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M&A ACADEMY: MAXIMIZING TAX BENEFITS AND MINIMIZING TAX RISKS IN DEALS

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Introductory Notes

- Focus on domestic taxable transactions
 - Cross-border M&A subject to special rules
 - Tax deferred “reorganizations” and other tax-deferred combination transactions subject to special rules
- Focus on taxable acquisitions of a target entity treated as a corporation or a tax partnership (as opposed to direct asset acquisitions)
- Treatment of non-U.S. selling shareholders differs from treatment of U.S. selling shareholders
- Note on LLCs in the M&A context

The background features a dynamic, abstract composition of light trails. On the left, numerous thin, parallel lines in shades of red and orange streak across the frame, creating a sense of motion. These lines transition into a more structured, grid-like pattern of blue and white lines that converge towards the right side of the image. The overall color palette is dominated by deep blues, bright reds, and crisp whites, set against a dark, almost black background.

OVERVIEW OF TAX REFORM IMPACT ON M&A

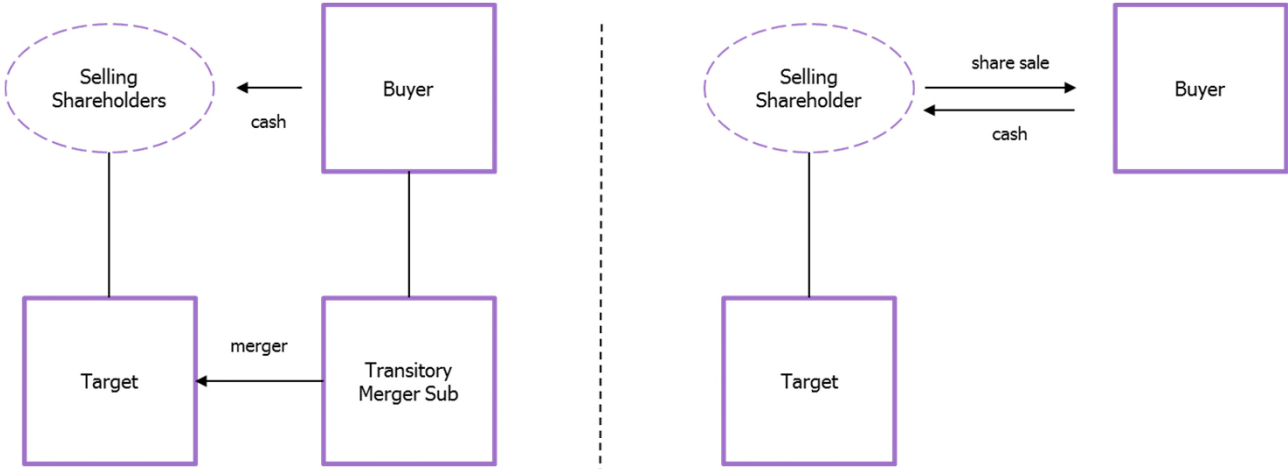
Overview of Tax Reform Impact on Domestic M&A

- Reduction in corporate and individual tax rates
- Limitation on use of NOLs
- Immediate capital expensing
- Limitations on business interest deductions
- Deduction for qualified business income
- Three-year holding period requirement for “carried interest”




The background features a dynamic, abstract composition of light trails. On the left, numerous thin, parallel lines in shades of red and orange streak across the frame, creating a sense of motion. On the right, a more prominent, thicker band of light trails in various shades of blue and white curves diagonally from the top right towards the bottom left. The overall effect is one of high speed and energy, set against a dark, deep blue background.

