

# M&A and Financings Trends

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## *Agenda*

### I. Recent Trends in M&A Transactions

- A. Contingent Value Rights
- B. Build-to-Buy Transactions
- C. “F Reorganizations”

### II. Seller Considerations: Eligibility for QSBS Treatment

### III. Inflation Reduction Act & M&A



## ***Recent Trends in M&A Transactions: Distributed Event-Based Contingent Value Rights***

### ***Contingent Value Rights—In General***

- Earn-outs are common in private company acquisitions, given potential information asymmetries/uncertainties regarding value of acquirer and/or target
- Used less frequently in public company acquisitions, but for similar reasons:
  - Event-based CVRs issued to target stockholders to bridge valuation gaps relating to post-closing contingencies
  - Event-based CVRs distributed to acquirer stockholders to isolate benefit of pre-closing lines of business to historic acquirer stockholders
  - Price protection CVRs to ensure minimum value of consideration paid to target stockholders for certain period post-closing
  - Can be non-transferable, transferable, publicly-traded, stock- or cash-settled

## ***Distributed Event-Based CVRs***

- Instead of including CVRs as part of the consideration paid to target stockholders, valuation gaps could be bridged by distributing CVRs to acquirer's stockholders
- Becoming relatively common in life sciences/biopharma reverse mergers in which nominal acquirer may have certain drug programs on which the combined company will not focus going forward
- Historic acquirer stockholders are entitled to a certain percentage of monetization transactions within certain timeframe
- Typically uncertificated, non-transferable (except in limited circumstances), not registered with the SEC or listed for trading on any exchange, and do not bear stated interest
- May include reverse stock split of acquirer shares, intended to avoid delisting by increasing the acquirer stock price (possibly only temporarily)
- Tax treatment of distributed CVRs is uncertain, and (as with CVRs issued to target stockholders) depends on what the CVRs are—promise to pay; distribution of property with respect to stock; open transaction; acquirer equity; debt instruments; or boot in recap

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## ***Distributed CVRs—Tax Issues on Receipt***

- **Tracking stock?** CVRs have some similarities to and some differences from tracking stock
  - Typical tracking stock has dividend rights that track the relevant assets and liabilities, but liquidation rights that do not track (but instead are the same as the issuer's regular stock). CVRs typically do not have liquidation rights with respect to all of the issuer's assets
  - If the tracked assets are disposed of, the proceeds benefit the holders of the tracking stock, like distributed CVRs
  - Tracking stock typically carries the same voting rights as the issuer's regular stock. CVRs do not carry voting rights
- If tracking stock is respected as stock of issuer, then distribution of tracking stock generally would be tax-free to recipients under Section 305(a), with stock basis allocated between stock and CVRs based on FMV, tacked holding period, and tax-free to issuer under Sec. 311(a)(1)
- Subsequent payments on the tracking stock would be taxed as a distribution--dividend under Section 301 to the extent of current or accumulated earnings and profits or redemption under Section 302, based on the structure and other facts at the time of the payment
- Tracking stock remains on IRS "no rule" list. Rev. Proc. 2022-3

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## ***Distributed CVRs—Tax Issues on Receipt, cont'd***

- **Debt instrument?**
- Seems unlikely to be characterized as debt under general tax principles because of contingent principal. No obligation to pay sum certain on fixed maturity date. *Gilbert*, 248 F.2d 399 (2<sup>nd</sup> Cir. 1957)
- If CVR were debt, CPDI rules would apply
  - Section 1275(a)(4) provides that any debt obligation of a corporation distributed with respect to its stock is treated as if issued for property
  - CPDI rules under Treas. Reg. §1.1275-4(c) generally would result in current imputed interest, with contingent payments treated when made as in retirement of debt instrument--capital gain, with some imputed interest

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## ***Distributed CVRs—Tax Issues on Receipt, cont'd***

- **Current property distribution or promise to make future distributions?**
- If the latter, then distribution CVR would be disregarded and payments on CVRs would be treated as distributions under Section 301 when paid
- Obligation of distributing corporation in the form of a debt instrument generally would be property for purposes of Section 317(a). Section 312(a)(2); Treas. Reg. § 1.301-1(a), -1(j); Treas. Reg. § 1.317-1; *Bazley v. Comm'r*, 331 U.S. 737 (1947)
- *Moser v. Comm'r*, 914 F.2d 1040 (8<sup>th</sup> Cir. 1990) (journal entry evidencing obligation constituted dividend)
- *Roe v. Comm'r*, 192 F.2d 398 (5<sup>th</sup> Cir. 1951) (debtor-creditor relationship was created by corporate resolution establishing accounts payable “as cash is available;” distribution occurred when resolution was adopted and subsequent payments were payments on debt and not dividends)

