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M&A Deals – What's New?

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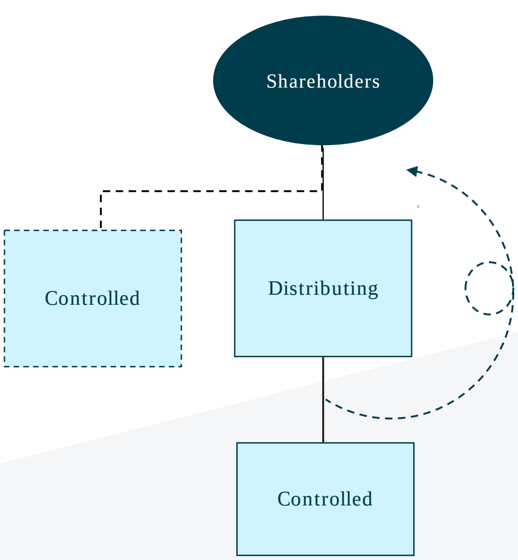
Agenda

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
- **Pro-rata spin-off distribution or non-pro-rata split-off or split-up redemption**

Comparison to Section 301 Distributions

	Section 301 Distribution	Section 355 Spin-Off
Income/Gain	• Corporate level deemed sale treatment under Section 311(b) • Apply Section 301(c)(1) – (c)(3) to determine shareholder tax treatment (dividend to extent of Distributing's E&P, reduction of Distributing's stock basis, excess capital gain) • For internal distributions within consolidated group-deferral triggered on external distribution	• Non-recognition treatment
Impact on Tax Attributes	• Gain on deemed sale of target shares - Subpart F - Section 1248 or Section 964(e) • Shareholders' tax basis in Controlled shares equal to fair market value of the shares	• Treas. Reg. Section 1.312-10 impact • Treas. Reg. Section 1.367(b)-5 analysis • Shareholders' tax basis in Controlled shares equal to a proportionate allocation of their tax basis in Distributing's shares
Elective?	• No, distributions that do not meet qualifications of Section 355 transactions are treated as Section 301 distributions	• No, Section 301 distributions that meet qualifications of Section 355 transactions are treated as Section 355 transactions

Key Requirements for Tax-Free Spin-Off

- **Business Purpose.** The spin-off must be motivated by one or more real and substantial non-tax corporate business purposes
- **Control.** Distributing must own at least 80% of the vote (and 80% of each class of non-voting stock) of Controlled immediately before the spin-off, and generally must not have acquired control in a taxable deal in the 5-year period before the distribution
- **Active Trade or Business.** Immediately after the transaction, each of Distributing and Controlled must be engaged (directly or indirectly) in an "active trade or business" that has been actively conducted throughout the 5-year period before the distribution (and that was not acquired in a taxable transaction during that period)
  - Expansion doctrine" may permit certain taxable acquisitions of a trade or business to the extent treated as an expansion of an original business that meets the active trade or business test
  - Active trade or business test historically has been interpreted to require five-year history of revenues, expenses and managerial and operational functions. Recent IRS guidance has indicated some flexibility (e.g., R&D-type activities might also qualify)

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

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

- **Distribution of Control.** Generally, Distributing must distribute all of the stock and securities of Controlled that it holds immediately prior to the spin-off
  - In limited circumstances, Distributing may be permitted to retain a portion of the stock of Controlled, so long as it distributes 80% "control" in the spin-off
  - Any such retention must be motivated by a sufficient business purpose for the retention, without a principal purpose of tax avoidance, and retained shares generally must be divested within a specified period
- **Disqualified Distributions.** Distributing recognizes gain if, immediately after the distribution, 50% or more of the stock of Distributing or Controlled is owned by persons the stock ownership of which is attributable to Distributing or Controlled stock acquired by purchase within five years before the distribution
- **Stockholder Continuity.** Historic Distributing stockholders must maintain continuity of interest in both Distributing and Controlled for some period following spin-off
- **Continuity of Business Enterprise.** Continued operation by Distributing and Controlled of businesses existing prior to the spin-off

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

- Distributing (but not its stockholders) recognizes gain under Section 355(e) if spin-off is part of a plan for 3rd party to acquire 50% or more (by vote or value) of the Distributing or Controlled
  - Rebuttable statutory presumption that acquisition of 50% or more (by vote or value) is part of a plan triggering Section 355(e) if it occurs within 2 years before or 2 years after the spin-off
  - Issuances of stock by Distributing or Controlled in public offerings or acquisition transactions, as well as acquisitions of Distributing or Controlled by 3rd parties, may contribute to or result in a transfer of 50% or more for purposes of Section 355(e).
  - Issuances of options or stock to employees generally are not included in the 355(e) analysis
  - Section 355(e) rules apply to certain successors and predecessors of Distributing and Controlled, such that certain acquisitions of stock of other corporations may be relevant to the 50% or more test

