

TAX CONSIDERATIONS IN M&A TRANSACTIONS

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The tax considerations involved in a business acquisition vary depending on the form of transaction and the types of entities involved. The structure of the transaction will affect the tax consequences arising from the deal, be it taxable gain or matters relating to tax attributes such as net operating loss carryovers ("Net Operating Losses"). As there is often more than one way to structure a transaction to achieve the parties' business goals, tax advice early in the negotiation process can yield meaningful economic benefits. This article will review the typical transaction structures used to acquire business and the general tax consequences to the parties under each structure. It will also describe some of the more common tax due diligence concerns and indemnity considerations. Finally, the article will touch upon the importance of purchase price allocations and the key considerations for buyers and sellers.

TRANSACTION STRUCTURE

Fundamentally, there are two forms of business acquisitions: (1) an acquisition of all or most of the assets and liabilities of a company or line of business (an "asset purchase"), or (2) a business transfer where either corporate stock or partnership interests are transferred. The equity in a limited liability company ("LLC") is typically called a membership interest, and can be the equivalent of stock in a corporation or a partnership interest, depending on the classification of the LLC for tax purposes. Domestic LLCs with more than one member are usually treated as partnerships or, in the case of single member LLCs, are disregarded as entities separate from their owners. It is possible, however, to make an affirmative election for the LLC to be taxed as a corporation.¹

CORPORATIONS

Asset Purchase. Asset deals are relatively straightforward for tax purposes. The overall sale for a single purchase price is treated as separate transfers of the individual assets purchased and liabilities assumed. For this purpose, the purchase price is allocated among the assets in accordance with their respective fair market values at the time.

As a general matter, the seller corporation recognizes gain equal to the difference between the adjusted basis of the property transferred and the amount paid by the purchaser. The character of the gain is determined separately for the different properties sold. Where there is a complete sale of the business, and the asset sale is followed by a

liquidation of the corporation, there will be two levels of taxation – that is, at the corporate and shareholder levels. Accordingly, in terms of tax consequences, sellers generally prefer stock sales.

The corollary to the seller's recognition of gain is that the buyer acquires the various assets with bases equal to their fair market values, a so-called "step up" in basis. The buyer takes the assets with full basis and new holding periods, and where applicable will get the benefit of depreciation deductions, thereby reducing the buyer's taxes going forward. Thus, from a tax perspective, this structure would generally be preferable to a buyer.

There are also commercial reasons for using an asset purchase. The purchaser may want to pick and choose specific assets to buy, or the seller may desire to sell only one of several lines of business. Another reason a buyer might want to do an asset purchase is to avoid assumption of all the company's liabilities, particularly when there are likely to be significant unquantifiable future costs for liabilities from issues such as product defects or environmental clean up.

Corporate Stock Purchase - Taxable. Like asset transfers, the tax issues in a taxable stock purchase are relatively straightforward. The selling shareholders will recognize gain equal to the difference between the purchase price received and their bases in the target corporation's (the "Target's") stock. The buyer acquires the target's stock with a stepped up basis equal to the cash paid and liabilities assumed.

For tax purposes, the essential difference to the buyer of acquiring a business through a stock purchase, rather than purchasing the assets directly, is that the individual assets retain their character, bases and holding periods. This has advantages and disadvantages. For example, the Target may have Net Operating Losses that the acquiring corporation may use against its other income, subject to certain limitations. On the other hand, this would typically be a negative factor if the Target has a substantial amount of appreciated assets or depreciable assets that have been fully depreciated. In that case, the assets have inherent untaxed gain for which taxes will likely need to be paid at some point in the future.

In general, it would appear that a stock sale would have tax benefits for sellers and result in a corresponding tax detriment for buyers, and vice versa for asset deals. This reciprocity may be true in theory, but is not necessarily true in practice. Because there are a variety of factors influencing a taxpayer's net tax bill, a structure that benefits one party will not necessarily result in an offsetting detriment to the other party. For example, the buyer may have more Net Operating Losses than it can use and thus not need the depreciation deductions. In that case, structuring the transaction as a stock sale would minimize the seller's



taxes without adversely affecting the buyer – thus yielding an overall net economic benefit that the parties might be able to share. In other words, the tax consequences of the structure generate real economic costs and benefits, which the parties should take into account when negotiating the purchase price.

Section 338(h)(10) Election. In some cases, it is possible to achieve the tax consequences of an asset sale notwithstanding that in form the transaction is a stock transfer. This option is useful, as it may be preferable to do a stock sale for commercial purposes, as this structure avoids the need to transfer title for all the individual assets. For a stock transfer to be treated for tax purposes as an asset sale, the parties must make an affirmative election to that effect under Section 338(h)(10) of the Internal Revenue Code of 1986, as amended (the “Code”).² This election is only available if the Target and both parties are C-corporations. The effect of a Section 338(h)(10) election is that the Target’s owner recognizes taxable gain or loss equal to the difference between the purchase price and the Target’s bases in its assets, and the Target’s bases in its assets are stepped up.

