Taming Tax Terrain in M&A Transactions

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Introductions

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Tax Due Diligence Considerations

Area of Focus	Description
Review Tax Structure & Historical Transactions	▪ Current tax structure and prior restructurings, acquisitions and dispositions ▪ Intercompany transactions and transfer pricing
Analyze Tax Accounts in Financial Statements	▪ Effective tax rate, rate reconciliation, and any variances from the statutory tax rate ▪ Deferred tax assets and liabilities ▪ Uncertain tax positions and tax reserves
Review Income Tax Filings	▪ Tax reporting, including filing of income tax returns ▪ Impact of Tax Cuts & Jobs Act of 2017 (e.g., immediate deductions of capital expenditures) ▪ Book-to-tax differences ▪ Tax accounting methods (e.g., leases, capital expenditures, repairs and maintenance, etc.) ▪ Tax attributes and potential limitations post-transaction to offset future taxable income
Review Non-Income Tax Filings	▪ Tax reporting, including filing of payroll, property and sales/use tax returns ▪ Impact of Wayfair on sales tax filings ▪ Independent contractor v. employee analysis
Understand Tax Audits	▪ Issues analyzed by tax authorities for current and prior tax audits ▪ Remediation of issues identified during audit
Management and Tax Advisor Interviews	▪ Tax function and external advisors utilized ▪ Income and non-income tax policies and procedures
Mitigation of historical tax issues identified during due diligence	▪ Indebtedness ▪ Purchase price reduction ▪ Escrow ▪ Indemnity ▪ R&W Insurance

Transaction Structures – Stock Acquisition (C-Corporation)

	Advantages	Disadvantages
Buyer	▪ Allows the buyer to acquire assets that may otherwise be difficult to transfer (e.g., licenses, franchises and contract rights) ▪ Target's tax attributes (e.g., NOLs) are preserved, but may be limited	▪ No basis step-up in assets; no depreciation / amortization of full purchase price ▪ Assets acquired remain subject to unknown liabilities ▪ No flexibility in selecting which liabilities to assume
Seller	▪ Lower cost compared to asset acquisition ▪ Only one level of tax to seller ▪ Capital gain treatment	▪ Less flexibility in disposing of unwanted assets ▪ Lower purchase price than if the buyer received step-up

Transaction Structures – Asset Transactions (C-Corporation)

	Advantages	Disadvantages
Buyer	▪ The buyer obtains FMV basis in purchased assets that may be depreciated or amortized for federal income tax purposes (e.g., obtains step-up) ▪ Permits the buyer to selectively acquire seller's assets and assume seller's liabilities	▪ May require approval of creditors or regulatory agencies ▪ Cumbersome and expensive ▪ The buyer does not acquire seller's favorable tax attributes (e.g., NOLs) ▪ May generate transfer taxes ▪ **Make-whole provisions & Gross-up Payments**
Seller	▪ Permits seller to selectively dispose of unwanted assets ▪ Utilize losses/credits	▪ Potential double-level tax for seller at corporate level and shareholder level ▪ Corporate-level state income taxes on sale ▪ Potential for ordinary income

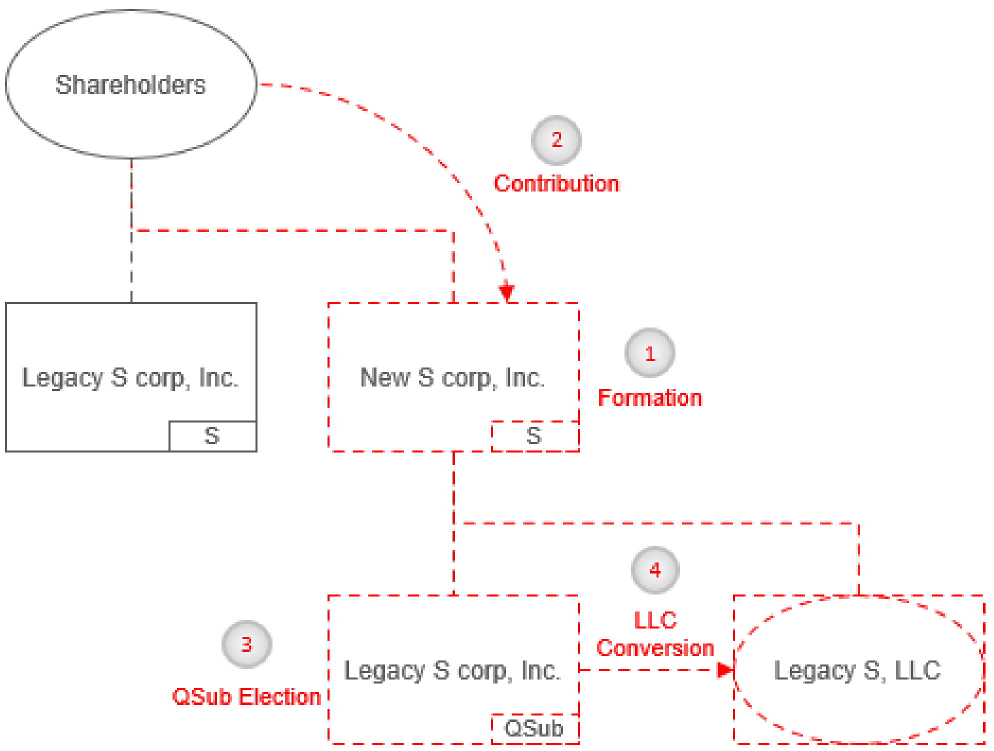
Transaction Structures – Structuring into a Deemed Asset Acquisition