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 Controlled by contract if its actions cause the liability
- **Diligence Issue.** Potential acquirers and strategic partners of Distributing or Controlled will tend to be conservative in analysis of whether proposed post-spin-off transaction could trigger Section 355(e) liability

Preserving the Tax-Free Spin-Off – Safe Harbors

- **Section 355(e) Safe Harbors.** Safe harbors relax 2-year presumptions and may provide flexibility to enter into certain unplanned acquisition transactions. Key factors affecting applicability of safe harbors include the timing of negotiations and business purpose for spin-off
- **"Super Safe Harbor."** Except in the case of a public offering, a post-distribution acquisition can be part of a plan only if there was an agreement, understanding, arrangement or ***substantial negotiations*** regarding the acquisition or a similar acquisition at some time during the ***2-year period ending*** on the date of the distribution
  - Base case for Super Safe Harbor is where Distributing has had no contacts with the eventual acquirer regarding an acquisition for more than two years pre-spin
  - Assumes substantial business purpose for spin-off unrelated to any potential acquisition
  - Substantial negotiations involve discussion of significant economic terms by officers, directors, controlling shareholders or other persons with implicit or explicit permission to engage in such discussions
  - Super safe harbor is not available for post-spinoff public offerings

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

- **18-Month Safe Harbor.** A post-distribution acquisition will not be considered part of a plan if:
  - Spin-off was motivated in whole or substantial part by a ***business purpose*** other than to facilitate acquisition
  - acquisition occurs ***more than six months after*** spin-off and
  - there was no agreement, understanding, arrangement or ***substantial negotiations*** regarding the acquisition or a similar acquisition during the period beginning ***one year before and six months after*** the spin-off

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

- **One-Year Safe Harbor.** A post-distribution acquisition will not be considered part of a plan if there was ***no agreement, understanding or arrangement*** regarding the acquisition or a similar acquisition at the time of the distribution, and there was no agreement, understanding, arrangement or ***substantial negotiations*** regarding the acquisition or a similar acquisition within ***one year after*** the distribution
  - Pre-distribution negotiations without reaching an agreement , understanding or arrangement should not compromise the spin-off, provided that there are no negotiations for one year post-spin
  - Distributing and Controlled generally could not re-engage with potential acquirers with which there were substantial negotiations pre-spin for one-year period post-spin

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

Safe Harbors Simplified

Timing of Substantial Negotiations	**Safe Harbor for Post-Spin Transaction**
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

Preserving the Tax-Free Spin-Off – Overlapping Stockholders

- Overlapping shareholders may be helpful in preventing a 50% or more change in ownership where stock of Distributing or Controlled is acquired post-spin
  - Overlap rule excludes from the 50% or more calculation the acquisition of stock in Distributing or Controlled to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease
  - **Example 1.** Individual B owns all of the stock of Distributing, which owns all of the stock of Controlled. Distributing spins off Controlled to B, and then merges with Corporation X, which also is wholly owned by B. Because B directly or indirectly owns 100% of both the X and Controlled stock after the merger, and directly or indirectly owned 100% of Distributing and Controlled before the merger, the merger is not a prohibited acquisition
  - **Example 2.** Assume the same facts as Example 1, except that Distributing and X are both owned, before the merger, by the same 20 5% stockholders. The result is the same as in Example 1
  - Exception does not apply if pre-acquisition stockholders acquired their stock pursuant to a prohibited plan

Extracting Value or Reallocating Liabilities in a Spin-Off

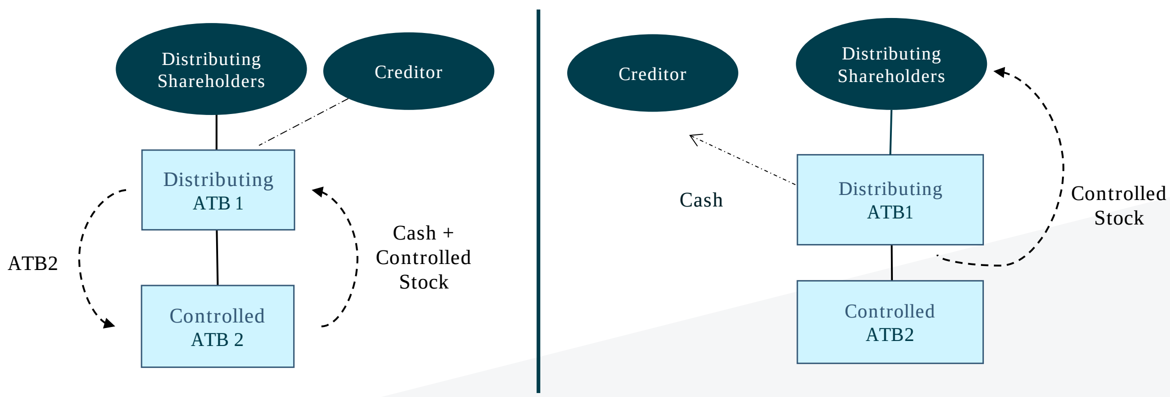
- **Cash distribution:** Controlled distributes cash to Distributing as part of a Section 368(a)(1)(D) reorganization.
- **Liability assumption:** Controlled assumes a liability of Distributing as part of a Section 368(a)(1)(D) reorganization.
- **Securities-for-debt exchange:** Distributing transfers business to Controlled in exchange for Controlled stock and Controlled securities (i.e., long-term debt). Distributing repays Distributing debt with the Controlled securities and distributes Controlled stock to its shareholders.
  - Current holders of Distributing debt may prefer cash. Investment bank may be able to facilitate by acquiring Distributing debt for cash, but not as Distributing’s agent.
  - Only old and cold debt or newly issued debt too?
- **Stock-for-debt exchange:** Distributing transfers business to Controlled in exchange for Controlled stock. Distributing uses up to 20% of the Controlled stock to repay debt and distributes the balance of the Controlled stock to its shareholders.