Corporate Stock Purchase - Non-Taxable. There are basically five types of “tax-free reorganizations” and each one has its own set of specific tax requirements that must be satisfied in order for the transaction to be respected as a non-recognition transaction. Discussion of the specific details involved in tax-free reorganizations is complicated and outside the scope of this article. The common theme is that all or a substantial part of the consideration received by the Target’s shareholders is in the form of stock. Calling these transactions “tax-free” is really a misnomer since taxation is deferred rather than avoided forever.³

Tax deferral occurs because the stock received by the Target’s shareholders has a carryover basis equal to the basis of the Target stock relinquished (rather than a basis equal to the stock’s fair market value). The theory is that the Target’s owners retain a continuing interest and, therefore, can defer recognition of gain or loss until some future time when they sell the new stock. As in a taxable stock sale, the Target’s assets do not get a step-up in basis. Given the prevalence of LLCs taxed as pass-through entities, tax-free reorganizations are now rare outside of the public company arena.

Where the parties desire to avoid gain recognition, it is essential to have a tax lawyer involved throughout the deal, as the requirements are very specific and the Internal Revenue Service (the “IRS”) might not agree with the parties’ tax characterization.

PARTNERSHIPS

Asset Purchase. The tax consequences to the buyer of an acquisition of a partnership’s assets are essentially the same as for an asset purchase from a corporation.⁴ In an asset sale, the partnership is treated as selling, and the purchaser is treated as buying, the various assets of the partnership separately for allocable portions of the aggregate purchase price. The buyer takes ownership of the transferred assets with bases stepped up to the purchase price paid, as allocated among the assets. Any gain or loss on these transfers flows through

to the partners, who directly recognize their share of the partnership’s gain or loss on the underlying assets.⁵ This is fundamentally different from an asset sale and liquidation by a corporation where there is gain recognition by the corporation and a second level of tax to the selling shareholders. Accordingly, from the seller’s perspective, the difference in the tax consequences between a transfer of assets and a transfer of partnership interests is far less significant than the difference between an asset or stock sale in the case of a corporation.

Partnership Interest Purchase. Similar to a stock sale, the transfer of a partnership interest generally gives rise to capital gain or loss equal to the difference between the original partner’s adjusted basis in the interest and the fair market value paid. However, to the extent the partnership owns certain “hot” assets, a portion of the gain or loss will be characterized instead as ordinary. Hot assets are generally assets that would give rise to ordinary income if sold by the partnership.

There are two facets to the consequences for the buyer. The incoming partner’s basis in the acquired partnership interest (referred to as “outside” basis) is stepped up to equal the amount paid. The buyer will also have an undivided interest in its share of the bases of the partnership’s assets (so called “inside” basis). Gain or loss from a sale by the partnership of its assets will flow through to the incoming partner based on the partner’s inside basis, as will the availability of depreciation deductions and amortization. Thus, if there is a mismatch between the incoming partner’s inside and outside basis, the new partner’s expected economics may be adversely affected.

Such a mismatch typically occurs when the partnership has substantially appreciated assets or that has been amortized or depreciated for tax purposes. The general rule is that an incoming partner’s inside basis is not stepped up to reflect the fair market value paid by the new partner for its share of the partnership’s assets. Absent such a step-up to inside basis, the new partner would have inflated income upon the sale by the partnership of any such appreciated property, and would be deprived of depreciation and amortization deductions.

It is possible, however, for the partnership to make adjustments to step-up (or potentially step-down) to the incoming partner’s share of the partnership’s assets’ bases to match the cost paid for the partnership interest. To make these adjustments, the partnership must have in place or make an affirmative election under Section 754. No adjustment is made to the inside bases of the continuing partners. Once made, the Section 754 election will apply to all partnership interest transfers that year and in the future.⁶

Accordingly, in acquiring partnership interests it is important to review the underlying assets of the partnership to determine any economic cost to the purchaser of assets with built-in gain, potential depreciation recapture and loss of tax deductions for depreciation or amortization. If the cost of any mismatch between inside and outside basis cannot be avoided because the partnership has not previously made a Section 754 election and is not willing to do so now,⁷ the issue might be able to be addressed by a reduction in purchase price.



DUE DILIGENCE AND TAX INDEMNITIES

After considering structure, parties to M&A transactions should turn their attention to due diligence, which in turn will help focus tax indemnity negotiations. Typically, there is not much need for tax due diligence when the buyer is acquiring assets rather than an entity. In an asset deal, the principal considerations are making sure that there are no liens on the assets and that the seller has paid all taxes that arose prior to the closing date.