	Section 338(h)(10)	Section 336(e)	Section 338(g)	F Reorganization
Requirements	▪ Qualified stock acquisition within 12 months of acquisition date (e.g., taxable acquisition of at least 80% of the vote and value of target stock)	▪ Qualified stock disposition within 12 months of disposition date (e.g., taxable sale, distribution, or exchange of at least 80% of the vote and value of target stock)	▪ Qualified stock acquisition within 12 months of acquisition date (e.g., taxable acquisition of at least 80% of the vote and value of target stock)	▪ Shareholders of S corporation to form new holding company and contributed Target to holding company followed by a Qsub election. Qsub converts to LLC ▪ Buyer acquires the LLC
Target	▪ S Corporation or corporate subsidiary of consolidated C corporation parent	▪ S Corporation or corporate subsidiary of consolidated C corporation parent	▪ Corporate target ▪ Generally utilized with foreign corporate targets or domestic corporate targets with sufficient NOLs	▪ Generally S corporations
Buyer	▪ Corporation	▪ Flow-through (LLC or Partnership)	▪ Corporation	▪ Corporation or Flow-through
Election	▪ Buyer and Seller	▪ Seller	▪ Buyer	▪ N/A
Legal Transaction	▪ Equity	▪ Equity	▪ Equity	▪ Equity
Tax Treatment	▪ Asset	▪ Asset	▪ Asset	▪ Asset
Pre-transaction Restructuring	▪ None	▪ None	▪ None	▪ Seller required to reorganize the company
Seller – Tax Deferred Rollover	▪ None	▪ None	▪ None	▪ May achieve tax deferred rollover for Seller

Entity Choice Considerations

Entity Classification Considerations	
Single vs. double layer of tax	▪ Distributions from flow-through entities are not subject to a second layer of tax, provided the individual has basis. ▪ Corporate dividends are subject to a 20% qualified dividend rate, as well as 3.8% net investment income tax for qualifying individuals. ▪ Second layer may be deferred for years if no material distributions ▪ If there are no distributions from a corporation, corporate income will be taxed at a 23-28% rate. On the other hand, income from a flow through may be taxed at a rate of up to ~50% (depending on residence state of regarded owners).
Basis creation in flow-through	▪ Flow-through entities allow for an adjustment to basis reducing gain upon sale.
IRS examination	▪ There is increased emphasis on auditing flow through structures.
Foreign vs. domestic ownership/activities	▪ How much are you currently blocking? ▪ How significant is your international activity? ▪ Pay U.S. tax on foreign earnings?
Exit strategy	▪ Full expensing will make an asset sale more attractive to buyers.

S corp Acquisition – F Reorganization



Transaction Steps

1. At least three days prior to closing, Legacy S corp, Inc. ("Legacy S corp") Shareholders form a new Delaware corporation, New S corp, Inc. ("New S corp").
2. Immediately after Step 1, the Shareholders contribute 100% of the stock of Legacy S corp to New S corp in exchange for an equal amount of stock in New S corp (the "Contribution").
3. Immediately following the Contribution, Legacy S corp elects to be treated as a Qualified Subchapter S Subsidiary ("QSub") for U.S. federal income tax purposes by making a valid election on IRS Form 8869 effective as of the date of the Contribution indicating such election is made pursuant to Section 368(a)(1)(F) and Rev. Rul. 2008-18 (the "QSub Election").
4. At least one day following the QSub election, Legacy S corp converts to a limited liability company ("LLC") pursuant to state law and is renamed Legacy S, LLC.

Partnership Acquisition – Step-up Amortization and Interest Deduction

- If a partnership makes a valid section 754 election, then a basis adjustment step-up is available to the acquirer of a partnership interest for the tax basis of the transferee's share of partnership property (743(b) adjustment). Corresponding depreciation or amortization deductions are subsequently available to the transferee partner.

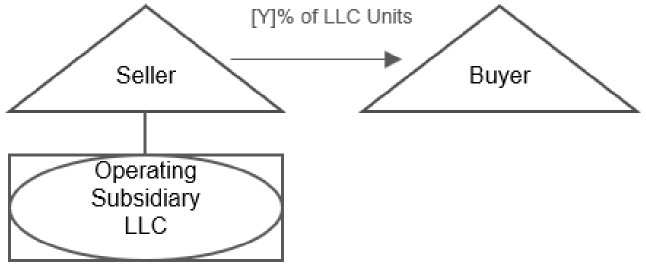
- Partner-level adjustments, such as a 743(b) adjustment, will not be taken into account when the partnership determines its Sec.163(j) limitation.

