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KEY TAX INSIGHTS

MERGERS & ACQUISITIONS NEWSLETTER

TARGET COMPANY: BE CAREFUL IN CHANGING ITS TAX STATUS PREACQUISITION AT THE INSISTENCE OF THE ACQUIROR

Target companies in mergers and acquisitions are often directed by the acquiror to change its tax classification preacquisition for U.S. tax purposes. Initially, the target usually gives the request little thought as they are focused on selling their company at the highest value. However, checking the box or changing the tax classification of a company can have important tax implications and can significantly reduce the after-tax return on the sale to the owners of the target company. It is important to have the right tax professionals involved in determining the structuring of an acquisition to ensure the maximum return to the owners of the target company.

There are several reasons that an acquiror may request the target company to change its tax classification. For example, the acquiror may not want an entity taxed as a c-corporation in its portfolio of companies. For the target company, checking the box or otherwise changing its tax status to treat a c-corporation as a partnership or disregarded entity results in a deemed liquidation of

the target. As part of the deemed liquidation, the target will be treated as selling all its assets for fair market value and would recognize any gain or loss of the deemed sale on the final c-corporation tax return.

In addition, the target shareholders will recognize gain or loss equal to the fair market value of the assets deemed to be received in the deemed liquidation compared to their stock basis in the target. What seemed to be a simple change in tax status resulted in two levels of tax to the target company and its shareholders and likely greatly reduced the after-tax proceeds to the target company shareholders from the acquisition.

WWW.BASSWOODCOUNSEL.COM INFO@BASSWOODCOUNSEL.COM +1 202-980-4788

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For the acquiring company, the deemed liquidation results in the company being acquired not being a c-corporation thereby avoiding double taxation on future revenue from the target. Also, the deemed liquidation allows the acquiror to receive the assets of the target at their fair market value at the time of acquisition without recognizing the tax as the tax has been paid by the target company immediately preacquisition. There can be other implications as well that may impact the target shareholders in other ways. The acquiror and their tax counsel rarely if ever reveal the potential negative tax implications of the change in tax classification to the target.

A client was being acquired by a company with private equity investment. The target company was a c-corporation for tax purposes. The stock of the target company was qualified small business stock (“**QSBS**”) allowing the owners to exclude the greater of $10 million or 10 times their tax basis in the stock on the sale or exchange of their QSBS stock. The acquiror was represented by one of the large New York City law firms. The acquiror quickly directed the target company to change its tax classification to a partnership prior to acquisition so that a c-corporation was not in the acquiror’s structure post-closing. Not thinking much about it, the target company initially agreed to change its tax treatment preclosing.

The target was being purchased for about $8 million in total consideration.

The target had a low tax basis in its assets. **For purposes of illustration, let’s assume the target had a tax basis of $200,000 in its assets.** As a result of the deemed liquidation from changing the tax treatment of the target from a c-corporation to a partnership, the target would owe $1.638 million in federal income tax. For purposes of this illustration, let’s assume the shareholders have a tax basis of $500,000 in their target stock. The shareholders would then recognize gain of 5.862 million preacquisition. This would be an additional tax to the shareholders of approximately 1.395 million. The net result of the deemed liquidation to the target shareholders results in after tax proceeds of $4,967,000 and the target shareholders would not receive the benefit of the QSBS treatment.

Whereas, if the transaction went forward as a stock sale as was provided in the letter of intent, the shareholders would have incurred no federal income tax on the sale of their target stock. That is if the transaction went forward as the acquiror proposed, the target shareholders **would have lost 38% of the value that they would have otherwise received if the target remained a c-corporation**. The client came to us in time, and we were able to keep the transaction as an acquisition of a c-corporation thereby preserving the favorable tax treatment and after-tax return to the target shareholders of $8 million, thus receiving $3,033,000 more than if the sale proceeded as the acquiror requested.

Notice of Firm Name Change

We have long believed that the firm is larger than any one person and it is time for the name of the firm to reflect this value. **In 2024, the name of the firm will transition over time from Klug Counsel PLLC to Basswood Counsel PLLC.** The Basswood Tree is known as a symbol of unity, prosperity, versatility, and justice. The Basswood Tree is found all over the world and in some cultures important meetings and outdoor celebrations occur under the shade of a Basswood Tree. Pulling this all together and in line with our firm ideals, Basswood symbolizes that *"we have you covered."*

In order for the name change to proceed smoothly it will transition over time. There will be notifications when the official name change occurs with our new contact information. Should you contact us through the Klug Counsel contact information after the name change, we will still receive the messages so there will be no disruption to our clients as a result of the name change.

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