax Consequences if C Corp Target

- Sale of LLC interest treated as deemed sale of a 75% interest in each Target asset with deemed contribution of assets by Target and P Corp to a new partnership (Rev. Rul. 99-5).
- P Corp will step-up tax basis for 75% of Target LLC's assets.
- Two levels of tax: to Target (absent NOLs) and its shareholders.
- Tax on remaining 25% deferred; taxable to Target when 25% sold in the future.

Tax Consequences if S Corp Target

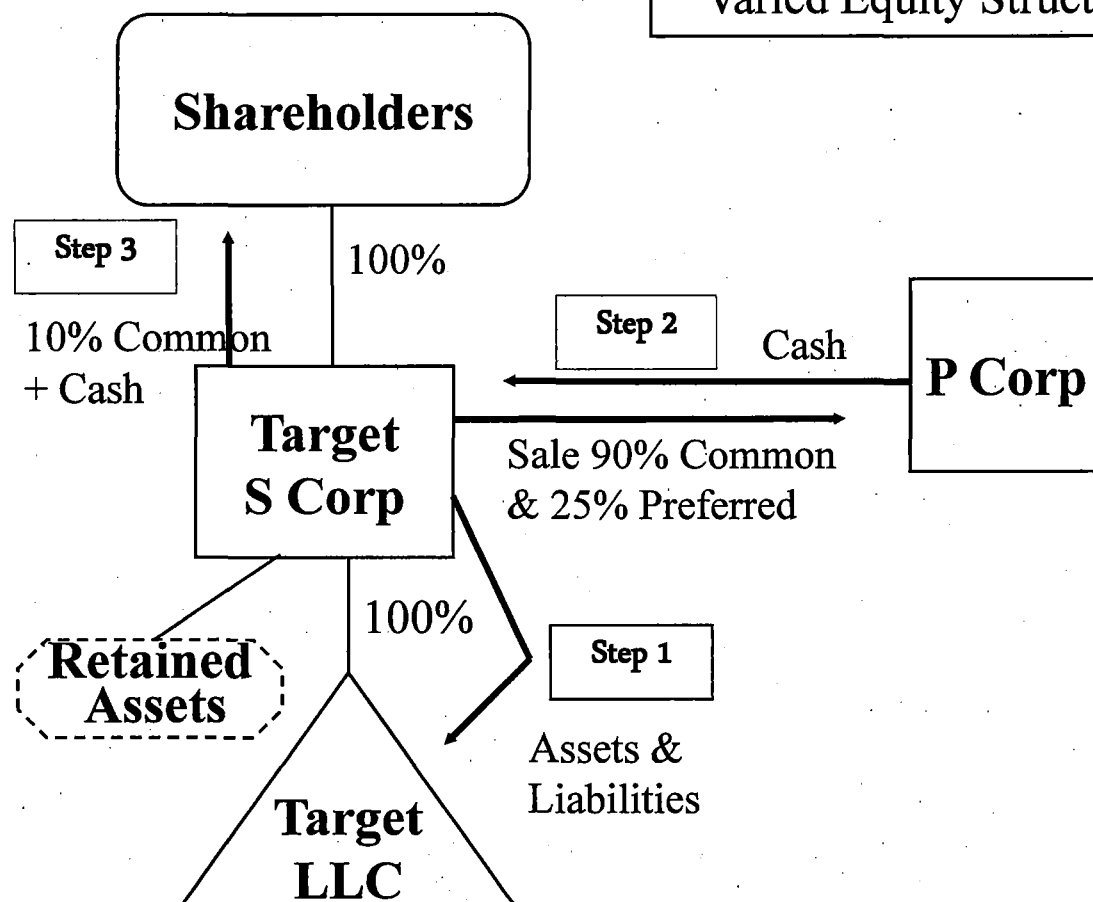
Same as C Corp Target, except:

- Shareholders (not Target) subject to tax on 75% of BIG in Target's assets (assuming BIG not taxed under IRC § 1374).
- Shareholders not subject to "dividend tax" on cash received.
- Shareholders taxed in future on remaining 25% when sold.

Rollover and Deferred Sale Strategies: Right Way?

Example 4-A

Varied Equity Structure



Alternative Structure for Common & Preferred

Step 1: Target receives common and participating preferred on asset transfer to LLC.

Step 2: Target sells 90% of common and 25% of preferred equity to P Corp; retains 10% common and 75% preferred.

Step 3: Target could distribute cash + 10% common to shareholders.

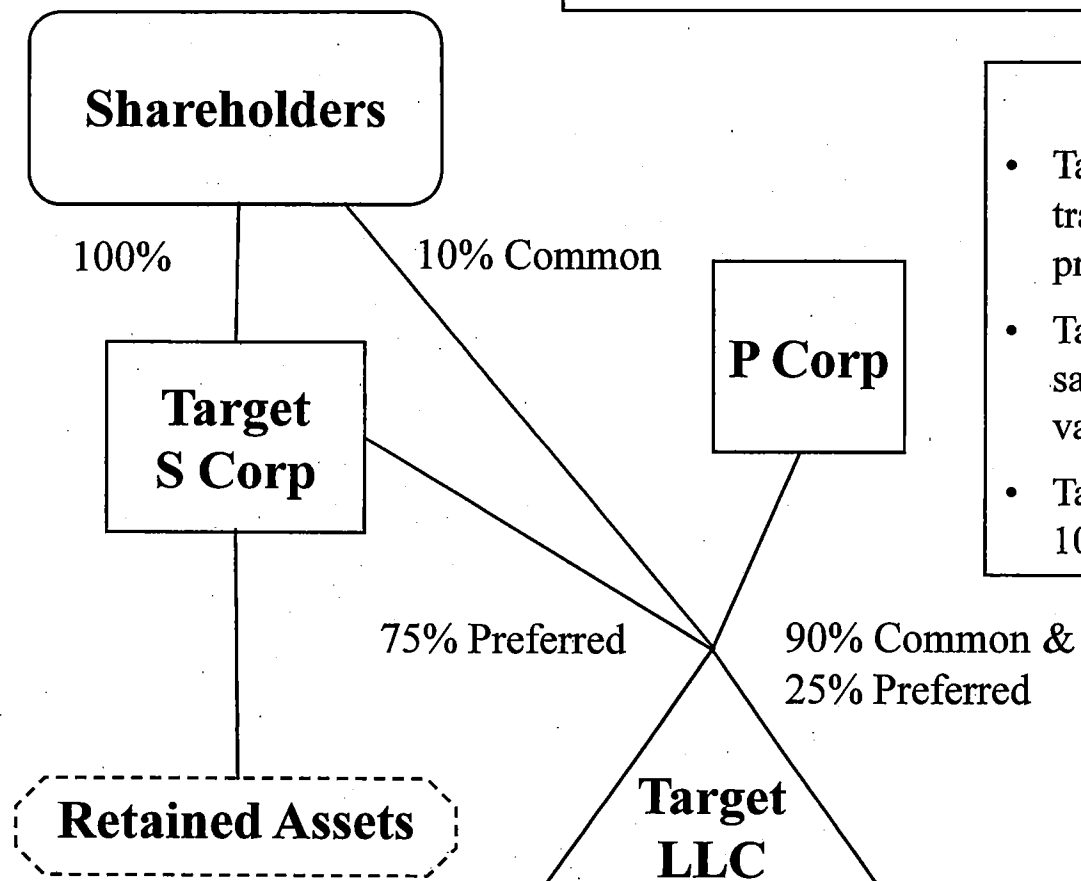
Result: Target retains 75% of preferred + other assets (e.g., other business line).



Rollover and Deferred Sale Strategies: Right Way?

Example 4-A (Cont'd)

Varied Equity Structure



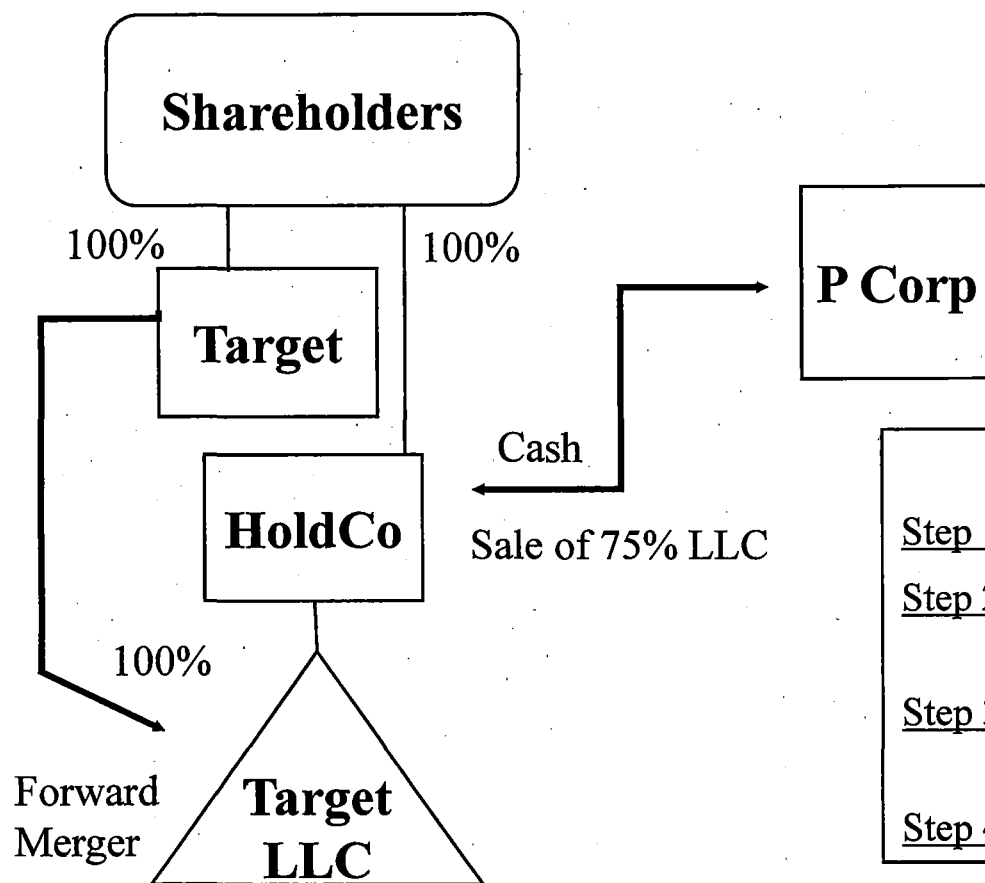
Result:

- Target retains disproportionate share of transferred asset value via 75% preferred.
- Target sells (presumably for reduced sale price) 25% of transferred asset value plus 90% of future profit.
- Target retains other assets; can distribute 10% common to shareholders



Rollover and Deferred Sale Strategies Example 5

Structure to Drop Assets into LLC



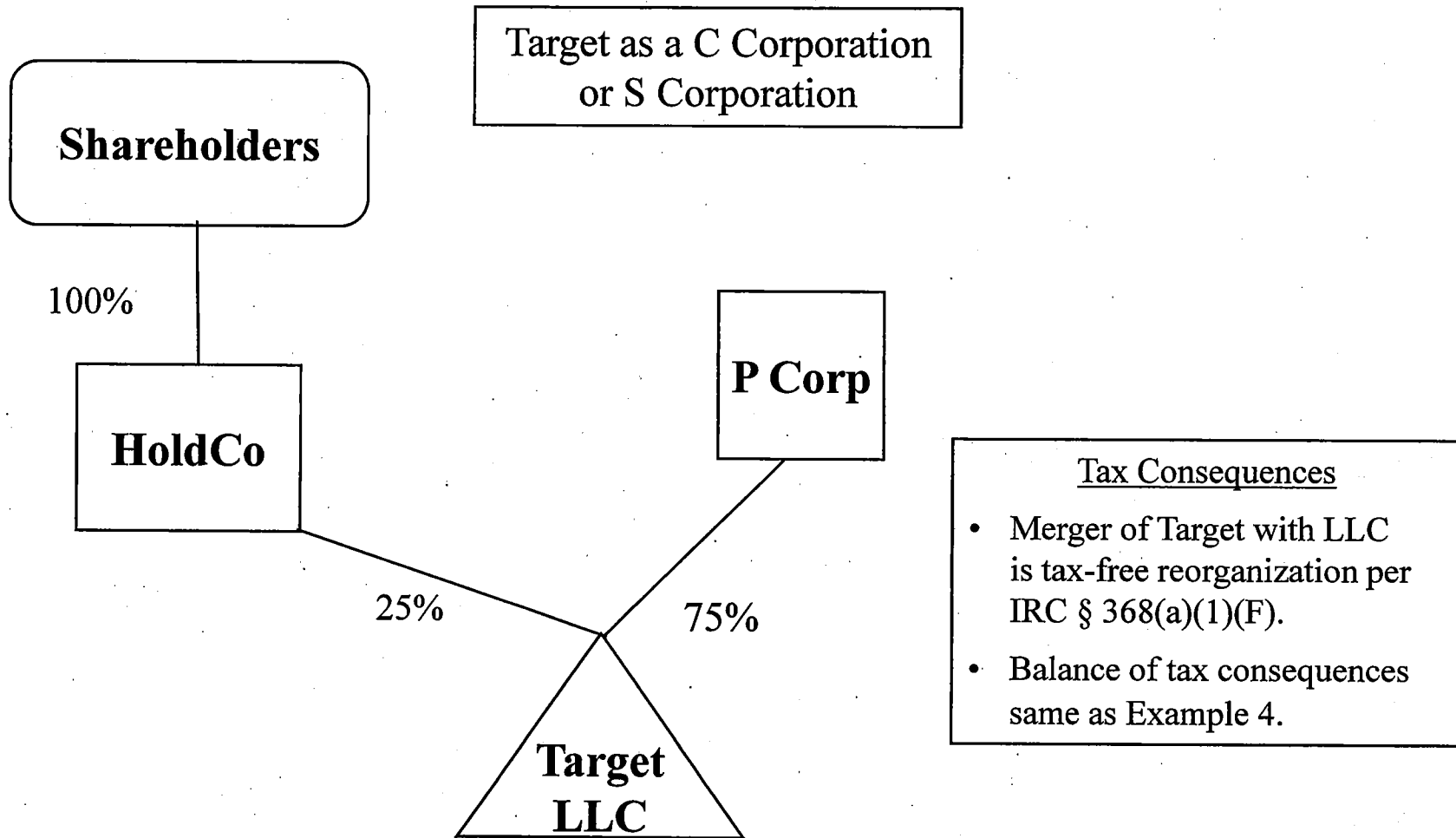
Transaction Steps

- Step 1: Formation of HoldCo.
- Step 2: Merger of Target into Target LLC with Shareholders receiving HoldCo stock.
- Step 3: Cause HoldCo to sell 75% of the LLC interests to P Corp or NewCorp.
- Step 4: Dividend of cash to Shareholders.



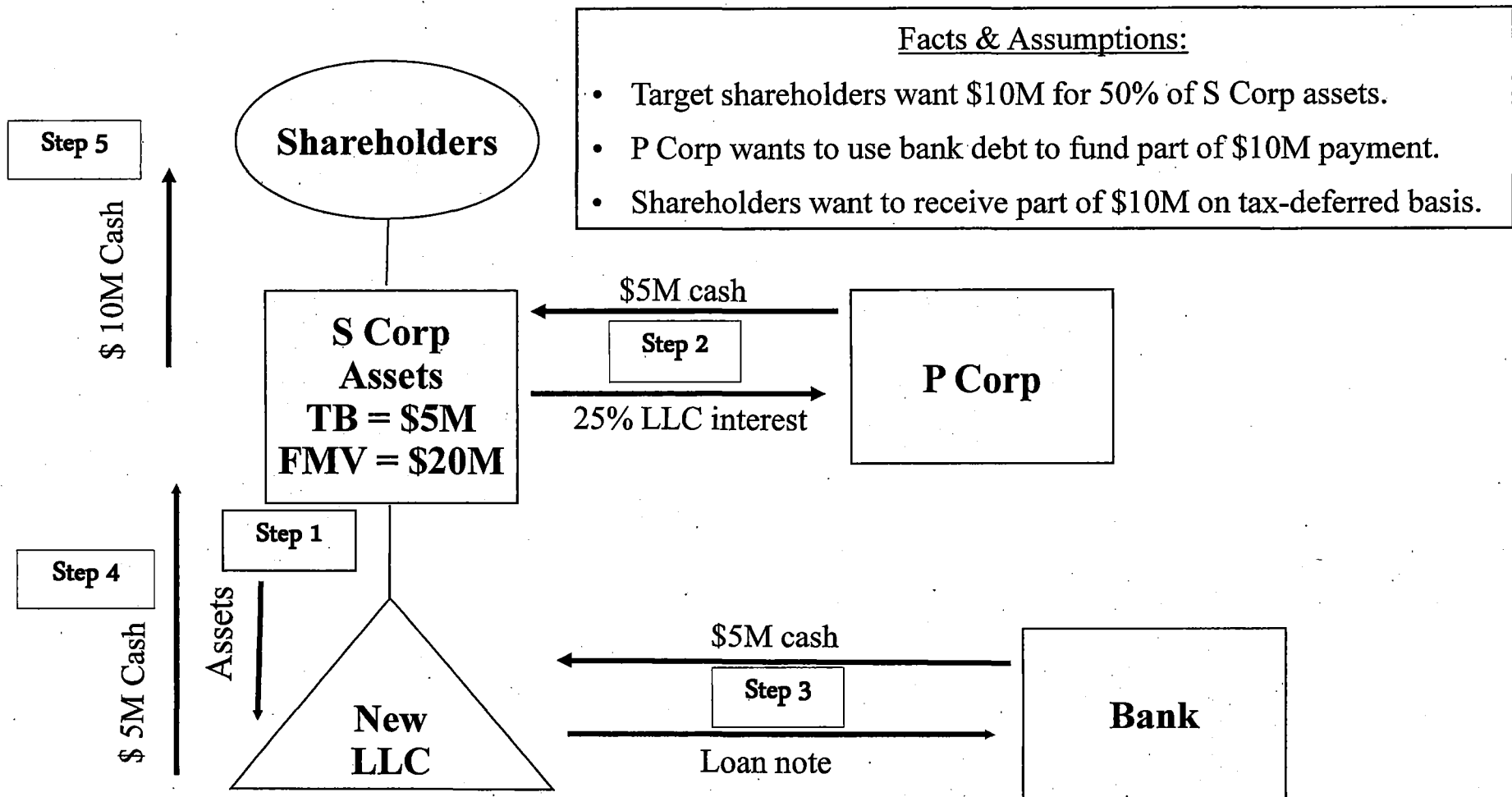
Rollover and Deferred Sale Strategies

Example 5 (Cont'd)