When the buyer is acquiring a business entity there is a greater need for scrutiny because the purchaser will assume liability for the entity's entire tax history.⁸ The purchaser could end up having to pay back taxes for the entity, and the amount could be significant enough to turn what appeared to be a profitable business acquisition into a costly mistake. Accordingly, tax due diligence in the case of an entity acquisition may include review of the entity's entire tax history, and inquiries about matters such as open audits, notices of audits and extensions of statutes of limitations.

One development that has made the diligence process somewhat easier for purchasers is the requirement under FASB Interpretation No. 48 ("FIN 48")⁹ to post financial statement reserves for "uncertain tax positions." This requirement affects all companies (including partnerships and LLCs) that report their financial statements in accordance with US-GAAP. In general, a tax position is considered "uncertain" unless it is more than likely to be sustained if challenged. The existence of FIN 48 reserves thus serves as a flag to purchasers that the Target may have taken questionable or aggressive tax positions, and the buyer can inquire about and focus its attention on those positions.

A recent change applicable to "large" corporations filing Form 1040 will enable buyers to get even more information about uncertain tax positions because, beginning with returns for 2010, the affected corporations must include a tax return schedule describing and quantifying the specific tax positions that gave rise to any FIN 48 reserves. The applicability of this requirement will expand over the next few years - initially affecting corporations with worldwide assets totaling at least \$100 million, and then expanding to corporations with total assets of at least \$50 million in 2012 and \$10 million in 2014.

Sometimes it is not practical (or even possible) to conduct the kind of "scorched earth" form of diligence that would be sufficient to identify all material tax risk. This is where tax indemnities fit in. As is the case with general business risks, the parties negotiate tax indemnity provisions to allocate the cost of known and unknown tax risks. The due diligence findings help focus these negotiations and provide assurance that the wording in the agreement addresses the specific tax risks involved. The information also lets the buyer know how hard to fight in the negotiations. If it is known that the seller took aggressive tax positions, particularly in areas currently being challenged by the IRS, there is a heightened need for tax protection. It is worth noting, however, that tax indemnification is usually not practical if the Target is a public company.

SPECIAL CONSIDERATIONS IN CORPORATE ACQUISITIONS

The issue of potential liability for back taxes when an entity is acquired is even more significant when the Target is a corporation that is part of an affiliated group filing consolidated tax returns. Under Treasury Regulations §1.1502-6, each member of an affiliated group of corporations is jointly and severally liable for the taxes of any other member of any affiliated group with which it joined in filing a consolidated return. In other words, the IRS could come after a tiny subsidiary of a huge conglomerate for unpaid taxes that arose with respect to a sibling corporation engaged in an entirely different line of business, even if the Target had losses for the year in question and thus individually did not accrue any tax liability.

For this reason, tax due diligence in the case of a corporate acquisition should extend beyond the Target and include the tax returns of the consolidated group, to the extent possible. Still it is often difficult to ascertain the entire history of all previously affiliated corporations, especially given that the seller may not permit such an extensive review of tax returns for the consolidated group. This risk is typically dealt with through seller provided tax indemnities. Most sellers are willing to provide these indemnities, as they already bear tax risk for all of the other members in their consolidated groups. For these tax indemnities, and tax indemnities in general, it is also important to ensure that the seller will have the ability to pay if the indemnity is called upon. Therefore, buyers typically request support for the indemnity from a credit worthy parent when the seller's creditworthiness is in doubt.

One trap for the unwary is that joint and several liability under the consolidated return rules will apply to the acquisition of a corporation even if the parties make a Section 338(h)(10) election. In other words, the tax law will follow the corporate form of the transaction for liability purposes even though the transaction is otherwise considered an asset sale for tax purposes.

TAX APPORTIONMENT, RETURN FILING AND AUDITS

The parties to a business acquisition transaction also need to address administrative matters, including apportionment of taxes and deciding which party will control tax matters such as tax return filing and audits. In terms of taxes, the parties must determine how to apportion the cost of taxes that accrued prior to the closing date, but are due after the closing date, and provide for payment of any taxes that are imposed with respect to the transaction itself. These are primarily property taxes, transfer and stamp taxes, excise taxes and other similar taxes (the "non-income taxes"). Sometimes the parties agree to split the cost of these taxes. The amounts are often quite large and joint liability for these types of taxes is not uncommon. The other common approach is to factor these costs into the purchase price.

Non-income taxes need to be considered in both asset and entity deals, and most cases it is advisable to consult local tax counsel. These types of taxes vary widely from jurisdiction to jurisdiction, and local counsel will have the necessary expertise to quantify the costs, and identify the relevant procedural requirements and due dates.