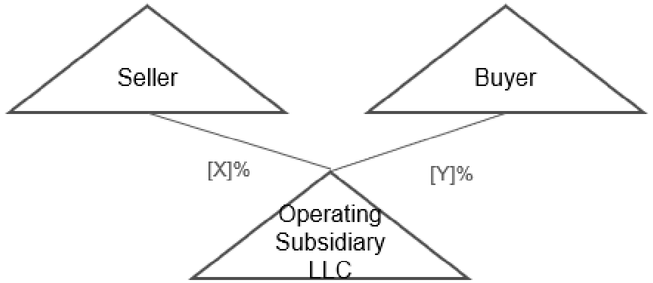
- Common amortization (e.g., as a result of an asset acquisition or transaction which creates a partnership (99-5)) would be included in the 163(j) computation and could reduce interest deductibility.

- Consider a partial acquisition in an existing disregarded entity vs. an acquisition of a partial partnership interest in an existing partnership

Partnership Acquisition – Step-up Amortization and Interest Deduction

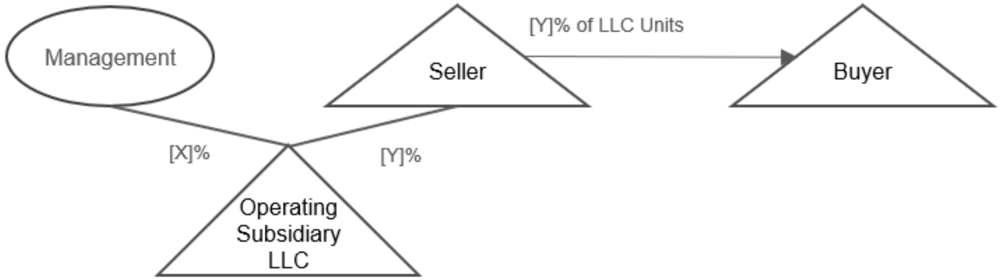
- Acquisition of partial interest in a disregarded entity:

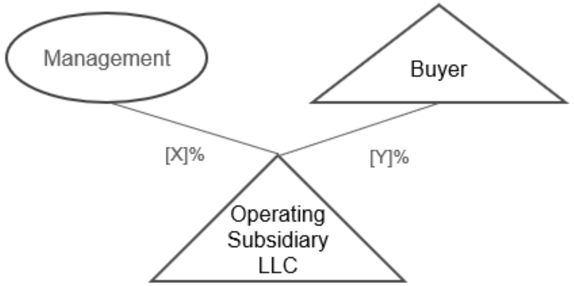




  - In this scenario, buyer's amortization would reduce section 163(j) limit

- Acquisition of partnership interest in existing partnership:





  - In this scenario, 743(b) amortization allocated to buyer would not reduce the operating subsidiary's section 163(j) limit

Pre-Transaction Planning

Gift/Estate Tax Exemption

- Federal gift/estate tax exemption currently $13.61M per person

- Doubled as a result of 2018 Tax Cuts and Jobs Act – scheduled to sunset end of 2025

- Anti-clawback regulations

- Use exemption now!

Pre-Transaction Planning

Planning without Exemption

- Annual exclusion gifts ($18,000 per recipient, unlimited recipients)
- Direct payment of tuition and/or medical expenses
- Unlimited marital deduction for gifts between US citizen spouses
- “Intra-family” loans using AFR
- Grantor retained annuity trusts & sales to grantor trusts
- Charitable gifts

Pre-Transaction Planning

Planning with privately held interests

- Leverage gift tax exemption with valuation discounts for lack of marketability & lack of control

- Transfer interests to irrevocable trust or charity before transaction
  - Charitable gift to private foundation or donor-advised fund
    - Timing is important – avoid assignment of income
  - Gift or sale to irrevocable trust – understand income tax implications with grantor trust
    - Timing is important – earlier is better

- Requires independent appraisal & advisor coordination

Pre-Transaction Planning

Income Tax Considerations

- Understand tax implications of domicile
    - Massachusetts Millionaire's Tax
- Basis considerations
- Tax attributes at the personal level- carryover losses, material participation
- Installment Sale Considerations
- Section 1202 Stock/Section 1031 for real estate
- Timing of exercising options

Post-Transaction Planning

Income Tax Considerations

- Structuring family office

- Paying capital gains taxes on behalf of grantor trust
  - Option to turn off grantor trust status or give independent trustee discretion to reimburse

- Installment Sales, Earnouts, Escrow Releases

- Planning with rollover interest

Post-Transaction Planning

Estate Planning Considerations

- Draft side letter of wishes to provide guidance to trustee of irrevocable trust(s)

- Charitable gift – develop charitable mission statement and plan to engage family members

- Develop plan to communicate wealth to family members in time and age-appropriate manner
  - Financial education for family members
  - Ensure core estate plan is up to date

- Understand estate tax exposure & planning opportunities that are consistent with lifestyle funding and values

Questions?