Rollover and Deferred Sale With Leverage

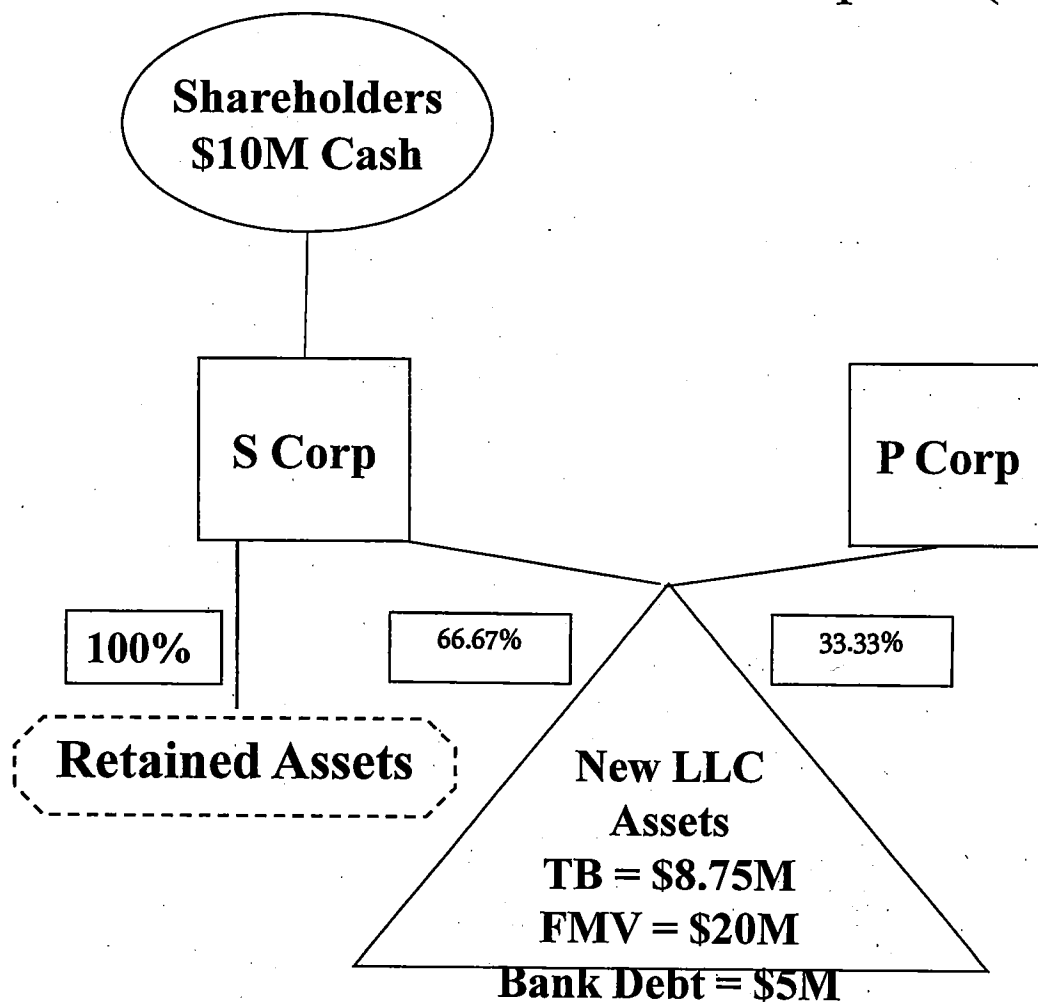
Example 6





Rollover and Deferred Sale With Leverage

Example 6 (Cont'd)



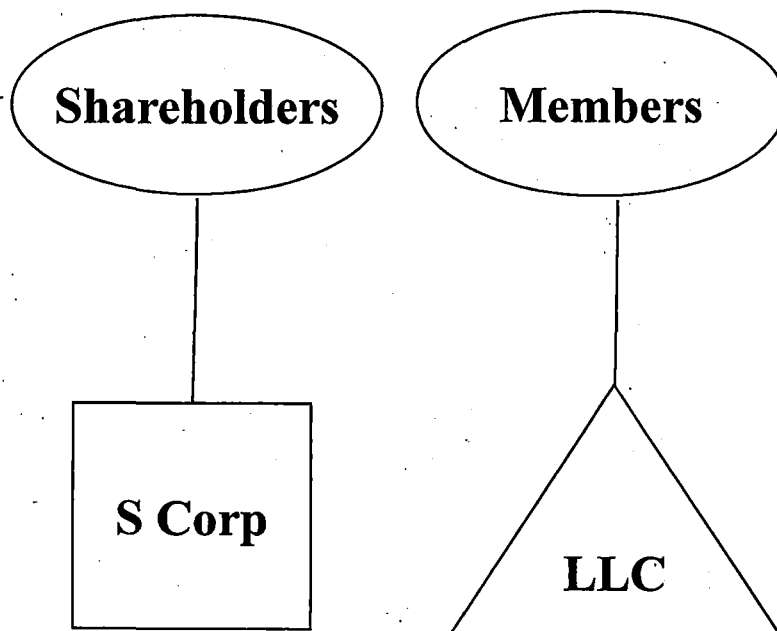
Result

- LLC becomes a “partnership” for tax purposes.
- Shareholders receive \$10M cash (\$5M from S Corp and \$5M from LLC).
- Cash received from LLC may be tax-deferred.
- S Corp’s ownership interest in LLC is 66.67% (because P Corp only contributed 1/3 of LLC value).
- Can combine with Example 4-A and use common & preferred equity with retained assets in S Corp to achieve deal objectives.



Rollover and Deferred Sale With Leverage: Rollups

Example 7



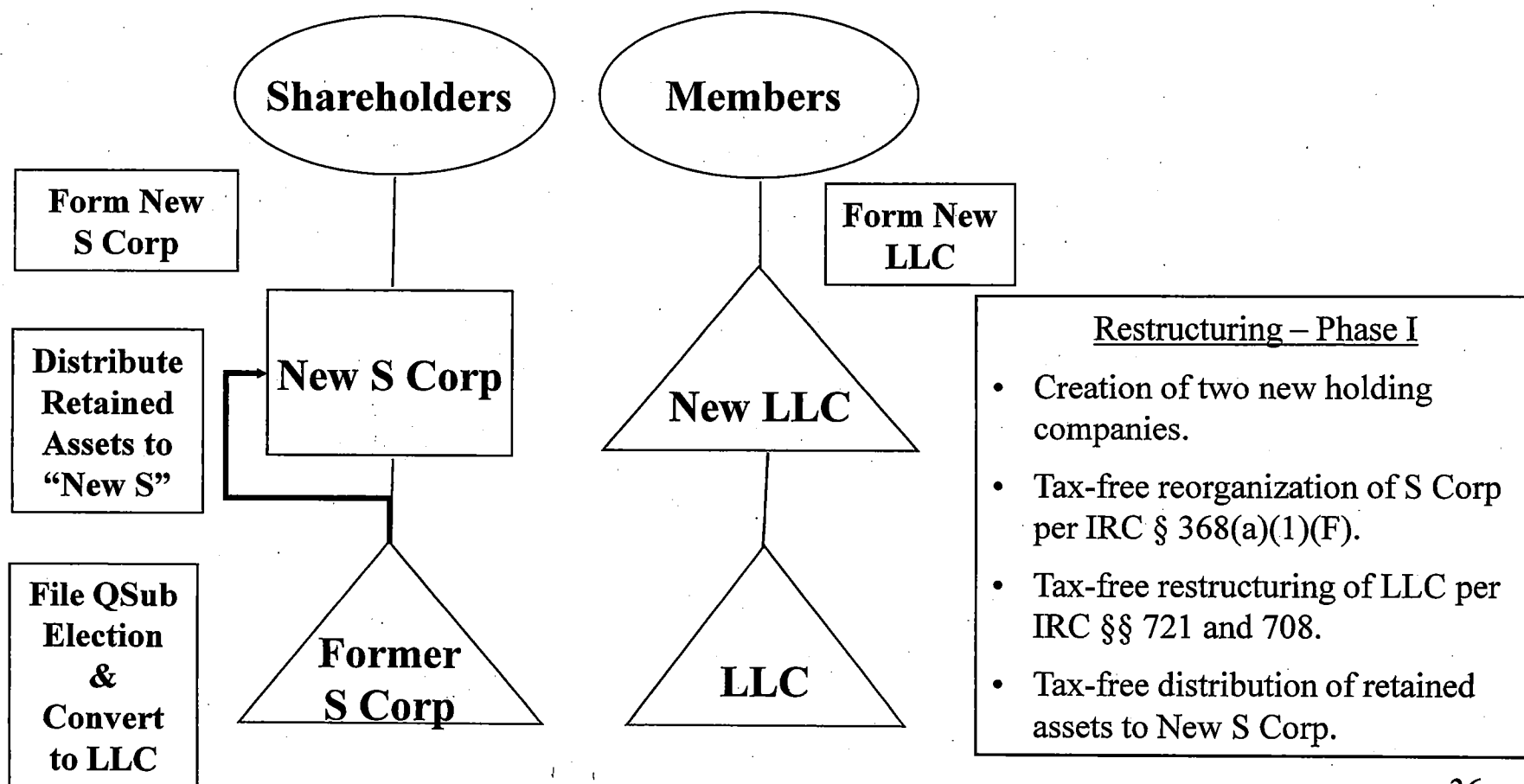
Facts and Assumptions:

- Different individuals own S Corp and LLC.
- P Corp wants to invest cash or do a partial buy-out of equity held by shareholders and members.
- Parties want to use a holding company structure.
- S Corp wants to retain 100% ownership of certain assets (*e.g.*, real estate).