The parties must also deal with tax return filing obligations, and control over audits. The common approach is for the seller to file returns and have control over audits for all tax years ending prior to the transfer date, and for the buyer to file returns and have control over audits for all tax years beginning after the transfer. The question for discussion is how to handle the “straddle” year - that is, the tax year during which the sale occurs, as it includes both pre-sale and post-sale periods. Typically, the parties agree that the buyer will file the tax returns for the straddle year, with review and input from the seller, and for control over straddle year audits to be divided in a similar fashion.

PURCHASE PRICE ALLOCATIONS

The final tax consideration we will discuss is purchase price allocations. This is an important part of the negotiation process in all taxable asset purchase transactions, including those that are treated as asset transfers for tax purposes by virtue of an election under Section 338(h) (10). As business acquisitions that do not involve stock transfers are treated as transfers of the individual assets that comprise the business, the parties must identify each and every asset included in the sale and determine how the overall purchase price is allocated among these assets.

Under Section 1060, the total purchase price related to the sale of a business is allocated among seven asset classes in the following order: (1) cash, (2) marketable securities, (3) market to market assets and accounts receivable, (4) inventory, (5) assets not otherwise classified, (6) Section 197 intangibles other than goodwill and going concern, and (7) goodwill and going concern value. The allocation is done using a top down approach, meaning that the total fair market value of all assets in a class are added up and subtracted from the overall price before going on to the next category. Any remaining amount (or “residual” value) is considered goodwill / going concern value. The allocations are important, as they determine the buyer’s bases in the assets and the seller’s gain or loss on the sale, and in turn affect the tax consequences to the parties.

For the most part, the parties’ interests are opposed in terms of allocation preferences. From the seller’s perspective, it is generally better to have as much value as possible allocated to assets that give rise to capital gain (rather than to assets such as inventory and accounts receivable, which generate ordinary income). The buyer, in contrast, would typically want maximum value allocated to items that are currently deductible and to depreciable assets with short recovery periods.

The value of intangibles such as goodwill is not always easy to quantify and is, therefore, an area where tax considerations can be especially important. Buyers typically do not want a high value assigned to goodwill, as it is amortized over 15 years. Instead, a buyer might negotiate some form of short-term consulting agreement with the seller. The purchase price would be reduced to take into account the future payments to the seller under the consulting agreement. The reduced price would mean less value to allocate to goodwill. When this approach is taken, it is essential for the consideration under the consulting agreement and the purchase price to both reflect actual

“fair market value.” Otherwise, the IRS could reallocate amounts between the consulting agreement and the sales contract.

In contrast, from the seller’s perspective, a consulting agreement is less desirable than an allocation of purchase price to goodwill, as the consulting agreement generates ordinary income, albeit with some deferral of income recognition. Covenants not to compete have undesirable tax consequences to both parties -- ordinary income for the seller, and a 15-year recovery period for the buyer.

Ultimately, it is best if the parties can reach agreement on the allocations, as these agreements are binding under the Code. Moreover, the IRS can challenge the allocations, but tends to defer to the parties’ agreed allocations if the parties have diverse interests and the allocations are factually reasonable. Accordingly, it is common practice to include either the agreed allocations in the sale documents or a provision providing that the parties will work to reach agreement on the allocations prior to filing their tax returns for the year of sale.

CONCLUSION

The foregoing description of certain tax considerations to keep in mind when buying or selling a business is meant as a general introduction to this topic. The issues discussed are just a sampling of the various and nuanced tax considerations that will arise in a given deal. Nor does this discussion address all of the “common” areas of concerns, as there are often standard concerns that are specific to certain industries or types of business. The point to remember is that the economic consequences of proper tax planning in the context of M&A transactions can be significant, and it is therefore advisable to obtain tax advice.

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¹For simplicity, we will not discuss transfers of membership interests in LLCs separately, it being understood that the tax consequences will be the same as those described for corporations or partnerships, as applicable.

²Unless otherwise specified, all "Section" references herein are to the Code.

³Permanent deferral could, however, be achieved if the owner of Target was an individual who later died. In that case, the basis of the stock received by the heirs would get a step up in basis to fair market value.

⁴This is also true with respect to purchases from a sole proprietorship or single member LLC.

⁵Section 702.

⁶It is possible to revoke the election, but doing so requires permission from the IRS, which will not be granted if the purpose is to avoid having to mark down inside bases.

⁷The reasons for not making the Section 754 election include the additional administrative burden of maintaining different asset bases for different partners, as well as the fact that the possible need to make undesirable downward basis adjustments for future new partners.

⁸To some extent, this may also be a concern when buying a disregarded LLC, as some state and local taxing authorities treat transfers of LLCs as entity transfers. Moreover, certain types of taxes, like payroll taxes, will transfer with the entity.

⁹FIN 48 is now incorporated in Accounting Standards Codification (ASC) 740-10.

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