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 subsidiary) or Distributing's basis in the contributed assets (if Controlled is newly formed in connection with the transaction). Sections 357(c), 361(b)(3).
  - Use of proceeds limitation (boot purge) – Cash received by Distributing as part of a Section 368(a)(1)(D) reorganization will be taxable boot unless used to pay off debt or distributed to shareholders. Section 361(b)(1).
    - Distributions to creditors are subject to basis limitation.
    - Distributions to shareholders are not subject to basis limitation, but also does not result in monetization for Distributing.
- Securities-for-debt exchanges and stock-for-debt exchanges generally are not subject to basis limitation. Section 361(c)(3).

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

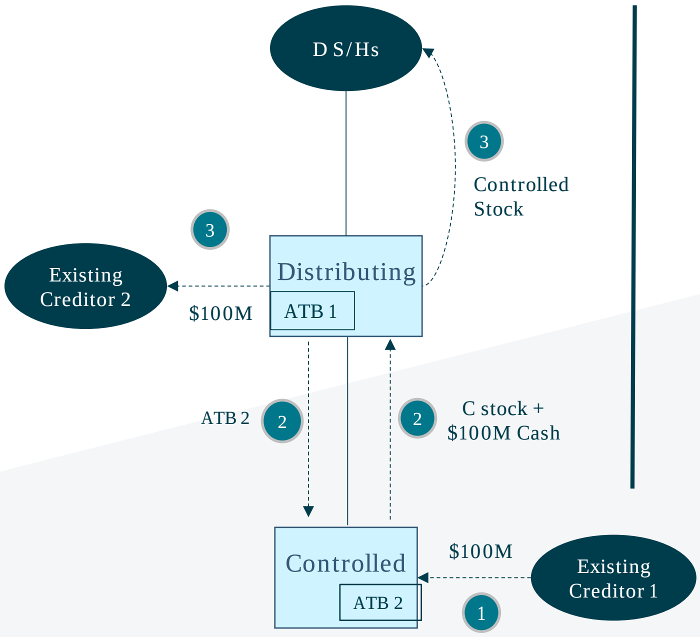
Example 1: Cash Distribution, Boot Purge



- Cash distributed by Controlled in excess of tax basis in contributed assets generally will have gain implications.
- Boot purging rule of Section 361--Cash distributed pursuant to plan of reorganization to repay debt or make distributions to shareholders is not treated as boot in Section 361(a)(1)(D) reorg, subject to basis limitation where used to repay debt.
- Debt repaid can be incurred post-distribution and may include ordinary course liabilities (e.g., compensation).

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

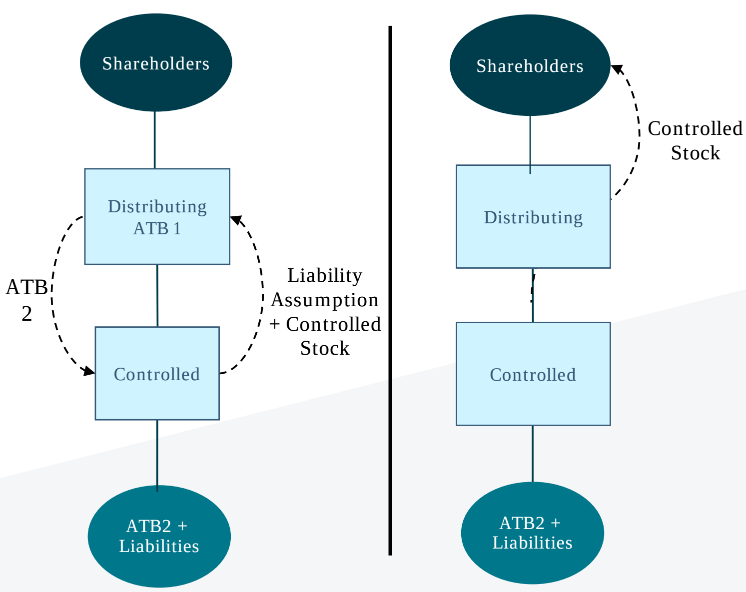
Example 2: Boot Purge



- **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.