BASIC TAXABLE ACQUISITION OF A CORPORATE TARGET

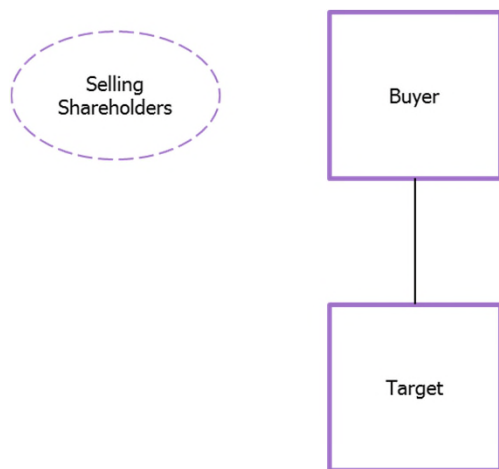
Reverse Cash Merger / Taxable Stock Purchase – Transaction Structure



U.S. Federal Income Tax Classification

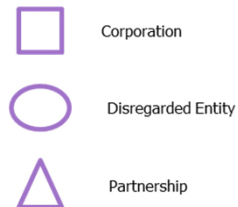
-  Corporation
-  Disregarded Entity
-  Partnership

Basic Consequences



- Selling Shareholders
 - Recognize gain / loss on sale of shares for cash
 - Special issues for non-corporate shareholders
 - LTCG / STCG (depends on holding period and assumes shares are held as capital assets)
 - Potential reduction in rate or rollover of gain under Code Sections 1202 / 1045 for "qualified small business stock"
 - 3.8% Medicare tax
- Buyer
 - Cost basis in shares purchased
 - New holding period in shares
 - Target becomes part of Buyer group
- Target
 - No gain or loss
 - No step-up in asset basis
 - Tax year ends for income tax purposes (generally)
 - Limitations on use of Target NOLs (Section 382)

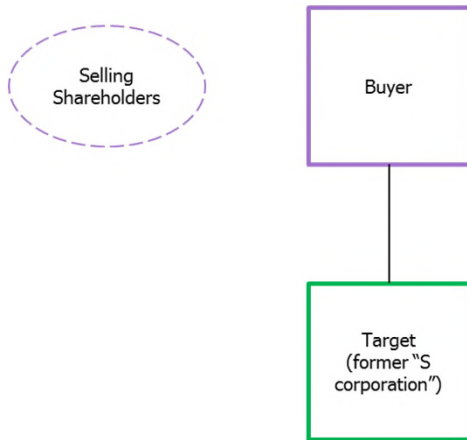
U.S. Federal Income Tax Classification



The background features a dynamic, abstract design with numerous light trails in shades of red and blue, creating a sense of motion and energy. The trails are most prominent in the upper right and lower right areas, converging towards the top right corner. The overall color palette is dominated by dark blues and blacks, with the light trails providing a vibrant contrast.

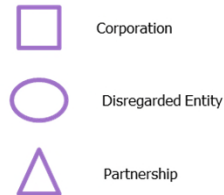
ACQUISITIONS OF A CORPORATE TARGET THAT ACHIEVE A TAX BASIS STEP- UP

Basic Consequences – “S Corporation” Target w/ Section 338(h)(10) election

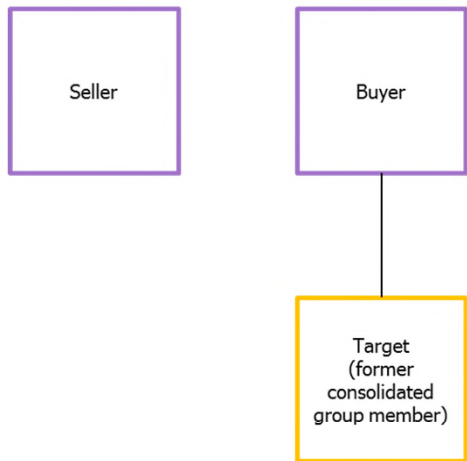


- Target
 - Deemed for tax purposes to sell assets and liquidate
 - Gain or loss recognized at Target level
 - Generally flows through to selling shareholders
 - However, may be Target level consequences (e.g., built-in gain tax, state income tax) – pricing point
- Selling Shareholders
 - Recognize gain / loss on deemed liquidation (but have tax basis attributable to flow-through gain)
 - LTCG / STCG (depends on holding period and assumes shares are held as capital assets)
 - May be differences w/ and w/o 338(h)(10) election (e.g., character differences due to depreciation recapture, inventory sales, etc.) – pricing point
- Buyer
 - Stepped-up basis in assets deemed purchased (including goodwill, which may be amortized under Code Section 197)
 - New holding period in assets
 - Target becomes part of Buyer group
- Mechanics of the election

