STATUTORY MERGERS, COMBINATIONS, & REORGANIZATIONS

There is a significant difference between a statutory merger under the Internal Revenue Code ("IRC" or "the Code"), and the countless possibilities along the merger and acquisition spectrum that may not fall, technically, under the IRS's definition of a merger, consolidation, reorganization, or tax-free exchange. For this reason, it is important to understand the basic details of the formal merger process to know which questions to ask and to understand the range of possibilities.

A universal goal of most business combinations is to minimize the current tax bill to the participants. The proper legal structure should result in the deferral of most, if not all, federal taxes. Note that while state tax laws generally follow the federal laws, and the individual transactions described in this white paper are all executed under state laws, variations among state laws exist and are not discussed in this white paper.

Mergers come in a variety of formats authorized by IRC Sections 368 and 351. Generally, stock received as the result of a properly structured merger is acquired tax free, with the shareholder's basis in the newly acquired shares equal to the shareholder's adjusted basis in the prior entity. Any additional cash or other property received in a merger is generally taxable to the recipient.

In this white paper, the focus is entirely on "acquisitive tax-free reorganizations," and not on "divisive transactions" in which a company is split apart, because the former is the most common and practical solution set for the vast majority of financial advisors interested in this process.

The rules under IRC Sections 368 and 351 are significantly different. We will explore the world of mergers under Section 368 first. To qualify for any of the different types of tax-free mergers, or reorganizations under Section 368, five initial requirements must be met:

1. There must be continuity of ownership;
2. There must be continuity of business enterprise;
3. The transaction must have a bona fide business purpose and not be for tax avoidance;
4. The transaction must not be deemed a step transaction; and,
5. The transaction must take place pursuant to a plan of reorganization.

The Code recognizes three primary types of corporate acquisition deal structures that qualify as tax-free (or tax-deferred) reorganizations under Section 368:

- **Type "A" Reorganization** (four sub-types)
  - Statutory merger
  - Statutory consolidation
  - Forward triangular merger
  - Reverse triangular merger
- **Type "B" Reorganization** (stock for stock acquisition)
- **Type "C" Reorganization** (stock for assets acquisition)

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Before proceeding further, it will be helpful to create a common vocabulary to help explore the range of possibilities. For our purposes, we will use the following definitions:

"Target" refers to the company or business being acquired. In the financial advisory industry, the target is generally an S-Corporation or an LLC taxed as a disregarded entity, a partnership, or an S-Corporation.

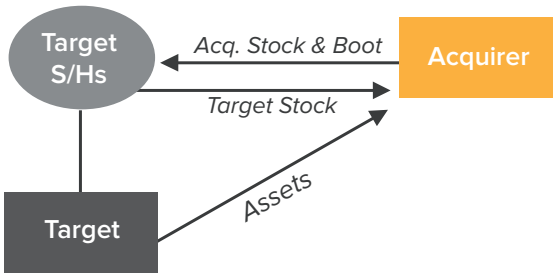
"S/Hs" refers to either shareholders of a corporation or individual members of an LLC.

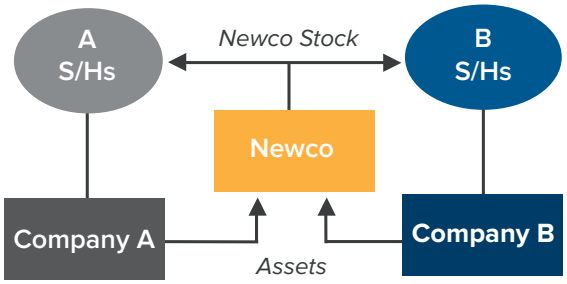
"Boot" is cash or other property received in addition to stock to complete an exchange or transaction.

"Newco" refers to a newly set-up company, usually as part of a strategic plan to augment the process of merging, consolidating, or reorganizing.