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

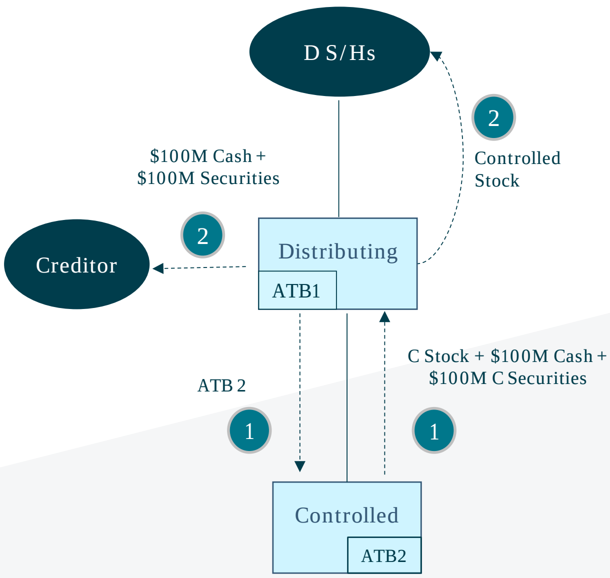
Example 3: Liability Assumption



- 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 Section 368(a)(1)(D) reorg).

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

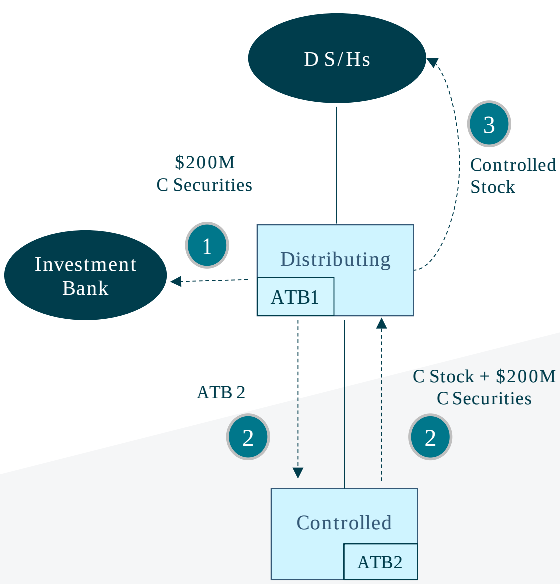
Example 4: Debt-for-Debt Swap with Controlled Securities



- **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, $100M cash, and $100M of Controlled securities;
  - **Step 2:** Distributing distributes Controlled stock to Distributing's shareholders and repays Creditor using $100M cash, and $100M of Controlled securities. Basis limitation does not apply to Controlled securities [and Distributing's creditors need not hold Distributing securities]

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

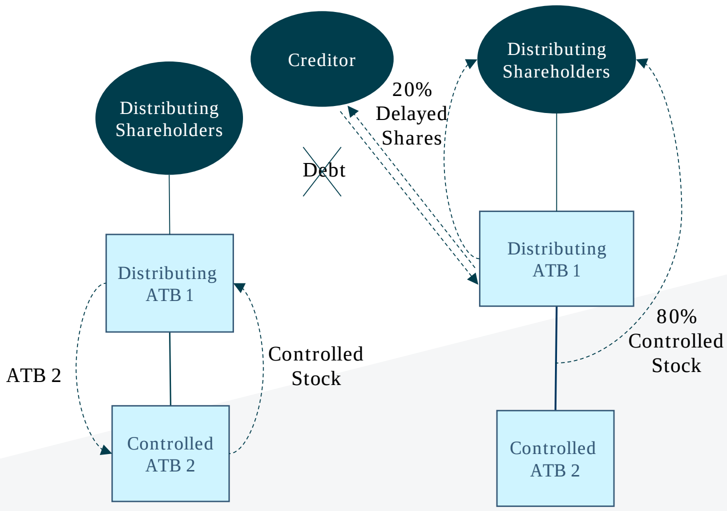
Example 5: Intermediated Debt-for-Debt Swap



- **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, continuing relationships, overlapping board. Representation that there is no tax avoidance motive.

Revenue Procedure 2024-24 and Notice 2024-38

- **Key Changes under Revenue Procedure 2024-24**
  - Limitations on historic debt that can be repaid with Section 361 consideration (distinction between debt and other obligations)
  - Direct issuance structure for debt exchanges generally prohibited
  - Refinancing debt not treated as old and cold (even if debt that it refinanced is)
  - New standard for re-leveraging
  - More specificity required for plan of reorganization
  - No optionality on retained shares ("pick a lane")
  - Stricter standards for delayed distributions/retentions

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

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?

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 debt for Section 361 consideration

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 exchange ratio set based on FMV of debt on signing date
  - 14 days after IB's purchase of Distributing debt, Distributing transfers Controlled stock or securities to IB in satisfaction of debt
  - IB sells Controlled stock or securities
  - Developed out of IRS ruling practice. What's wrong with this approach?