U.S. Federal Income Tax Classification

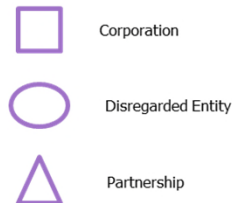


Basic Consequences – Consolidated Group Target w/ Section 338(h)(10) election

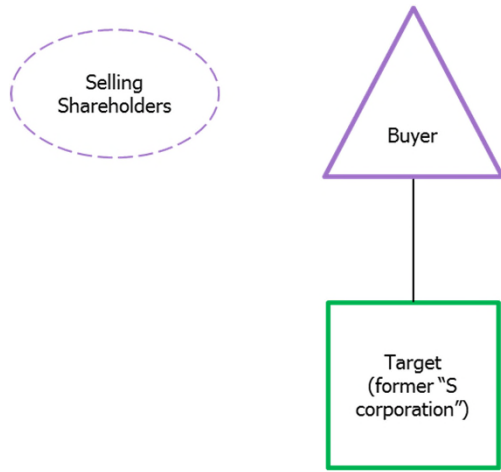


- Target
 - Deemed for tax purposes to sell assets and liquidate
 - Gain or loss recognized at Target level
 - Generally flows through to selling group
 - Target remains liable for group tax liability under Treasury Regulations Section 1.1502-6
 - Tax year ends at the close of business on the closing date
- Seller
 - Deemed liquidation generally tax-free under Code Section 332
 - Target exits the selling group, which can have consolidated return consequences (e.g., triggering of deferred intercompany gain, excess loss accounts)
- Buyer
 - Stepped-up basis in assets deemed purchased (including goodwill, which may be amortized under Code Section 197)
 - New holding period in assets
 - Target becomes part of Buyer group

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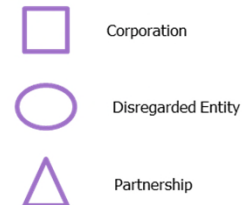


Basic Consequences – “S corporation” Target w/ Section 336(e) election

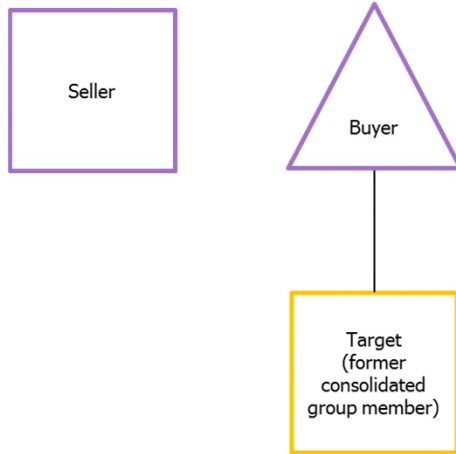


- Same basic consequences as Section 338(h)(10) election
 - Buyer not required to be a corporation
 - Immediately after acquisition, Target can be converted into a tax transparent entity (e.g., a disregarded LLC) if desired (because the Target has a stepped-up basis in its assets)
- Mechanics of the election

U.S. Federal Income Tax Classification



Basic Consequences – Consolidated Group Target w/ Section 336(e) election



- Same basic consequences as Section 338(h)(10) election
 - Buyer not required to be a corporation
 - Immediately after acquisition, Target can be converted into a tax transparent entity (e.g., a disregarded LLC) if desired (because the Target has a stepped-up basis in its assets)