Type A Reorganizations. These cover four different merger or consolidation strategies:

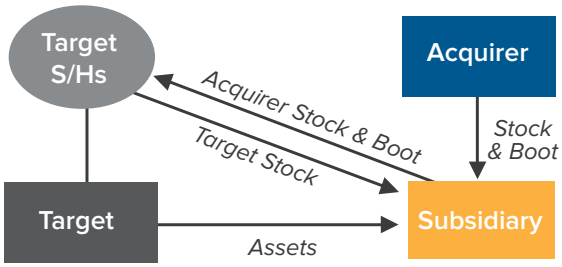
(a) The most common type of merger in this industry is the Type A **statutory merger**. Under a statutory merger, the target shareholders exchange their shares for the acquirer's stock. The target is liquidated and all the target's assets and liabilities are assumed by the acquirer. Approval of the Plan of Merger is subject to a vote of the shareholders in most states, and dissenting shareholders may have the right to an independent appraisal and subsequent purchase of their interests for cash.

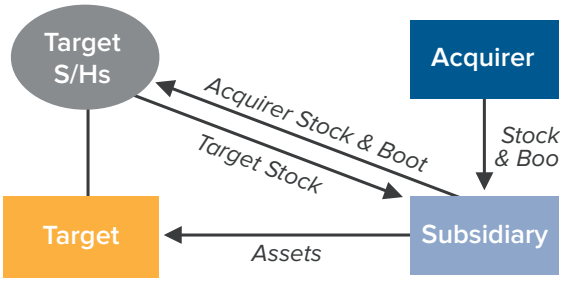




(b) In a **statutory consolidation,** two or more companies contribute all their assets and liabilities to a new entity formed for the transaction, and the original companies are subsequently dissolved. This structure is most appropriate when the merging companies are of similar size, i.e., a merger of equals. The same voting and appraisal rights apply as in a statutory merger.

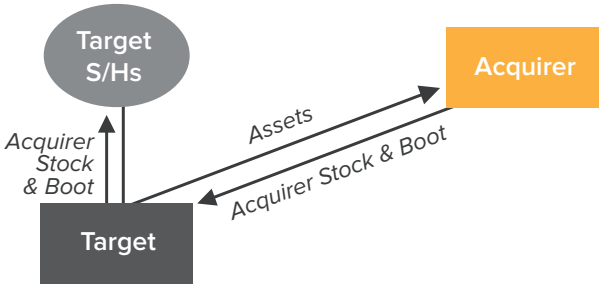
(c) In a **forward triangular merger**, instead of the target company merging into the acquirer, the target merges into a subsidiary of the acquirer. The advantage of this merger form is that the acquirer may be shielded from liabilities of the target as they are held by the subsidiary, and the shareholders of the acquirer may not need to approve the transaction. Disadvantages include the need to operate two entities instead of one going forward, and a requirement that substantially all of the target's assets be included in the transaction. Sales of assets by the target just before the transaction may jeopardize the tax-free status of the merger.

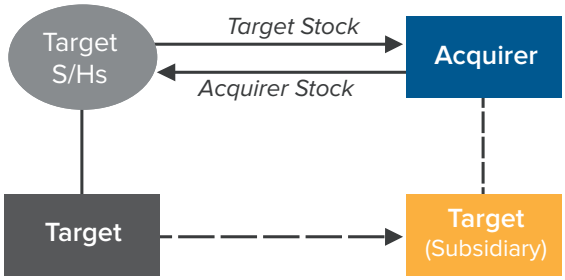




(d) In a **reverse triangular merger**, a subsidiary of the acquiring company is merged into the target company. This leaves the target company as a subsidiary of the acquiring company. As with the forward triangular merger, this structure protects the acquirer from the target's liabilities, but has the added advantage of not losing any contracts that may not be assignable by the target and that would otherwise be lost.