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## ***Distributed CVRs—Tax Issues on Receipt, cont'd***

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

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## ***Distributed CVRs—Tax Issues on Receipt, cont'd***

- **Boot in recapitalization or separate distribution?**
- Public disclosures typically treat reverse stock split as separate transaction from distribution of CVRs
- If CVRs and reverse stock split instead were treated as part of one integrated transaction, tax consequences would depend on resolution of similar characterization issues (equity, property, open transaction)
- Assuming CVRs are property, they could be "boot" in recapitalization under Section 356; U.S. stockholder would recognize gain (but not loss) equal to the lesser of (i) FMV of CVRs received, and (ii) excess (if any) of (A) sum of (1) FMV of CVRs received and (2) FMV of shares received in reverse stock split, over (B) adjusted tax basis in the stock surrendered
- If closed transaction, subsequent payments under CVR would be payments on contract
- Potential open transaction treatment if value of CVRs is indeterminable
- Boot would be tested for dividend equivalency under Rev. Rul. 93-61 and Section 302
- If open transaction, is relevant E&P as of year of recap or year of payment?

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## ***Distributed CVRs—Tax Issues on Payment***

- **Tax consequences if CVRs are treated as promises to pay future distributions**
- **To acquirer stockholders**--Distribution of CVRs is ignored and future payments are treated as dividends under Section 301 to the extent of current or accumulated earnings and profits, including withholding to the extent paid to non-U.S. taxpayers, then as return of capital to the extent of basis, then as capital gain
- **To acquirer**--Earnings and profits are reduced as payments are made. Section 312(a). Dividend reporting and withholding at that time. No deductible amounts

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## ***Distributed CVRs—Tax Issues on Payment, cont'd***

- **Tax consequences to acquirer stockholders if CVRs are treated as distribution of property in closed transaction**
- FMV of CVR when distributed is treated as dividend under Section 301 to extent of current or accumulated E&P
- Withholding to the extent paid to non-U.S. taxpayers (although distribution is non-cash transaction)
- CVR should be treated as capital asset, assuming stock with respect to which it was distributed was capital asset
- Initial basis in CVR equal to its FMV on date of issuance. Section 301(d)
- Holding period in CVR begins on [the day after] the date of issuance
  - If CVR were treated as a debt instrument, issue date would be date of distribution. Treas. Reg. § 1.1275-2(b)(2)

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## ***Distributed CVRs—Tax Issues on Payment cont'd***

- Subsequent payments on the CVR are treated as payments on a contract. Although it is not entirely certain, these payments generally should be treated first as return of basis, and then as ordinary income (but not dividend income?)
- Alternatives are ordinary income on all payments and capital loss at the end of the CVR term, or some ratable basis recovery method
- Capital loss if basis not fully recovered. Fair?
- Does Section 1234A have any relevance to payments on the CVR?
- Section 1234A. Gains or losses from certain terminations. Gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation...with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer...shall be treated as gain or loss from the sale of a capital asset
  - Doesn't apply to the retirement of a debt instrument
  - Exercise or settlement in accordance with the terms?
  - What if multiple CVRs were distributed, one for each milestone or payment?

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## ***Distributed CVRs—Tax Issues on Payment, cont'd***

- Section 1234A was intended to reduce character electivity
- If it does not apply to final payment under contract pursuant to its terms, TP with gain can sell contract (CG under §1222) or negotiate early termination (CG under Section 1234A); TP with loss can get paid under contract
- Rev. Rul. 2009-13, Situation 1:
  - Payment on surrender of a life insurance policy is ordinary
  - Section 1234A doesn't change the result
- *Pilgrim's Pride Corp. v. Comm'r*, 779 F.3d 311 (5th Cir. 2015), *rev'g* 141 T.C. No. 17 (2013)
  - Section 1234A applies to termination of rights or obligations with respect to capital assets (e.g., derivative or contractual rights to buy or sell) and not to termination of ownership of the capital asset *itself*
- Proposed regs for bullet swaps and forward contracts (final payment is termination payment for purposes of Section 1234A, but not for other NPCs (final scheduled payment expressly excluded). Prop. Treas. Reg. §1.1234A-1.