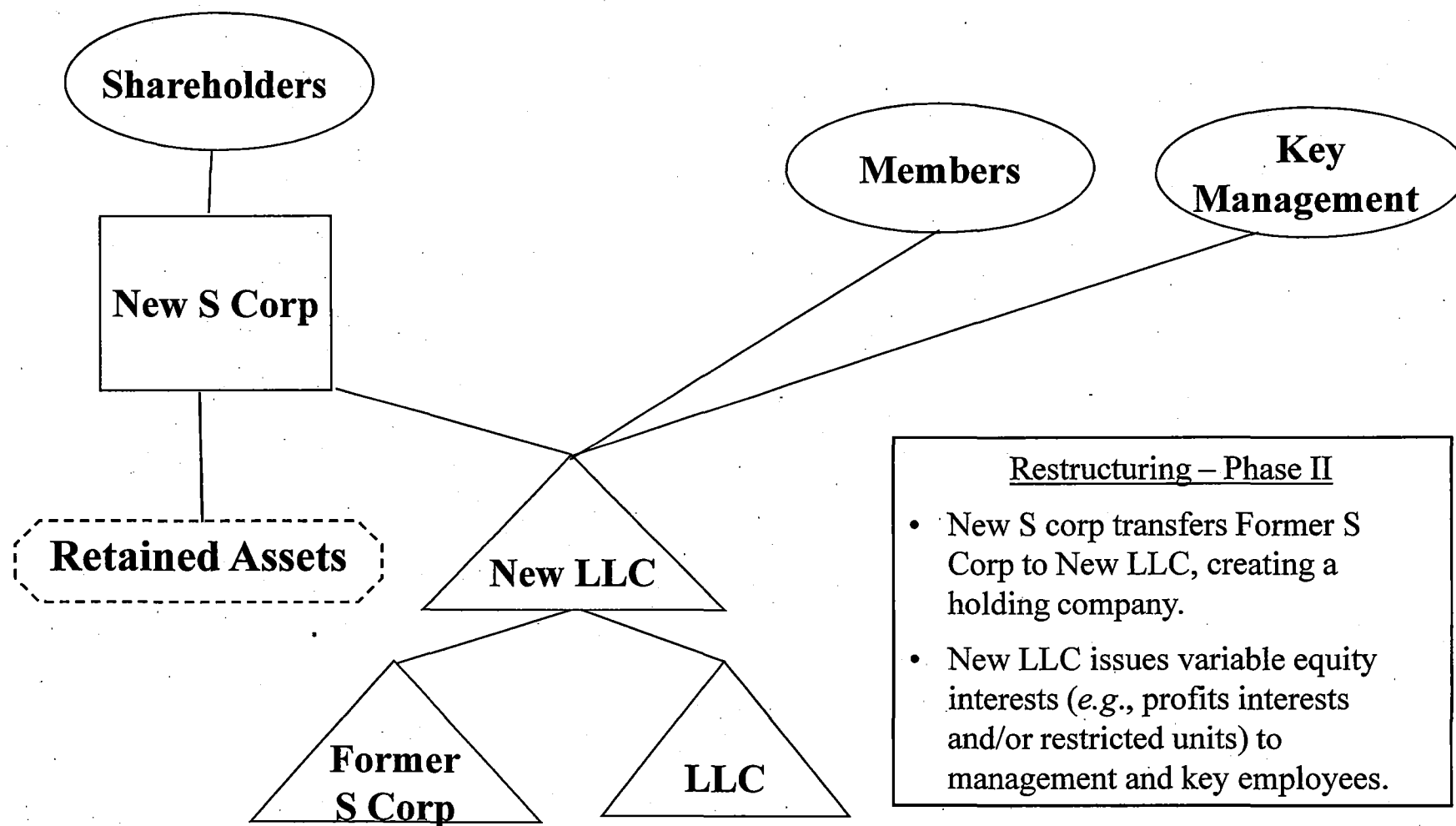
Rollover and Deferred Sale With Leverage: Rollups

Example 7 (Cont'd)



Rollover and Deferred Sale With Leverage

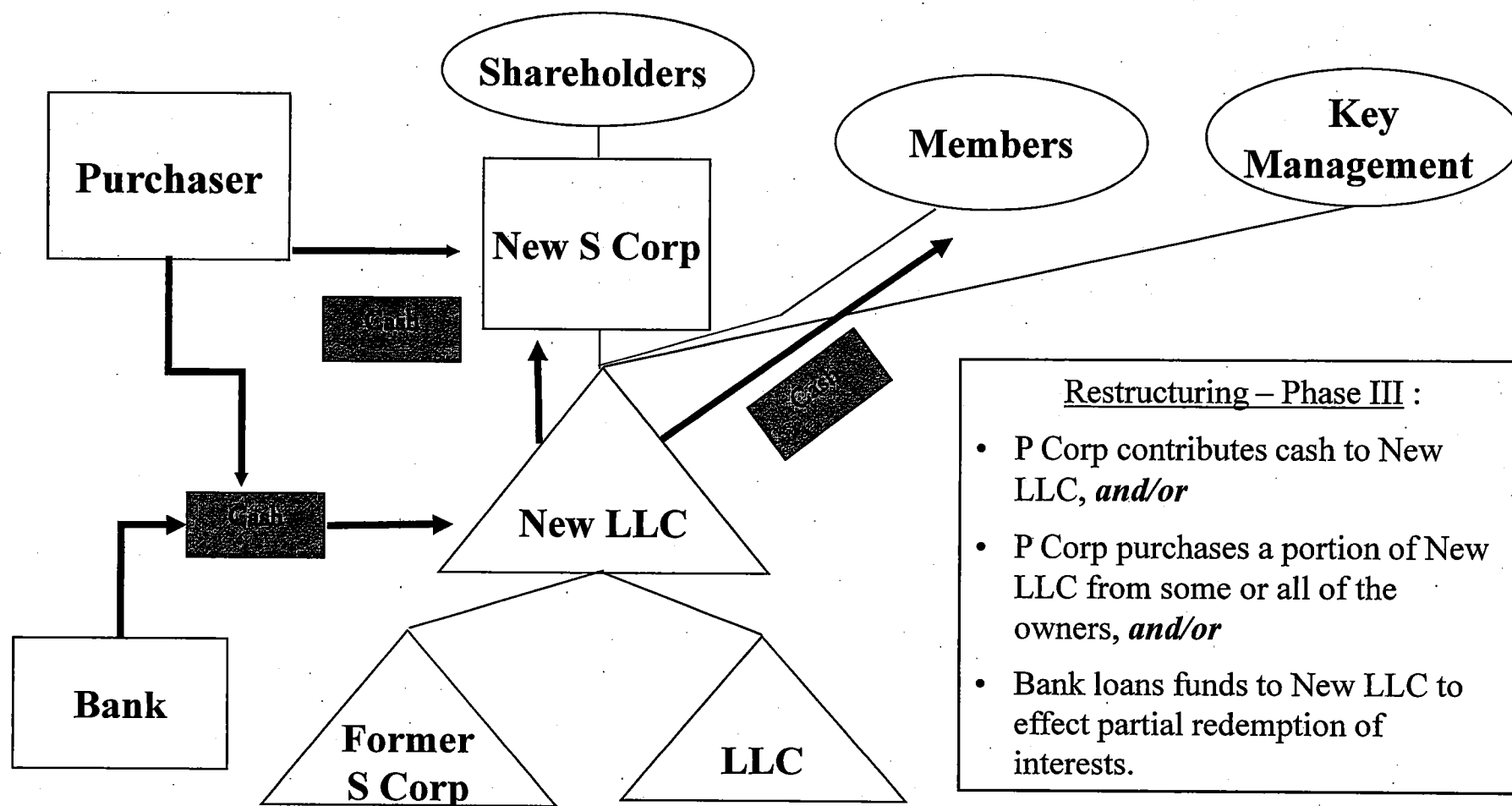
Example 7 (Cont'd)