U.S. Federal Income Tax Classification



Corporation



Disregarded Entity

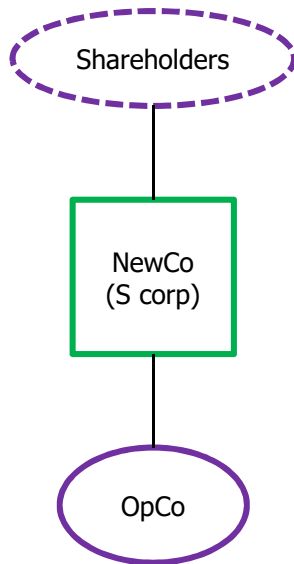


Partnership



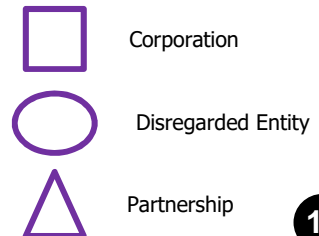
ACQUISITIONS WITH A ROLLOVER COMPONENT

"S corporation" Target – First Step "F reorganization"

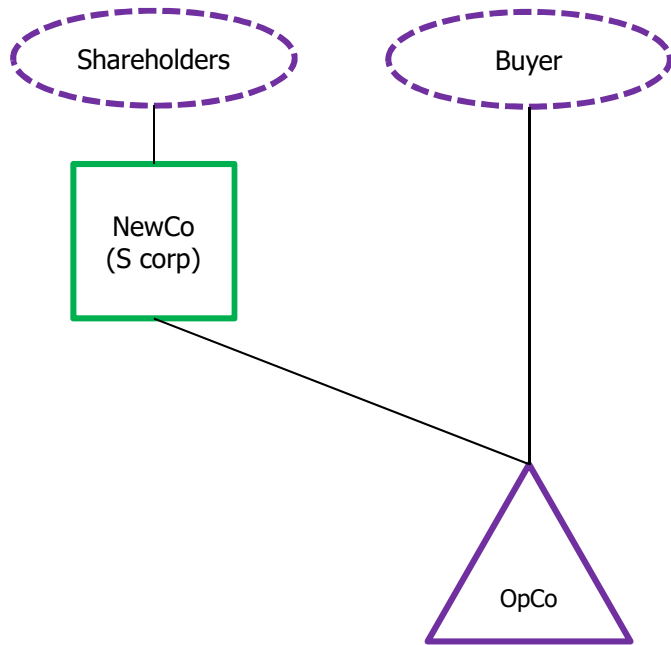


- The shareholders of an existing "S corporation" target (OpCo) contribute the target to a newly formed holding company (NewCo)
- OpCo elects to be treated as a "qualified subchapter S subsidiary", and the entire transaction is treated as an "F reorganization" in which NewCo is treated as a continuation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