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## ***Distributed CVRs—Tax Issues on Payment, cont'd***

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

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## ***Distributed CVRs—Tax Issues on Payment, cont'd***

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

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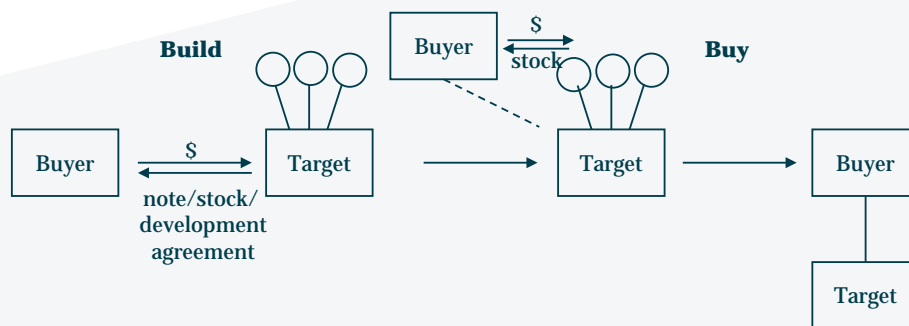
## ***Distributed CVRs—Tax Issues on Payment, cont'd***

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

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

# Build-to-Buy Transactions

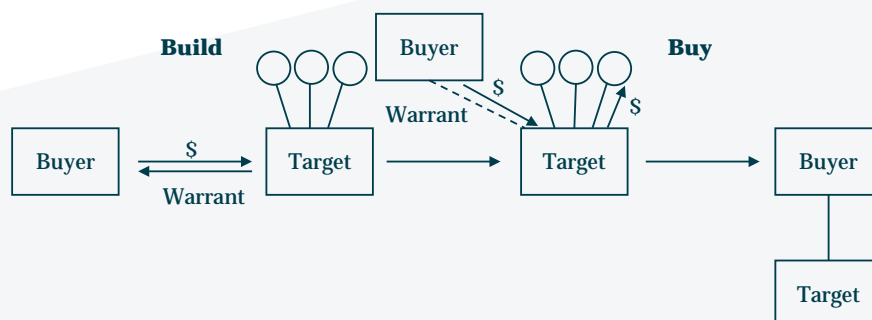
- Potential buyer provides financing (“builds”) Target and has the option to acquire (“buy”) the Target in the future
- Possible structures:
  - Option / Merger Transaction
    - **Build:** note (convertible or straight debt), preferred stock financing, development agreement
    - **Buy:** Option to acquire Target using a fully executed merger agreement, which option Buyer can elect to exercise and close the merger. Buyer acquires Target by consummating merger.



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# Build-to-Buy Transactions

- Potential buyer provides financing (“builds”) Target and has the option to acquire (“buy”) the Target in the future
- Possible structures:
  - Warrant Transaction
    - **Build:** Warrant is issued to buyer to purchase a special share of Target capital stock. Certificate of incorporation is amended to effect automatic redemption of all shares of Target stock (other than the special warrant share) upon exercise of the warrant.
    - **Buy:** Upon exercise, Buyer acquires Target by redeeming all other stockholders, leaving Buyer as only holder of Target capital stock.



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## ***Detailed Tax Treatment – Option / Merger - Seller***

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

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## ***Detailed Tax Treatment – Option / Merger - Buyer***

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

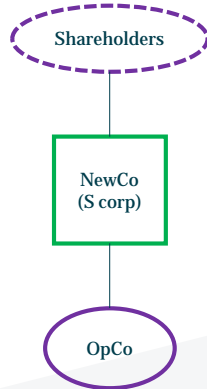
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## ***Detailed Tax Treatment – Warrant - Seller***

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

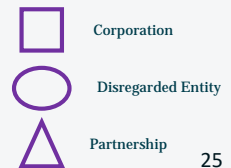
## ***Recent Trends in M&A Transactions: “F Reorganizations”***