Rollover and Deferred Sale With Leverage

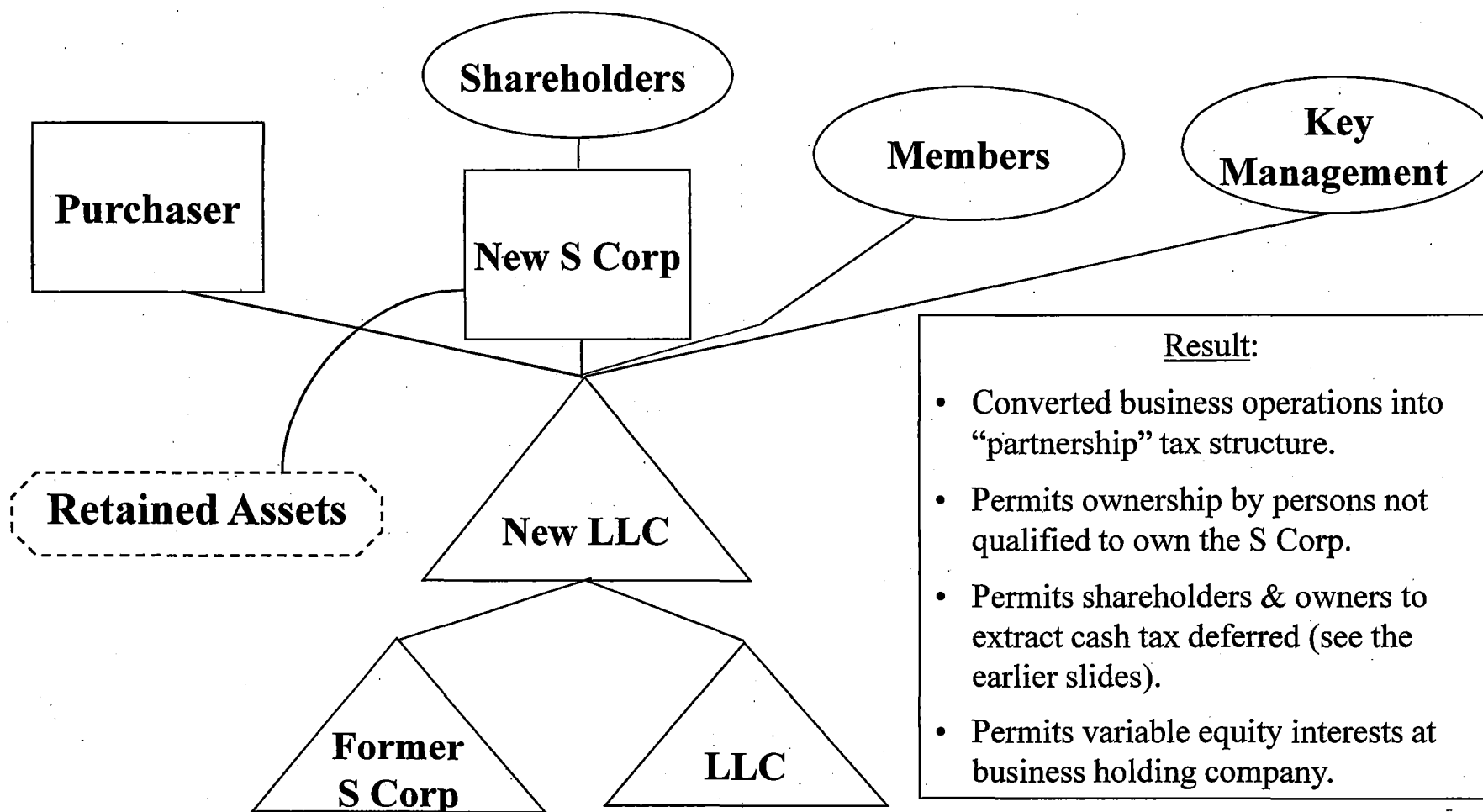
Example 7 (Cont'd)





Rollover and Deferred Sale With Leverage

Example 7 (Cont'd)





Application of Select Partnership Issues to Rollovers

- I. Profit & Loss Allocation Rules and Targeted Capital Accounts.
- II. Recourse and Nonrecourse Liability Allocations.
- III. Partnership Disguised Sale Rules.
- IV. Basis Step-Up and Anti-Churning Limitation.



I. Profit & Loss Allocation Rules & Targeted Capital Accounts



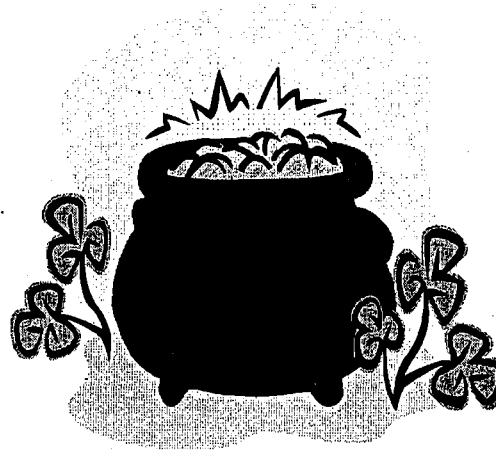
Importance of Partnership Tax Concepts

Proper analysis of rollover partnership structures requires an understanding of partnership tax concepts, especially:

- Capital Accounts,
- Profits Interests, and
- Capital Interests.



Importance of Capital Accounts



Partner's Ending Capital Account Balance
Equals

Cash to be Received by the Partner



Importance of Capital Accounts (Cont'd)

What determines a partner's ending capital account balance (*i.e.*, his/her share of ending cash)?

Capital Account Increased For:

- Cash invested
- FMV of property contributed
- Partner's share of profits
- Equity revaluations

Capital Account Decreased For:

- Cash distributed
- FMV of property distributed
- Partner's share of losses
- Equity revaluations





Capital Accounts: Key Variables

Four variables that need to be considered carefully:

1. FMV of property contributed to and distributed from the partnership.
 - Who determines value?
 - Does the agreement establish appropriate valuation standards?
 - Whose approvals are required?
 - At what point in time is the value to be determined?
2. Timing and character of profit and loss allocations.
 - Compliance with the “substantial economic effect” safe harbor of the tax regulations?
 - Will front-end losses be offset by back-end profits?
 - Do the allocations reconcile with the capital account requirements?



Capital Accounts: Key Variables (Cont'd)

3. Revaluation and “Book-Up” Events.

- What events trigger revaluations?
- Is it mandatory or discretionary?
- If discretionary, who makes the decision?
- Who determines the value of partnership’s existing tangible and intangible assets upon a revaluation? By what method?
- Whose approvals or consents are required?

4. Ownership in partnership capital vs. share of profits & losses.

- Profits Interest – A right to share in future profits and losses.
- Capital Interest – A right to receive distributions of property (*e.g.*, cash) upon dissolution of the partnership.
- Profits Interests \neq Capital Interest. Variance is common in rollover equity.



Profit Allocation: Traditional vs. Target Example 8

- Target LLC (or partnership) has agreed value of \$10 million.
 - Buyer contributes \$8 million cash to Target, which is distributed to Seller in redemption of 80% of its LLC interest (disregard “disguised sale” issues).
 - Seller retains a 20% interest in the LLC (with agreed value of \$2 million).
- Parties agree to the following distribution waterfall:
 - First to Buyer in amount equal to cumulative preferred return of 15%.
 - Second to Buyer in amount equal to unreturned capital (initially \$8 million).
 - Third to Seller in amount equal to invested capital of \$2 million.
 - Balance is split 50% to Buyer and 50% to Seller.
 - Amounts unpaid carryover to subsequent years.
- In Year 1, Target earns \$ 500,000 of net operating revenue, which it distributes to its members.



Profit Allocation: Traditional vs. Target

Example 8 (Cont'd)

	<u>Buyer</u>	<u>Seller</u>
Initial capital	\$ 8,000,000	\$ 2,000,000
Preferred profit allocation *	\$ 500,000	\$
Residual profit allocation (50%/50%)	\$	\$
1 st priority distribution **	\$ (500,000)	\$
2 nd priority distribution	\$	\$
3 rd priority distribution	\$	\$
Residual distribution	\$ <u>0</u>	\$ <u> </u>
Ending capital account	<u>\$ 8,000,000</u>	<u>\$ 2,000,000</u>
Ending value of assets		<u>\$ 10,000,000</u>

* Preferred profit allocation should be \$1.2M (\$8M x 15%). Amount limited to profits available. Shortfall of \$700,000 carries over.

** Distribution limited to available cash.



Alignment of Section 704(b) Requirements: Targeted Capital Accounts

- Focus on cash → “Cash is King”
- Concept: profit and loss allocations are a plug – used to force capital account balances at year end to equal amount of cash each partner would receive upon liquidation assuming asset value equals IRC § 704(b) “book” value.
- Note: amount distributable upon liquidation not tied to positive capital account balances (result would be circular) – but rather tied to the cash distribution section of the agreement.
- Targeted capital account provision usually incorporates the CA maintenance rules of § 1.704-1(b)(2)(iv), but requires the accountants to calculate the plug.
 - In concept, appears to satisfy the “partners interest in the partnership” test.
 - But preferred returns and other variable equity participation rights can impact economic equivalence.



Alignment of Section 704(b) Requirements: Targeted Capital Accounts

- Step 1: Adjust beginning of year capital accounts for any capital contributions or distributions during the year.
- Step 2: Determine how remaining partnership assets would be distributed if partnership were to dissolve at end of year, assuming liquidation at book value.
- Step 3: Use current year profits and losses to plug the capital accounts (determined after Step 1) so as to equal the amount each partner would receive upon a hypothetical liquidation of the partnership (determined in Step 2).