U.S. Federal Income Tax Classification

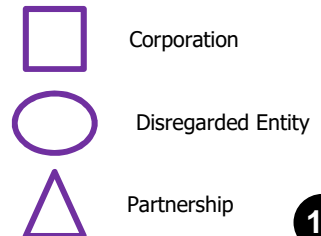


"S corporation" Target – Second Step Acquisition

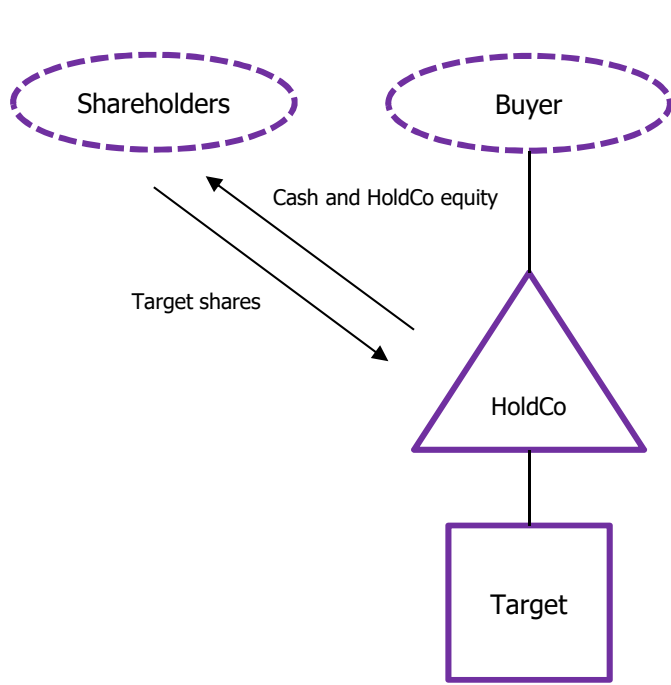


- The Buyer acquires an interest in OpCo in a taxable purchase
- The gain from the taxable purchase creates a partial tax basis step-up at the OpCo level
 - Additional structuring can be undertaken to cause the tax basis step-up to be "personal" to the Buyer under Code Section 743(b)
- NewCo retains the "rollover" equity in OpCo, on a tax-deferred basis

U.S. Federal Income Tax Classification

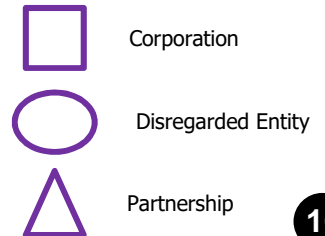


"C corporation" Target – Partnership Rollover

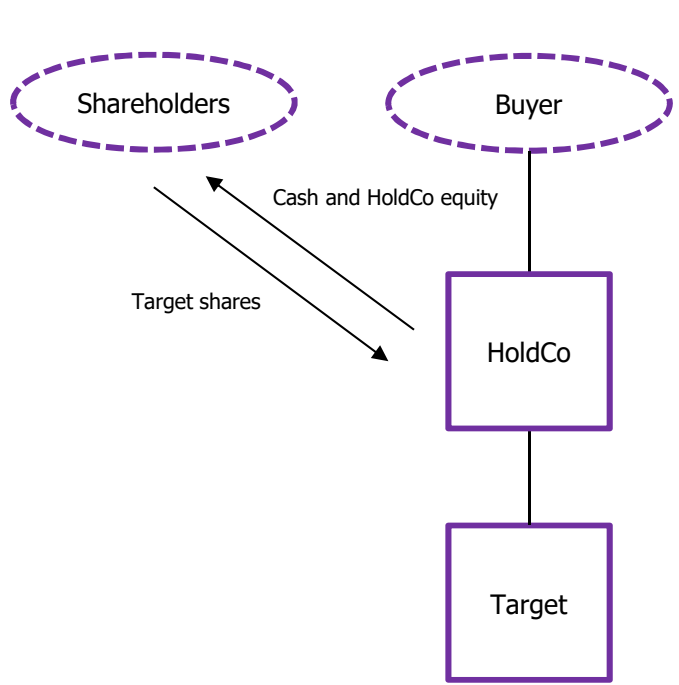


- HoldCo acquires Target for a combination of cash and equity interests
- No Target-level asset basis step-up
- Target shareholders receive the "rollover" equity in HoldCo on a tax-deferred basis under Code Section 721

U.S. Federal Income Tax Classification

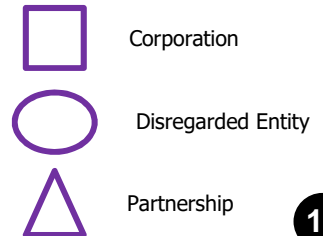


"C corporation" Target – Corporate Rollover



- HoldCo acquires Target for a combination of cash and equity interests
- No Target-level asset basis step-up
- Target shareholders receive the "rollover" equity in HoldCo on a tax-deferred basis under Code Section 351