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



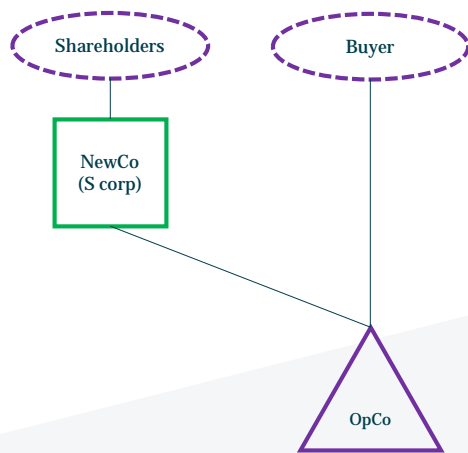
- The shareholders of an existing “S corporation” target (OpCo) contribute the target to a newly formed holding company (NewCo)
- OpCo elects to be treated as a “qualified subchapter S subsidiary”, and the entire transaction is treated as an “F reorganization” in which NewCo is treated as a continuation of the old OpCo “S corporation” for tax purposes
- OpCo converts to a limited liability company

### U.S. Federal Income Tax Classification



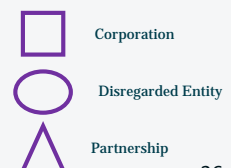
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## “S corporation” Target – Second Step Acquisition



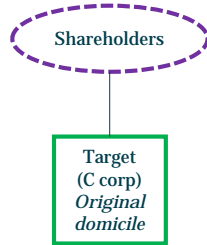
- The Buyer acquires an interest in OpCo in a taxable purchase (may be partial or 100%)
- The gain from the taxable purchase creates a partial tax basis step-up at the OpCo level (full if buying all OpCo)
  - If partial, additional structuring can be undertaken to cause the tax basis step-up to be “personal” to the Buyer under Code Section 743(b)
- If applicable, NewCo retains any “rollover” equity in OpCo, on a tax-deferred basis

### U.S. Federal Income Tax Classification



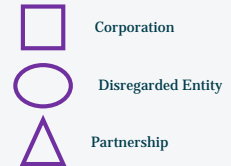
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## “C corporation” Target – First Step “F reorganization”



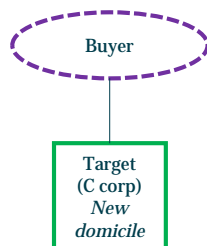
- The shareholders of an existing “C corporation” wish to redomicile target prior to deal
- Reasons: contract assignment, state law restrictions for mergers
- Redomicile transaction is treated as an “F reorganization”

### U.S. Federal Income Tax Classification



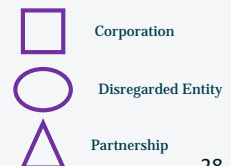
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## “C corporation” Target – Second Step Acquisition



- Not generally expected to adversely implicate any other deal structuring (e.g., tax-free reorg)

### U.S. Federal Income Tax Classification



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

## ***Section 1202***

- Section 1202 provides an exclusion for eligible gain if certain conditions are met
  - 50% when acquired 8/11/93 – 2/17/09 (subject to AMT addback). Non-excluded gain subject to 28% capital gain rate
  - 75% when acquired 2/18/09 – 9/27/10 (subject to AMT addback). Non-excluded gain subject to 28% capital gain rate
  - 100% when acquired 9/28/10 – Present. Note that Section 1202(a)(4)(C) provides that Section 57(a)(7) AMT addback of 7% of excluded gain does not apply to this period
- Various shareholder- and corporate-level requirements must be met (e.g., 5-year holding period, type of business, non-C corporation shareholder, gross assets do not exceed \$50 million at issuance)
- Section 1202(h)(4) permits existing appreciation in QSBS to be preserved in a tax-free exchange for non-QSBS stock

## ***Qualified Business—Active Business Requirement***

### ***Active Business Requirement***

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

### ***Qualified Trade or Business means any trade or business except:***

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

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## ***Qualified Trade or Business – PLR 202221006***

### **Facts:**

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

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

IRS considered whether the taxpayer was involved in the performance of (i) services in the field of health or (ii) services where the principal asset of the trade or business was the reputation or skill of one or more of its employees.