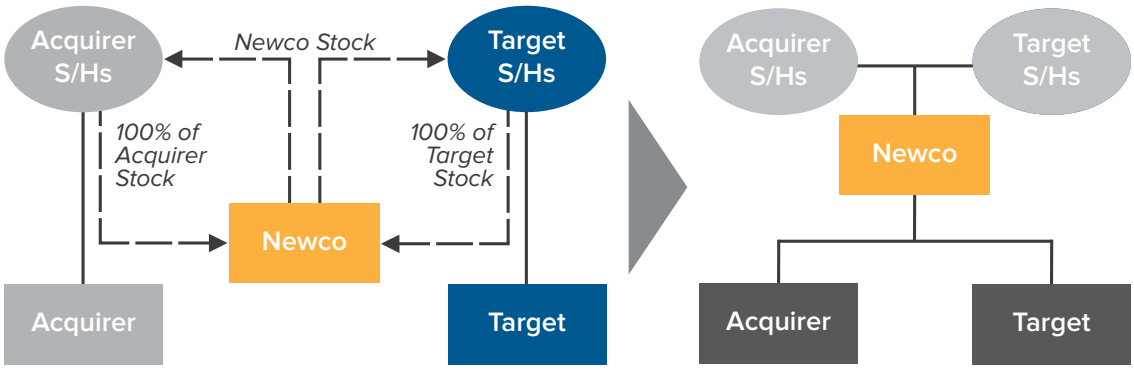
Type B Reorganizations (stock for stock). In a Type B reorganization, the acquirer exchanges its voting stock (no cash except for purchase of fractional shares) for control of the target company. This requires the acquisition of at least 80% of the target company's stock. The target becomes a subsidiary of the acquirer which shields the acquirer from the target's liabilities. The entire 80% does not need to be purchased all at once which allows for a gradual, or "creeping," acquisition. A Type B reorganization is similar to a reverse triangular merger except that the Type B reorganization does not allow payment with cash, does not eliminate minority shareholders, and does not require that substantially all of the target's assets be acquired.





Type C Reorganizations (stock for assets). In a Type C reorganization, the acquirer exchanges voting stock for all or substantially all the assets of the target company. The target company then liquidates and distributes the acquired stock to its shareholders. Non-stock consideration in the transaction cannot exceed 20% of the fair market value of the target's pre-acquisition assets, and liabilities assumed count towards the 20% requirement. This structure allows an acquirer to select the assets and liabilities acquired in the transaction as in a taxable asset purchase. The ability to reject specific liabilities is also an advantage that otherwise may require the use of a subsidiary company to protect the acquirer from contingent or unknown liabilities. But, like a taxable asset purchase, use of a Type C reorganization is often complex, time consuming, and expensive.

Section 351 Mergers. In some cases, the structures provided under IRC Section 368 are not appropriate, but a Section 351 merger will work. The foundation of Section 351 is in the rules applicable to the formation of a new company in which contributions of cash or property to a newly formed company are generally tax free. The contributor receives shares in the new company in exchange for his or her contribution, and the basis in the shares received is equal to the adjusted basis of the assets contributed. The transaction is generally tax free provided the contributing shareholders own at least 80% of the vote and value of each class of stock after the contribution.



Section 351 may also be appropriate when a financial advisor has not yet formed an entity and is operating as a sole proprietorship. A sole proprietor can contribute assets to a new company along with the acquiring company to achieve tax-free status.

Whether through a merger or an acquisition, the result is that two independent businesses can be combined into one. Choosing the right legal method for your business combination (e.g., stock purchase, asset purchase, IRC Section 368 or 351 merger) can have significant impacts on the tax results of the transaction for all the parties and requires professional guidance throughout the process. This white paper provides a high level overview of the landscape of possibilities that are available, While the details required to execute any of these strategies can be complex, and are beyond the scope of this white paper, all of these strategies are available to independent financial advisors and should be considered if appropriate.

Choosing which of the methods described above to use should be the result of a studied analysis of the business purpose behind the proposed merger. In a practical sense, the planning goals for most financial advisors are not centered primarily on tax efficiency or tax avoidance, but rather on realizing, building, and protecting value, and looking after the client base and the founding owner's staff over the long term, and as retirement plans come into focus. In addition, many financial advisors wisely undergo the rigors of a formal valuation after achieving some measure of success and financial stability. Most find that their intangible, professional services practice or business is the most valuable asset they own. Protecting and realizing the value of an intangible, professional services practice or business, even as the primary owner begins to work less and less with each passing year, is important work. The search for solutions leads many financial advisors down the merger path. In many cases, there is no better or faster way to solve this challenge .

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