Profit Allocation: Traditional vs. Target Example 8 (Cont'd)

Targeted Capital Accounts: Step 1

	<u>Buyer</u>	<u>Seller</u>
Initial capital	\$ 8,000,000	\$ 2,000,000
1 st priority distribution	\$ (500,000)	\$
2 nd priority distribution	\$	\$
3 rd priority distribution	\$	\$
Residual distribution	\$ _____	\$ _____
Partially adjusted CA	<u>\$ 7,500,000</u>	<u>\$ 2,000,000</u>



Profit Allocation: Traditional vs. Target

Example 8 (Cont'd)

Targeted Capital Accounts: Step 2

Assets remaining to distribute at end of Year 1: \$10,000,000

	<u>Buyer</u>	<u>Seller</u>
Unpaid preferred return *	\$ 700,000	
Unpaid capital: 1 st priority	\$ 8,000,000	
Unpaid capital: 2 nd priority		\$ 1,300,000
Residual profit distribution	\$ _____	\$ _____
Total liquidation distributions	<u>\$ 8,700,000</u>	<u>\$ 1,300,000</u>

* See Slide 38



Profit Allocation: Traditional vs. Target

Example 8 (Cont'd)

Targeted Capital Accounts: Step 3

	<u>Buyer</u>	<u>Seller</u>
Total liquidation distributions	\$ 8,700,000	\$ 1,300,000
Less: Partially adjusted CA	<u>\$(7,500,000)</u>	<u>\$(2,000,000)</u>
Profit allocations	<u>\$ 1,200,000</u>	<u>\$ (700,000)</u>
 <u>Note:</u> Compare to profit/loss allocations in Traditional approach	 <u>\$ -0-</u>	 <u>\$ -0-</u>

Net profit limited to \$500,000. Thus, must allocate items of gross income and deduction and/or taxable "phantom" income to Buyer (e.g., guaranteed payment under IRC § 707).



Profit Allocations: Alignment of Tax Distributions

- Tax Distributions: often included in cash waterfall – even with Targeted Capital Accounts.
 - Negotiate method of computation, including whether computed:
 - On cumulative vs. annual earnings.
 - On taxable income vs. “book” earnings.
 - Using actual or marginal tax rates.
- With Targeted Capital Accounts, increased risk that tax distributions result in excess distributions to one partner.
 - Consider claw-back requirement.
 - Consider effect if early period income cannot be offset by later stage losses (either due to timing or character).



II. Recourse and Nonrecourse Liability Allocations



Partnership Liability Allocations: Using Debt to Preserve Basis and Protect Distributions

- Objective: Extract cash from the partnership on a tax-deferred basis.
- General rule:
 - Distribution of cash not taxable unless amount received exceeds partner's basis.
 - Partner's basis includes its allocable share of partnership debt.
 - Thus, the greater a partner's share of partnership debt, the more cash it can extract from the partnership on a tax-deferred basis.
- How to determine a partner's share of partnership debt?



Partnership Liability Allocations: Using Debt to Preserve Basis and Protect Distributions

- Step 1: Identify “recourse” liabilities.
 - Must be allocated to – and included in basis of – the specific partner bearing economic risk of loss (per Treas. Reg. § 1.752-2).

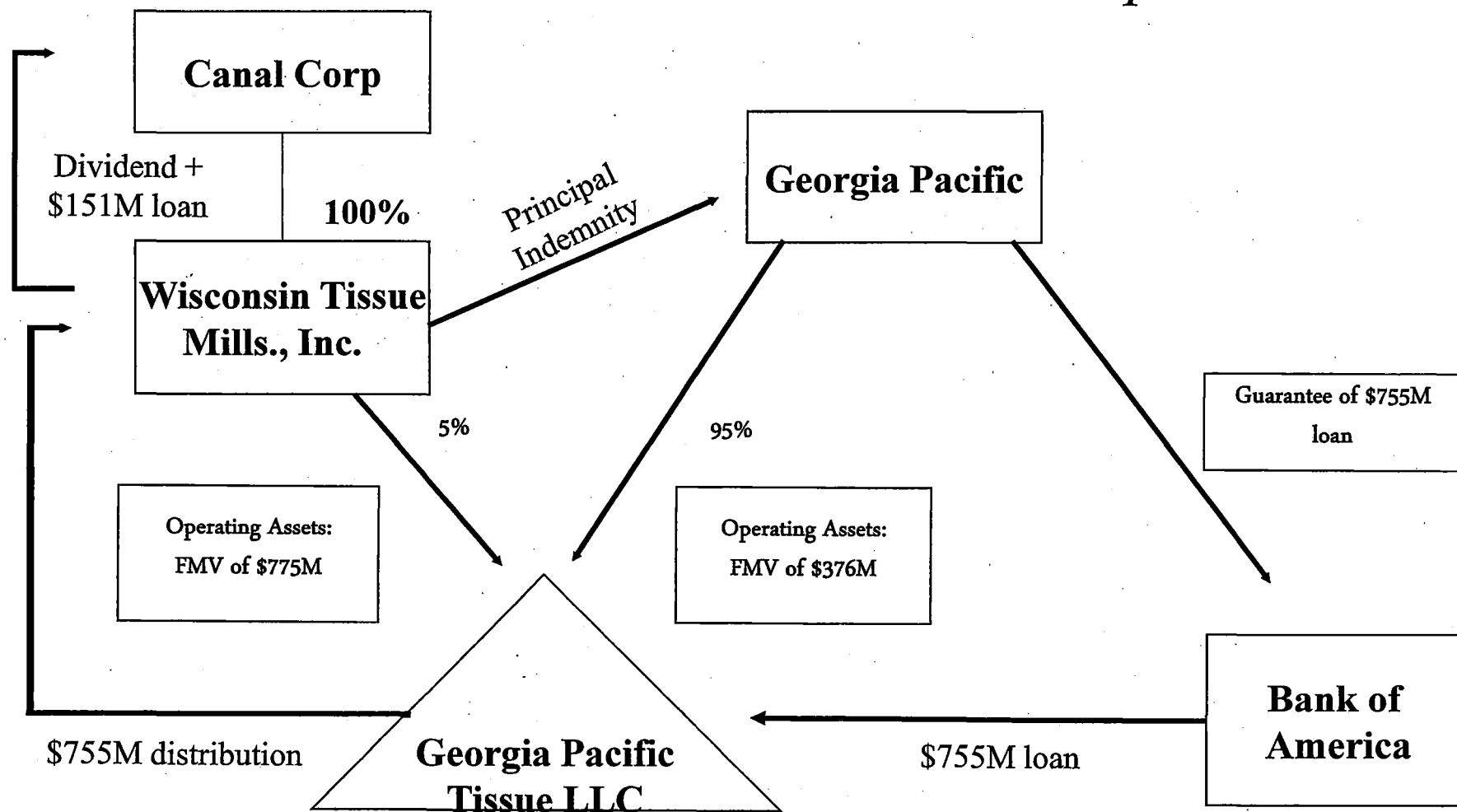
- Step 2:
 - Identify “nonrecourse” liabilities.
 - Must be allocated to – and included in basis of – partners under following rules (per Treas. Reg. § 1.752-3):
 - Tier I – Partnership minimum gain.
 - Tier II – Built-in gain (limited to gain assuming contributed property sold for cash equal to nonrecourse debt).
 - Tier III – Remaining built-in gain plus profit-sharing ratio, or other permitted method.



Partnership Liability Allocations: Partner Guarantees

- Guarantees of partnership debt convert nonrecourse liabilities into recourse liabilities. Treas. Reg. § 1.752-2.
- Issues:
 - Is guarantor partner reasonably expected to have sufficient assets and cash flow to satisfy obligation?
 - If guarantor partner is a disregarded entity, is the DRE's "net value" (excluding its investment in the partnership) sufficient? *See*, Treas. Reg. § 1.752-2(k)
 - Is guarantee legally enforceable under state law?
 - Does guarantor partner have any rights to reimbursement or contribution from other parties?
 - Has guarantor partner waived rights of subrogation?
 - Is guarantee a "first-dollar" commitment or a "bottom-guarantee"?
 - Does anti-abuse rule in Treas. Reg. § 1.752-2(j) apply?

Partnership Liability Allocations: Partner Guarantees & *Canal Corp.*





Application of Partnership Rules: Partner Guarantees (Cont'd)

Canal Corp v. Commissioner, 135 T.C. No. 9 (Aug. 5, 2010)

- Case involved a distribution of cash borrowed by the partnership from 3rd party.
- Debt was guaranteed by Georgia Pacific who received an indemnification from Wisconsin Tissue Mills, Inc. (“WISCO”)
- Partnership was not thinly capitalized.
- The assets of WISCO consisted of its partnership interest, a \$151 million note receivable from Canal Corporation (“Parent”) and a \$6 million jet. WISCO had contingent liabilities, including environmental.
- Tax Court concluded the transaction violated the “anti-abuse” rule in Treas. Reg. § 1.752-2(b)(6), in part because WISCO’s indemnity used to create the appearance of risk shifting from Georgia Pacific with “no more than a remote possibility” that WISCO would be called upon to perform.



Application of Partnership Rules: Partner Guarantees (Cont'd)

- Caution: Partner guarantees are not always effective. (*See Canal Corp v. Commissioner*)
- Even where guarantees are effective, the allocation of liabilities may not be a perfect cure for all tax ailments.
- Partner may have sufficient basis under IRC § 752 and still be subject to tax on cash distribution. For example,
 - IRC § 737 imposes taxable gain on a partner that receives an otherwise tax-deferred distribution that occurs within 7 years following its contribution of appreciated property to the partnership.
 - IRC § 751(b) requires partner to recognize gain if its pro rata share of “hot assets” is reduced following contribution.
 - IRC § 707 requires partner to recognize gain on “disguised sales”



III. Partnership Disguised Sale Rules



Partnership Disguised Sale Rules

- Disguised sale rules found in IRC § 707 and related Treasury regulations.
- Rules generally focus on partnership distributions made within 2 years of the contribution date.
- Regulations apply a “but for” test – *i.e.*, would the distribution have occurred “but for” the contribution of property by the partner?
- Special rule exempts distributions subject to entrepreneurial risks of the partnership.
- Borrowings within 2 years of contribution date treated as “sale proceeds” unless exception applies
- Regulations require special tax return disclosures



Partnership Disguised Sales Rules (Cont'd)

- Exception to disguised sale rule for “debt-financed” distributions:
 - Special rule under Treas. Reg. § 1.707-5(b) permits partner to extract debt financed cash (often tax free).
 - But Treas. Reg. § 1.707-5(a)(2) modifies general rules in IRC § 752 for allocating nonrecourse liability and deletes Tier I and Tier II allocations for this purpose.
 - Requires cash-receiving partner to rely on Tier III allocations (*e.g.*, profit-sharing ratio).
 - Cash received by a partner in excess of its share of partnership liabilities, as determined under the modified rule of Treas. Reg. § 1.707-5(a)(2), is treated as sale proceeds.