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 existing debt with Controlled stock or securities, which is what Sections 361(b) and (c) are about
- Intermediary acts for its own account in acquiring the Distributing debt, becomes its tax owner, and assumes the risk of default on the debt and pricing and execution risk on the exchange
- More friction costs than direct issuance transactions

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Direct Issuance Transactions

- Distributing issues new debt directly to intermediary for cash
- Distributing uses cash to retire outstanding debt held by unrelated third parties
- After [5/14 standard?] issuance of new debt, Distributing and intermediary enter into an agreement providing for satisfaction of new debt with Controlled stock or securities
- Distributing retires new debt by delivering Controlled stock or securities to intermediary
- Intermediary sells Controlled stock or securities
- Direct issuances had been ruled on favorably where the effect was reallocation of Distributing historic debt.
- Rev. Proc. 2024-24 generally prohibits direct issuance transactions unless the debt issued to the intermediary was issued before the earliest of public announcement date, binding commitment or board approval (i.e., old and cold). No exception for refinancing debt

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:
    - New debt qualifies as debt for tax purposes and will be fully paid
    - Debt and exchange agreement are legally separate instruments
    - Distributing is under no economic compulsion to pay new debt with Controlled stock or securities
    - Distributing is tax owner of Controlled stock and securities until paid to intermediary
  - If the proceeds of the debt issued in a direct exchange are used to repay historic Distributing debt, is a direct issuance different in substance from an intermediated exchange?

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?

Delayed Distributions versus Retentions – Backstop Retention Rulings

- If Distributing distributes Section 368(c) control of Controlled, but not all of the Controlled stock and securities owned by Distributing, to qualify for tax-free treatment, Distributing must establish that the retained stock was not pursuant to a plan with a principal purpose of tax avoidance. Section 355(a)(1)(D)(ii)
- Notice 2024-38 describes distinction between (1) temporary holdback (12 months or less) of Controlled stock or securities that will be distributed “as part of the distribution” under Section 355(a)(1)(D) or “in pursuance of the plan of reorganization” under Section 361, and (2) a retention of Controlled stock or securities
- Notice 2024-38 describes the statute as creating a rebuttable presumption that any retention evidences a tax avoidance plan
- In a significant change, backstop retention rulings will no longer be provided, which under prior IRS ruling practice had protected tax-free treatment for the spin in cases where Distributing was unable to execute its plan for a delayed distribution

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

Continuing Relationships (cont'd)

- Necessary?
- Section 355(a)(1)(D) already polices the continuing relationship of delayed distributions and retentions
- ATB test already requires independent business for Distributing and Controlled
- If Distributing or Controlled is a secondary business of (i.e., principally functioning to serve) the other, that is already a device factor if it continues for a significant period post-spin and the secondary business could be sold without adversely affecting the other
- Continuing relationships are already evaluated for consistency with stated business purposes (e.g., fit and focus). Rev. Ruls. 2003-74 (fit and focus, overlapping directors) and -75 (competition for capital, transition agreements)

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

Qualified Small Business Stock

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%
9/28/10 – present	100%	0%	0%	0%

- Gain exclusion is limited to $10 mil or 10x the taxpayer's aggregate adjusted bases in the stock
  - If stock is acquired in exchange for property, "basis" is no less than the fair market value of such property on date of exchange
- Potential to roll QSBS proceeds into new QSBS and tack holding period

Basic Eligibility Requirements

- Only available to **non-corporate taxpayers**.
- QSBS shares must be held for more than **five years**.
- Issuing corporation must be a qualified small business (i.e., the **$50 Million Requirement**).
- Stock must be acquired by the taxpayer at original issuance in exchange for cash, property other than stock, or for services (i.e., the **Original Issuance Requirement**).
- Issuing corporation must be an active business during substantially all of the taxpayer's holding period (i.e., the **Active Business Requirement**).
- Other special rules apply (e.g., for "pass-thru" entities, offsetting positions, rollover or successor transactions, etc.).

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."

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. **This requirement can only be met if the Corporation used at least 80% (by value) of its assets in the active conduct of at least one qualified trade or business**.
3. Provide copies of reports filed pursuant so Section 1202(d)(1)(C), **which provides that there should be reporting to the Service and Shareholders with respect to qualified small business stock**.