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## ***Qualified Trade or Business – PLR 202221006***

### **Ruling:**

IRS noted that any interaction between the taxpayer's employees and patients regarding their prescriptions was merely incidental to ensuring receipt of their prescriptions or answering questions about the prescriptions

Consistent with prior rulings, the Service observed that taxpayer's employees did not provide any diagnostic services or medical care to either patients or physicians and noted that taxpayer's principal asset is its exclusive pharmaceutical distributions rights, and not the reputation or skill of one or more employees

As a result, the Service ruled that the Taxpayer was engaged in a qualified trade or business as defined in section 1202(e)(3)

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## ***Qualified Trade or Business – PLR 202114002***

### **Facts:**

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

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

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

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

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## ***Qualified Trade or Business – PLR 202114002***

### ***Ruling:***

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

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

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

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

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

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## ***Qualified Trade or Business – CCA 202204007***

### ***Facts:***

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

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

The lessors paid the corporation both (i) a periodic fee for listing facilities on the website, and (ii) a percentage of rent paid to lessors from facilities actually leased through the website

IRS considered the meaning of the term “brokerage services” as used in Sec. 1202(e)(3)(A)

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## ***Qualified Trade or Business – CCA 202204007***

### **Ruling:**

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

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

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

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

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

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

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## ***Qualified Trade or Business – PLR 201717010***

### **Facts**

- Taxpayer developed a **proprietary tool to perform certain medical tests**
- Taxpayer's employees analyze the results of the tests and prepare laboratory **reports for healthcare providers**
- Those laboratory reports **do not diagnose or recommend treatment**, and the Taxpayer does not discuss diagnosis or treatment with patients or with the healthcare providers who commission the tests
- Taxpayer's employees are well educated and include a physician, but the pre-existing skills that they bring to the Taxpayer are not useful in performing the medical tests

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## ***Qualified Trade or Business – PLR 201717010***

- ***Ruling***

- Noting the **lack of diagnosis or treatment services** performed by the Taxpayer, as well as the fact that the skills of Taxpayer's employees are not useful to other employers, the IRS determined that Taxpayer **was not** in a disqualified trade or business that was:
  - (i) involving the performance of services in the **field of health**; or
  - (ii) where the principal asset of the trade or business is the **reputation or skill** of one or more of its employees
- Based on that determination, the IRS concluded that **Taxpayer was engaged in a qualified trade or business** for purposes of Section 1202

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## ***QSBS: Other Current Issues***

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

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## ***Inflation Reduction Act and M&A***

### ***The Inflation Reduction Act (“IRA”)***

- IRS Funding Increase
- Corporate AMT
- Stock Buyback Excise Tax

# ***IRS Funding Increase***

## **Overview**

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

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

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

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

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## ***IRS Funding Increase (cont.)***

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

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# ***Corporate Alternative Minimum Tax (“CAMT”)***

## **Overview**

- CAMT of 15% on adjusted financial statement income (AFSI), effective for tax years beginning after December 31, 2022
- Generally, applies to corporations with AFSI in excess of \$1 billion (for foreign parented groups, additional \$100 million test applies for US business)
- Computation of AFSI is relevant for determining if a corporation is subject to the tax, with modifications for computing CAMT
- Operative only if tentative minimum tax exceeds regular tax plus BEAT (i.e., if regular tax exceeds 15% of AFSI, then CAMT is inapplicable)
- Once a corporation is subject to the CAMT, it remains subject to it unless otherwise provided in Treasury regulations

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## ***Corporate Alternative Minimum Tax (cont.)***

### ***“Applicable Corporation” (i.e., corporations subject to the CAMT)***

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

#### ***AFSI test, in general:***

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

#### ***Two-part AFSI test for corporations with foreign parent***

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

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## ***Corporate Alternative Minimum Tax (cont.)***

### ***Applicable Corporation – Aggregation Rule***

- ***Solely to determine if a corporation is an applicable corporation, AFSI is aggregated with the AFSI of all persons treated as a single employer under Secs. 52(a) or 52(b)***
  - All members of the corporation's controlled group, and
  - All trades or businesses under common control with the corporation
- ***AFSI for purposes of applying the aggregation rules excludes the adjustments relating to a partner's distributive share of partnership AFSI and defined benefit pension plans***

### ***Applicable Corporation – Limited Exception***

- ***A corporation otherwise qualifying as an applicable corporation may be excepted if it***
  - Has a change in ownership, or
  - Does not meet the AFSI test for the most recent tax year and a number (to be determined by Treasury) of consecutive years; AND
  - Treasury determines that an exception is appropriate (not automatically applied)