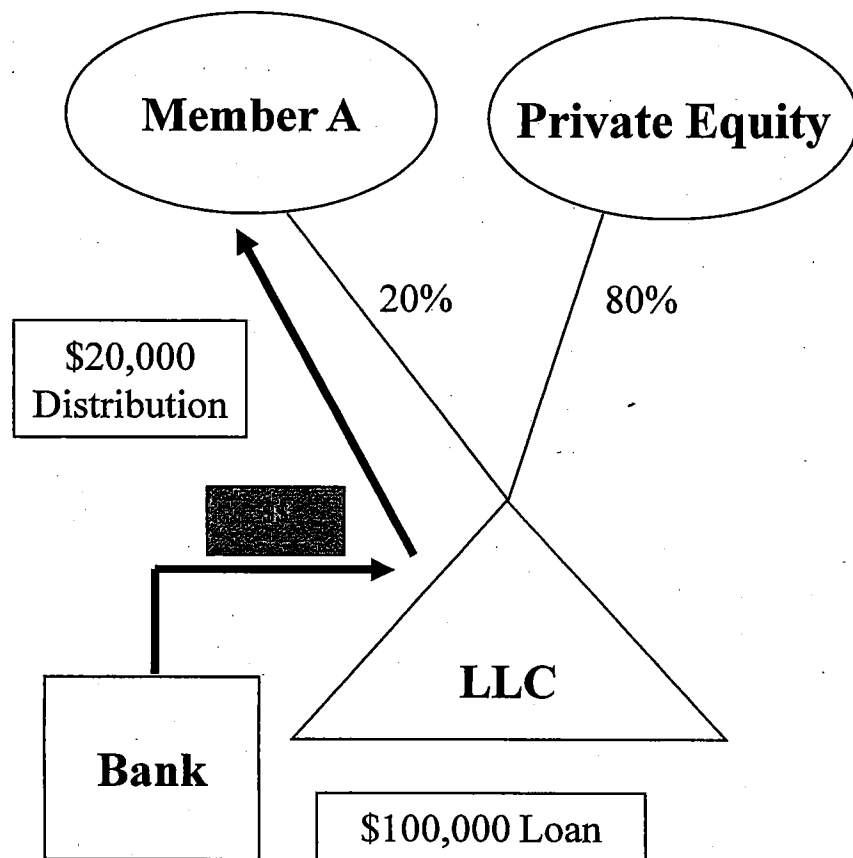


Partnership Disguised Sale Rules (Cont'd)

- Requires special focus on Tier III allocation and interplay with Treas. Reg. § 1.707-5(b).
- If partner's allocable share of the liability (as modified by IRC § 707) is not sufficient, consider partner guarantees to convert nonrecourse debt into recourse debt that can be specially allocated to the recipient partner.



Partnership Disguised Sale Rules: Interplay with Treas. Reg. § 1.707-5(b) – Example 9



Facts

- LLC borrows \$100,000 from Bank. Loan is nonrecourse per Treas. Reg. § 1.752.
- LLC distributes \$20,000 to Member A within 90 days of the loan.
- The \$20,000 is allocable to the loan under Treas. Reg. § 1.163-8T.
- Member A's share of the \$100,000 under IRC § 752 is \$20,000.
- But what portion of cash received by Member A is allocable to its share of the loan under Reg. § 1.707-5?

End of Analysis?

No. Must determine portion of cash received by Member A attributable to debt allocated to Private Equity. **See Next Slide**



Partnership Disguised Sale Rules: Interplay with Treas. Reg. § 1.707-5(b) – Example 9

Application of Rule

- Member A's allocable share of the LLC debt is \$20,000 per Treas. Reg. § 1.752-3.
- But, Treas. Reg. § 1.707-5(b) requires that the \$20,000 received by Member A be bifurcated into 2 components.
- Must split debt between portion of debt allocable to Member A (20%) and portion allocable to Private Equity (80%).
- Cash received by Member A from Private Equity's share of \$100,000 loan is treated as sale proceeds.
- Thus, 80% of \$20,000, or \$16,000 is treated as sale proceeds.

Conclusion

- Member A must guarantee a portion of \$100,000 loan to receive \$20,000 on tax-deferred basis.



Application of Partnership Rules: Qualified Liabilities

- Exception to disguised sale rule for “qualified liabilities” assumed or taken subject to by the partnership. *See*, Treas. Reg. § 1.707-5(c).
- Qualified liabilities include:
 - Debt allocable under Treas. Reg. § 1.163-8T to capital expenditures.
 - Debt incurred in the ordinary course of business if (and only if) all material assets related to the business are transferred to the partnership.
 - Debt incurred >2 years prior to contribution *if* the debt has encumbered the contributed property for the 2-year period preceding contribution.
 - Debt incurred within 2 years of contribution, *if* the debt has encumbered the contributed property for the 2-year period preceding contribution, and *if* the taxpayer can “clearly establish” that debt not incurred in anticipation of the transfer.



Application of Partnership Rules: Qualified Liabilities (Cont'd)

- But -- exception for “qualified liabilities” not a perfect safe harbor.
- If a transfer of property by a partner to the partnership is treated as a disguised sale without regard to qualified liabilities, then a portion of the qualified liabilities may convert into a nonqualified liability and trigger the recognition of additional income. *See*, Treas. Reg. § 1.707-5(i).



IV. Tax Basis Step Up and Anti-Churning Rules



Rollover and Deferred Sale Strategies

Importance of Tax Basis Step-Up

- Important for Buyers to benefit from a step-up in the tax basis of Target's assets.
- Resulting depreciation and amortization used to shelter tax on operating profits and increase investment yields and cash flows.
- The present value benefit of this stream of future tax deductions often is factored into deal pricing.
- Applies to tangible assets (*e.g.*, buildings, machinery, and equipment).
- Also applies to intangible assets (*e.g.*, goodwill, going concern, workforce in place, patents, copyrights, customer-based intangibles, licenses, permits, trade names, covenants not to compete). *See* IRC § 197(d).



Rollover and Deferred Sale Strategies

Application of IRC § 197 to Basis Step-Up

- Section 197 permits a taxpayer to deduct “amortizable Section 197 intangibles” ratably over a 15-year period. *See* IRC § 197(a).
- Not all intangibles qualify for amortization, and certain intangibles are subject to special rules. For example, most self-created intangibles are excluded. *See* IRC § 197(c)(2).
- Amortization available only for “Section 197 intangibles” acquired after August 10, 1993.
- Rules deny amortization of intangibles acquired in certain transactions or from related parties. *See* IRC § 197(f)(2) and (f)(9).



Rollover and Deferred Sale Strategies Limitation on IRC § 197 Amortization

- Section 197(f)(2) imposes a “stand-in-the-shoes” rule that limits amortization for intangibles acquired in carry over basis transactions such as IRC §§ 332, 351, 721, 731.
- Requires the transferee to “stand-in-the-shoes” of the transferor to the extent of the transferor’s basis that carries over.
- Effect is to require that the tax basis of the intangible be bifurcated:
 - A portion equal to the transferee’s historic basis will continue to be amortized as if the intangible were still owned by the transferor.
 - Any step-up in basis will be treated as newly acquired and amortized under Section 197. Compare to IRC § 754 and “reverse” § 704(c) basis adjustments.



Rollover and Deferred Sale Strategies Impact of Anti-Churning

- The anti-churning rule of Section 197(f)(9) overrides the “stand-in-the-shoes” rule.
- If the anti-churning rule applies, no portion of the intangible is eligible for amortization.
- The anti-churning rule will apply in several situations, including the acquisition of an intangible that was held or used by the taxpayer or a related person at any time between July 25, 1991 and August 10, 1993 (the “transition period”).
- This “related party” limitation often impacts equity rollover transactions.



Rollover and Deferred Sale Strategies

Anti-Churning Definition of “Related Party”

- Section 197 imposes fairly complicated ownership and attribution rules to determine whether or not two or more persons are “related.” In the partnership context:
- Two partnerships are “related” if they have more than 20% (actual or constructive) common ownership, and
 - A partner is “related” to a partnership if the partner holds (actually or constructively) more than 20% of the partnership interests.
- Parties are “related” if the requisite relationship existed immediately before or immediately after the acquisition of the intangible involved. *See* IRC § 197(f)(9)(C)(ii).