Short Positions, Hedges and Constructive Sales

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

- General principles of tax law
  - Simultaneous "put" and "call" options (i.e., Penn Dixie and Griffin Paper fact patterns)
  - Non-recourse loan when only collateral is QSBS shares (i.e., Lizzie Calloway fact pattern)
- Section 1202(j) rules
  - Short sale
  - Put rights
  - Position that substantially reduces the risk of loss
- Note other statutory rules, such as Section 1259 constructive sale rules

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);
  - (2) during next 6-month "quiet period" neither Buyer nor Seller have ability to cause a transfer of the shares; and
  - (3) during final 6-month period Seller has the ability to cause Buyer to purchase shares for $10 per share (i.e., put right).
- Considerations:
  - Should Seller be treated as selling the QSBS shares on DATE 1?
  - What if the "quiet period" is less than 6 months, or does not exist at all? What if the call and put rights overlap?
  - Does this fact pattern also implicate the Sec. 1202(j) rules?
    - What about a put at the then fair market value? (i.e., not a fixed price)
    - What about a call that is at the money or out of the money? (i.e., not more-likely than not to be exercised)
- *See*, for example, *Penn-Dixie Steel Co. v. Comm'r*; 69 T.C. 837 (1978)); *Griffin Paper Corp., et al v. Commissioner*, T.C. Memo 1997-409)

Short Positions and Hedges – Nonrecourse Loan

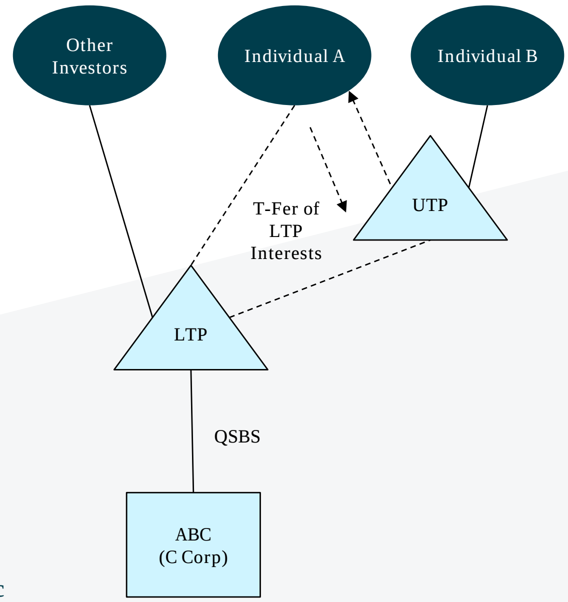
- Basic Facts: "Holder" of QSBS shares borrows cash from Buyer.
  - Loan is non-recourse.
  - Only collateral is the QSBS shares.
- Considerations:
  - Is this fundamentally the same as a "put" right for a fixed amount in the hands of Holder? In other words, if Holder never pays back the loan, he or 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).

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** with respect to any qualified small business stock if:
  - the taxpayer has made a short sale of substantially identical property.
    - **Legislative history considers this to be a call option that is more likely than not to be exercised.**
  - the taxpayer has acquired an option to sell substantially identical property at a fixed price.
    - **What if two potential prices or a "formula" based price? See Rev. Rul. 2003-7**
  - to the extent provided in regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding such qualified small business stock.
    - **Is this provision self-executing in light of the fact that no regulations have been issued?**

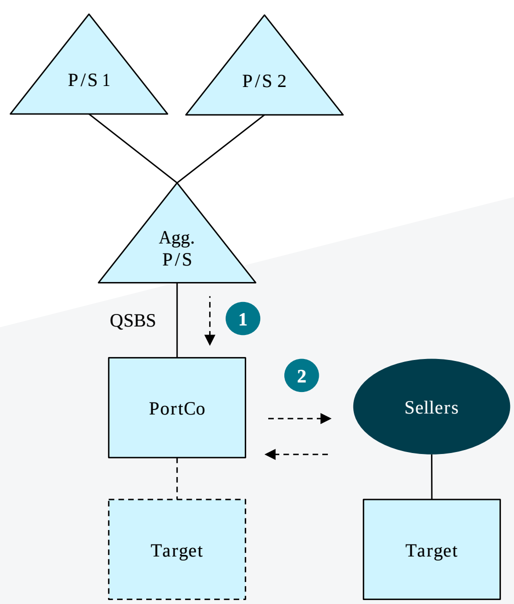
QSBS Example: Transfer of LTP interests to UTP

- 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 <u>disregarded</u>...**" (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).



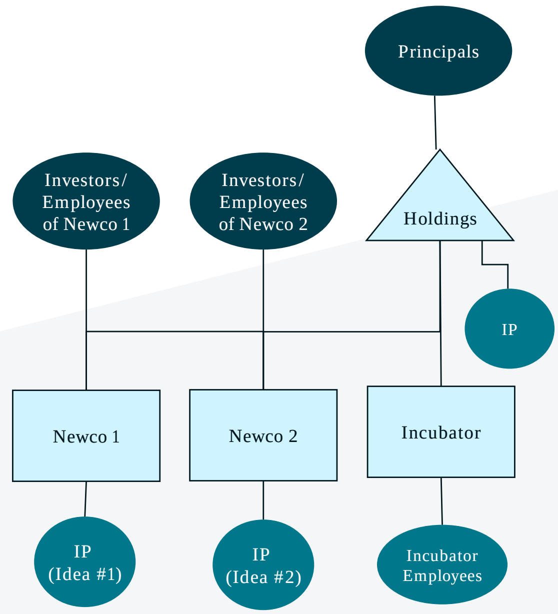
QSBS Example: Bolt-on Acquisition When Original Portfolio Company Shares are QSBS