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## ***Corporate Alternative Minimum Tax (cont.)***

### ***Adjusted Financial Statement Income (AFSI)***

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

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## ***Corporate Alternative Minimum Tax (cont.)***

### ***AFSI - Adjustments (cont.)***

- For partners in a partnership, AFSI limited to their distributive share of the partnership's AFSI
- For CFCs, take into account a taxpayer's pro rata share of items taken into account as net income or loss on the AFS (as adjusted) of each CFC of which the taxpayer is a U.S. shareholder unless adjustment is negative, in which case the adjustment is carried forward
- For foreign corporations, AFSI is based on effectively connected income principles
- For disregarded entities, take into account the AFSI of the disregarded entities
- Federal taxes and foreign income taxes, direct payment of certain credits, certain income related to mortgage servicing contracts, and tax-exempt income of tax-exempt entities are disregarded

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## ***Corporate Alternative Minimum Tax (cont.)***

### ***AFSI - Adjustments (cont.)***

For pensions, AFSI is (1) increased by amounts included in gross income, (2) reduced by deductions allowed, and (3) adjusted to disregard any income, cost, or expense included on the AFS

For depreciable property subject to Section 168 and qualified wireless spectrum amortizable under Section 197, AFSI is

- Reduced for deductions allowed in computing taxable income
- Appropriately adjusted to (1) disregard depreciation or amortization taken into account on the taxpayer's AFS, and (2) take into account other items Treasury specifies

Decrease AFSI for lesser of (1) the aggregate amount of financial statement NOL carryovers to the tax year or (2) 80% of AFSI computed without regard to financial statement NOLs

- Indefinite carryforward of financial statement NOLs
- Financial statement NOL is net loss on the AFS (adjusted) for tax years ending after 2019

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## ***Corporate Alternative Minimum Tax (cont.)***

### ***General Business Credit and Minimum Tax Credit***

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

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## ***Corporate Alternative Minimum Tax (cont.)***

### ***M&A Considerations***

- **Effect on Tax-Free Transactions – the financial accounting treatment of a variety of transactions (e.g., certain tax-free transactions) differs significantly from the income tax treatment**
  - E.g., Some split-offs -- where a publicly listed parent company hives off a unit and stockholders then choose whether to own shares in either the parent or the new company – may be affected
    - Split-offs can generate earnings for the parent on its financial statements, **even though the transaction is tax-free**
  - Section 56A(c)(15)(B) grants the Treasury/IRS authority to adjust items to carry out the principles of the provisions of Subchapter C relating to tax-free transactions (e.g., liquidations, reorganizations, formations)
- **Effect on Acquisitions/Dispositions**
  - Clarification will be necessary where a member of a group that is subject to the CAMT is acquired by a group that is not subject to the tax
  - Various issues will arise with respect to the treatment of AFSI NOLs, CAMT credits, and similar items in acquisitions/dispositions

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# ***Stock Buyback Excise Tax***

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

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

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## ***Stock Buyback Excise Tax (cont.)***

### ***The provision does not apply:***

- to the extent the repurchase is part of a reorganization under Sec. 368(a) and no gain or loss is recognized on the repurchase by the shareholder;
- if the repurchased stock or its value is contributed to an employer-sponsored ownership plan, or similar plan;
- if the total value of stock repurchased during the tax year does not exceed \$1 million;
- if the repurchase is by a dealer in securities in the ordinary course of business;
- to repurchases by a regulated investment company or real estate investment trust; or
- to the extent the repurchase is treated as a dividend

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## ***Stock Buyback Excise Tax (cont.)***

### ***M&A Considerations***

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

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

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## ***Stock Buyback Excise Tax (cont.)***

### ***M&A Considerations (cont.)***

- Other transactions that potentially also could be impacted include
  - (1) payments of cash or other "boot" to target shareholders in partially tax-free reorganizations,
  - (2) certain acquisition transactions, including leveraged buy-out transactions, in which cash is sourced or funded out of cash of the target corporations or debt proceeds that the target corporation assumes,
  - (3) partial liquidations and liquidations that do not qualify under Section 332,
  - (4) redeemable preferred stock,
  - (5) redemptions in connection with de-SPAC transactions,
  - (6) forward mergers with cash,
  - (7) certain Section 304 transactions,
  - (8) exercise of dissenter rights and cash in lieu of fractional shares

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