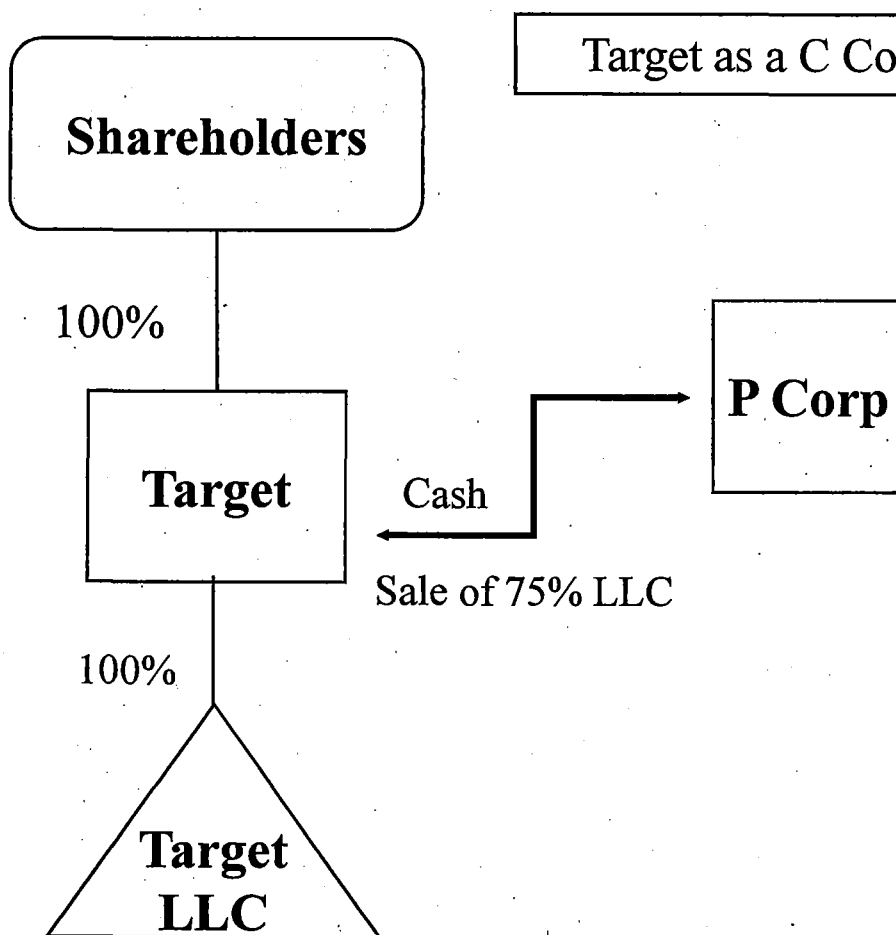
Rollover and Deferred Sale Strategies

Effect of Anti-Churning on Rollover Transactions

- Determine if any portion of the Section 197 intangibles were used by the company or any of its owners on or prior to August 10, 1993.
 - Straightforward if the company acquired all of its assets in a fully-taxable purchase from an unrelated third party after August 10, 1993.
 - Do not rely on date of corporate formation. Need to determine if the Section 197 intangibles were acquired from a related party (perhaps at formation via a capital contribution).
- Effects can be illustrated by Examples 10 and 11.



Rollover and Deferred Sale Strategies Example 10

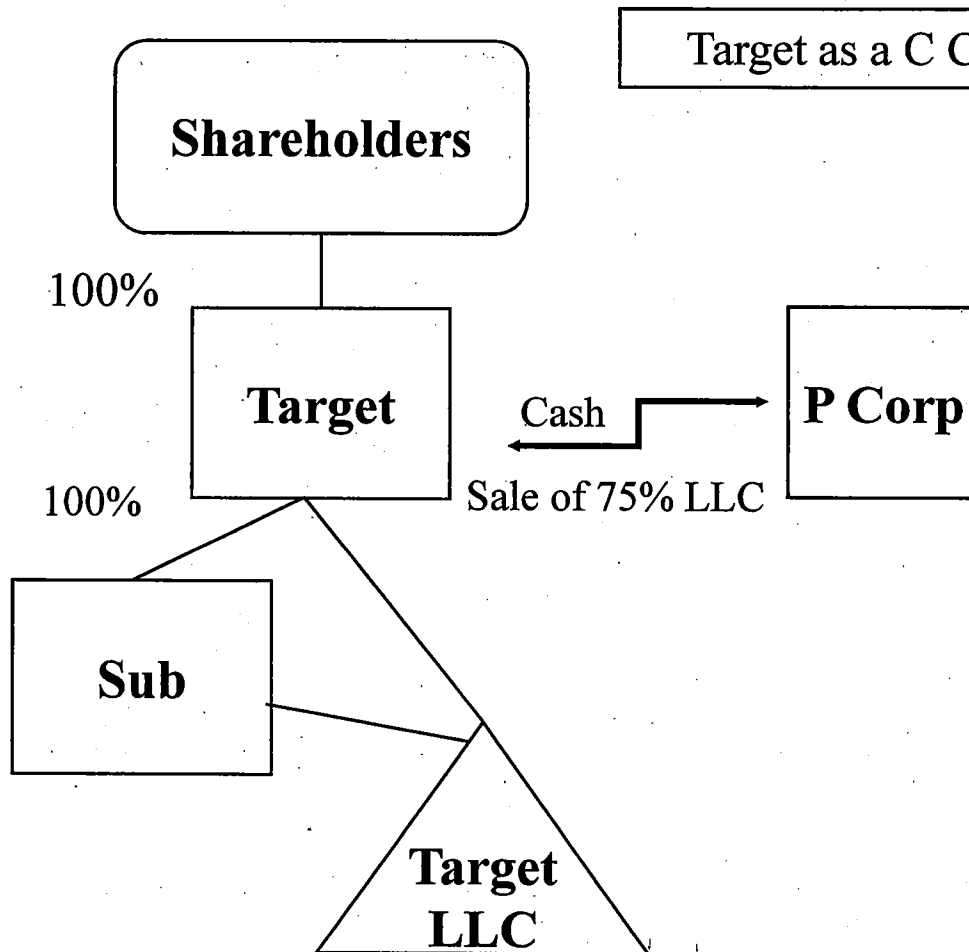


Tax Consequences

- If Target's assets are non-amortizable intangibles, the anti-churning rule will apply.
- Because Target owns >20% interest in Target LLC after sale, Target and P Corp are "related" for purposes of IRC § 197.
- Treated as sale of a 75% interest in each asset held by Target LLC followed by deemed contribution of assets by Target and P Corp to a new partnership. (Rev. Rul. 99-5)



Rollover and Deferred Sale Strategies Example 11



Tax Consequences

- Assume Target LLC formed as part of a separate transaction in an earlier year.
- Sale of a "partnership" interest eligible for IRC § 754 election.
- Election permits P Corp to bifurcate the tax basis of the intangibles.
- Possibility of obtaining a partial step-up. *See* Treas. Reg. § 1.197-2(k), *Example (18)*.
- Some risk of recharacterization by reason of IRC § 708(b)(1)(B).



Rollover and Deferred Sale Strategies

Application of Anti-Churning to Rollovers

- Anti-churning rules apply to intangibles that are not otherwise amortizable. Therefore, two requirements:
- First, rule only applies to intangibles that existed on August 10, 1993.
- Second, rule only applies if one of the following is true:
 - The taxpayer or a related person held or used the intangible asset during the “transition period” (defined as the period between July 25, 1991 and August 10, 1993);
 - The intangible was acquired from a person who held it at any time during the transition period and the user of the intangible does not change; or
 - The taxpayer grants the right to use the intangible to a person (or a person related to such person) who held or used it at any time during the transition period. *See* IRC § 197(f)(9)(A).



Rollover and Deferred Sale Strategies

Application of Anti-Churning to Rollovers

- With respect to a partnership, parties are “related” if there is a >20% interest in partnership capital or profits.
- Also related if the parties are engaged in trades or businesses under common control. *See* IRC § 197(f)(9)(C)(i)(II).
- Rule incorporates tax definitions to determine “capital” and “profits” interests as determined under Section 707(b)(1).
- A “profits interest” is generally defined as a right to participate in future profits – not current equity value.
- A “capital interest” is generally defined as an interest in the assets of the partnership distributable upon the partner’s withdrawal or upon liquidation. *See* Treas. Reg. § 1.704-1(e)(1)(v).



Rollover and Deferred Sale Strategies

Application of Anti-Churning to Rollovers

- Regulations combine a series of related transactions that comprise a “qualified stock purchase” per Section 338. *See* Treas. Reg. § 1.197-2(h)(6)(ii).
- Regulations adopt a subjective anti-avoidance test. Amortization denied if “one of the principal purposes of the transaction” is to avoid the anti-churning rules. Avoidance presumed if no “significant change in the ownership or use of the intangible.” *See* Treas. Reg. § 1.197-2(h)(11).
- Regulations contain a general anti-abuse rule; permits IRS to recast a transaction if “one of the principal purposes” was to achieve a tax result “inconsistent with the purposes of section 197.” *See* Treas. Reg. § 1.197-2(j).



Rollover and Deferred Sale Strategies

Application of Anti-Churning to Rollovers

- Not surprisingly, the anti-churning rules also apply to disguised sale transactions. *See* Treas. Reg. § 1.197-2(k), *Example (17)*.
- The rules also apply “constructive ownership” tests that can cause persons to be “related” by virtue of interests held by family members, etc.
- If a basis step-up is otherwise permitted, it is imperative that the partnership timely file an election under Section 754 in order to bifurcate the intangible assets. The failure to file will prevent the taxpayer from obtaining any basis step-up.



QUESTIONS

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