- Facts:
  - Partnership 1 and Partnership 2 own Aggregator Partnership.
  - Aggregator Partnership owns stock in Portfolio Company ("**PortCo**") that is QSBS (i.e., Block 1) and has a holding period of greater than 5 years.
  - PortCo is no longer eligible to issue new QSBS.
  - Aggregator contributes cash to PortCo, which is used by PortCo to acquire Target Corporation.
- Issues:
  - For purposes of maximizing its QSBS position, should PortCo issue new stock (i.e., Block 2) to Aggregator Partnership?
  - If no stock is issued (i.e., meaningless gesture when ownership is already 100%), what is risk is there that Block 1 will have a split holding period and/or split QSBS characterization?
    - GLAM 2020-005 (5/29/2020) (e.g., Sec. 1061)
  - If PortCo issues new stock, should it issue common stock or preferred stock?
    - "Freeze" non-QSBS component with Preferred Stock?



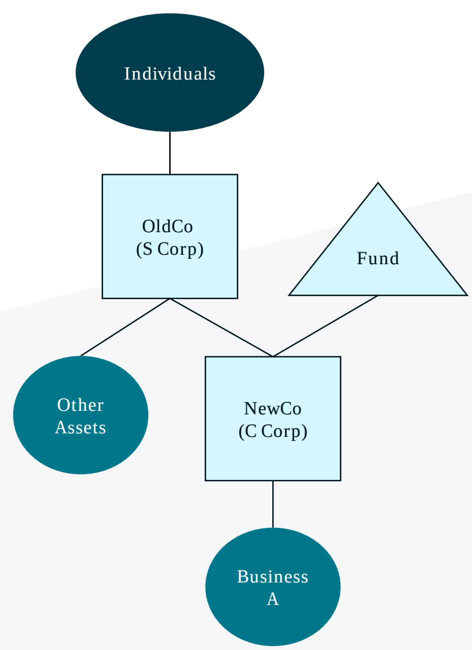
QSBS Example: Tech Incubator and Creation of Multiple Newco Operating Companies (Hub & Spoke or "Nimbus" Structure)

- Facts:
  - Holdings pays Incubator to develop IP owned by Holdings.
  - Incubator can be a C corporation or DRE of Holdings (or standalone entity not owned by Holdings).
  - Upon development of each viable product, Holdings contributes IP related to that product to a separate Newco.
  - Employees (and officers) of each Newco are issued restricted stock in Newco (or profits interests in investment entity above Newco).
  - Investors are issued stock in Newco in exchange for Cash.
- Issues:
  - Does stock issued to each of Holdings, Employees, and Investors meet the requirements to be QSBS?
  - Do the assets of each Newco need to be aggregated for various QSBS tests (such as $50M test).
  - Does anti-abuse rule in Section 1202(k) apply?



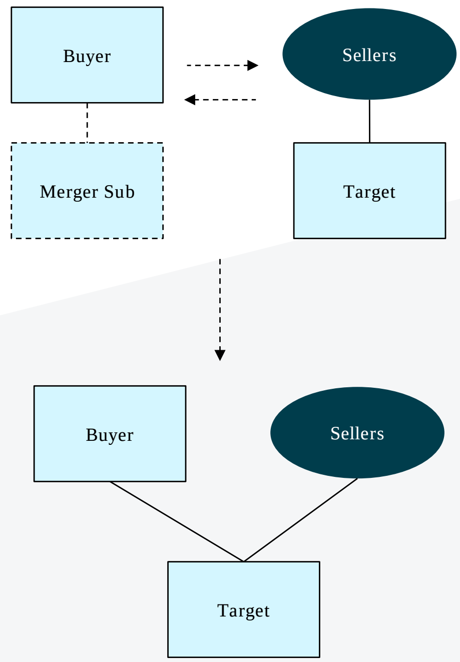
QSBS Example: S Corporation Transfer of Business to Newco in Exchange for QSBS

- Facts:
  - Individual shareholders cause S corporation to transfer its historic "Business A" to a newly formed C corporation (NewCo).
  - S Corporation retains "Other Assets" with a FMV and tax basis of $20 million.
  - Fund invests cash in NewCo.
  - Total FMV of Business A assets plus cash received from fund equals $40 million.
- Issues:
  - Is the NewCo stock treated as QSBS in the hands of OldCo & Fund?
  - **What assets should be taken into account to determine if NewCo meets the QSB $50 million test?**
    - Compare Section 1202(d)(3)(B) reference to controlled group with 1202(g)(2)(A) treatment of S corporation as if an individual.
    - Should a partnership be interposed between OldCo and NewCo?
  - What if NewCo was a QSUB and OldCo sells 21% of NewCo's stock to Fund?



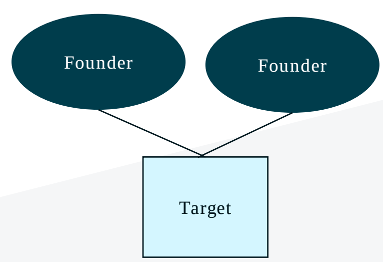
QSBS Example: Holding Period Is Not Satisfied

- 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



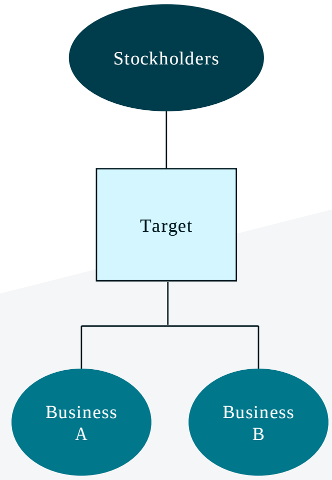
QSBS Example: Packing and Stacking

- Facts:
  - Target is owned by two individual founders.
  - Target is worth $100 mil.
  - Each individual is eligible to exclude $10 mil of gain from sale of Target.
- Issues:
  - Can founders maximize QSBS?
  - Packing:
    - Increase basis of QSBS shares to take advantage of 10X basis rule
  - Stacking:
    - Gift shares to maximize # of QSBS taxpayers (exclusion of $10 mil per "taxpayer")



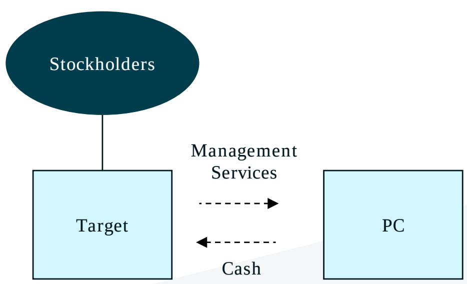
QSBS Example: Separate Non-Qualified Trade or Businesses

- Facts:
  - Target is a C-corporation.
  - Business A is a qualified trade or business; while Business B is not a qualified trade or business.
- Issues:
  - Does Business B taint the QSBS eligibility of Target?
    - Active trade or business test requires that 80% of the assets of Target be used towards the conduct of one or more qualified trades or businesses
  - Spin-out Business B?
  - Spin-out Business A?
    - How to accomplish a spin in a tax-efficient manner?
  - If spin-off of Business A, does the spin-off also need to be a "D" reorganization? Does there need to be an "exchange" (i.e., not just a distribution)?



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.

How to Comply

- The excise tax generally must be reported and paid with the Form 720 for the first full calendar quarter after the end of the tax year of the covered corporation or person treated as a covered corporation (the taxpayer).
  - Therefore, a calendar-year taxpayer's deadline generally would be April 30 of the following year.
  - For a taxpayer with a taxable year ending after December 31, 2022, and on or before June 28, 2024, the due date for the first payment of the excise tax and the filing of the Form 7208 is October 31, 2024.
- The final procedural regulations, like the proposed procedural regulations, require a return for a taxable year even if a taxpayer has no excise tax liability due to exceptions or issuances that exceed repurchases made during its taxable year.

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).

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.

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.

Update on Success-Based Fees

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 the target assets or stock so acquired.
  - Examples: costs to draft deal documents, term sheets, due diligence costs, investment banker's fees.

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 to establish that a portion of the fee is allocable to activities that do not facilitate the transaction."
  - Historically, the question of what records are needed to substantiate a success-based fee deduction was a source of disagreement between taxpayers and IRS (see, e.g., PLRs 200953014 and 200830009 and TAM 201002036).

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.

PLR 202308010 (released Feb. 24, 2023)

- IRS addressed a taxpayer’s request for relief under Treas. Reg. section 301.9100-1 through -3 (9100 relief) to elect to deduct a success-based fee under the Rev. Proc. 2011-29 safe harbor.
- The facts are like those of the numerous other taxpayers that have claimed a deduction for success-based fees under Rev. Proc. 2011-29.

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 <u>the majority shareholder</u>, a private equity fund, instead of a cost of the target (see Regs. Sec. 1.263(a)-1(e)(1)).

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 (?).
  - If so, it becomes unclear whether a target may deduct success-based fees paid to financial advisers for their assistance with a sale and engagement with buyers, particularly when owned by a private equity fund.
  - IRS recently granted 9100 relief to a privately held corporation that "had no majority controlling shareholder" prior to the transaction (PLR 202349003).
    - Does this mean PLR 202308010 views private equity-owned companies as subject to special scrutiny when analyzing deductions for success-based fees?

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 2011-29 for success-based fees.
- Timely filing of the safe harbor election under Revenue Procedure 2011-29 is critical as seeking 9100 relief provides the IRS an opportunity to challenge the location of transaction costs.

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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.
  - *Liberty Global Inc. v. United States*, No. 1:20-cv-03501 (D. Colo. Apr. 4, 2022).
- Implications for M&A?