U.S. Federal Income Tax Classification



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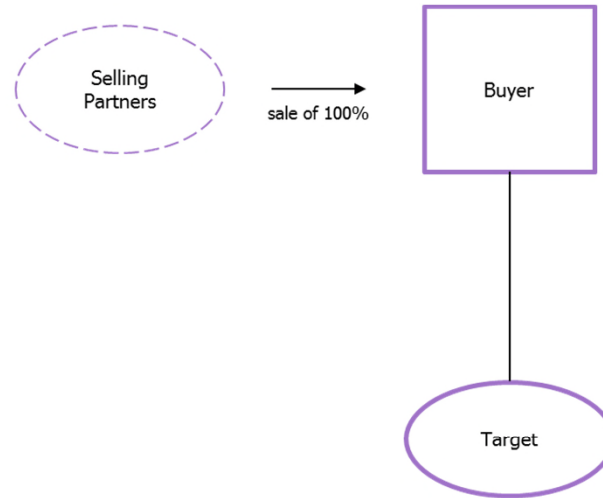
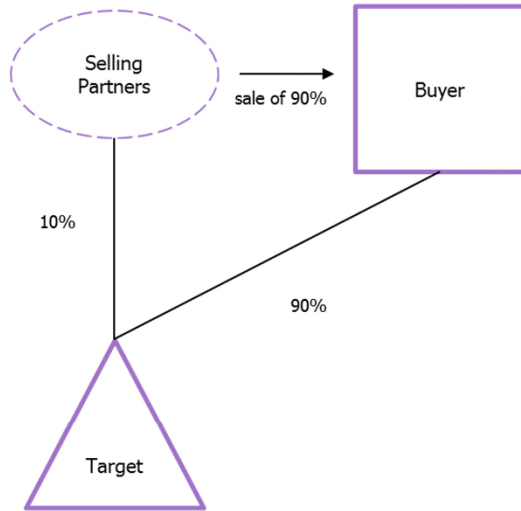
Please save this number; you will need this to receive a Certificate of Attendance. You will be contacted within 30-60 days by our CLE administrative team. We will process your credits for other states where this program has been approved.

Please email Chris Chang at chris.chang@morganlewis.com if you have any questions.

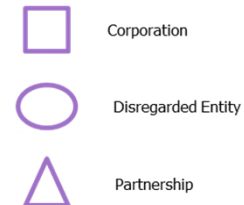
The background features a dynamic, abstract composition of light trails. On the left, numerous thin, parallel lines in shades of red and orange streak across the frame, creating a sense of rapid movement. These lines transition into a more structured, blue-toned pattern on the right, consisting of multiple parallel lines that appear to form a perspective view of a road or a series of tracks receding into the distance. The overall color palette is dominated by deep blues, vibrant reds, and bright whites, set against a dark, almost black background.

ACQUISITIONS OF A PARTNERSHIP TARGET

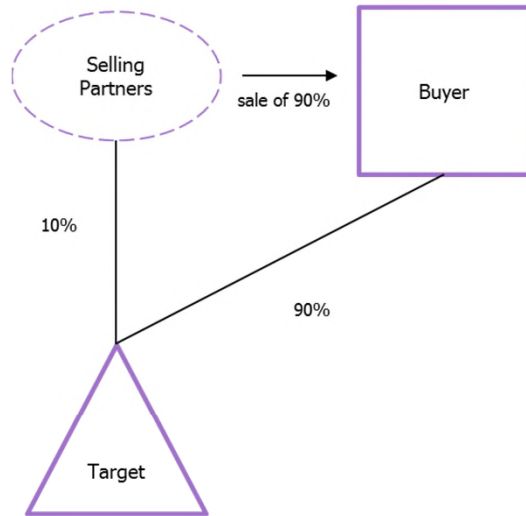
Partnership Target – Partial or Complete Acquisition



U.S. Federal Income Tax Classification

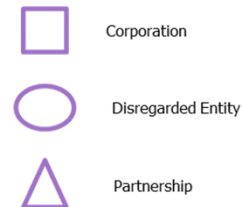


Partial Acquisition – Basic Consequences

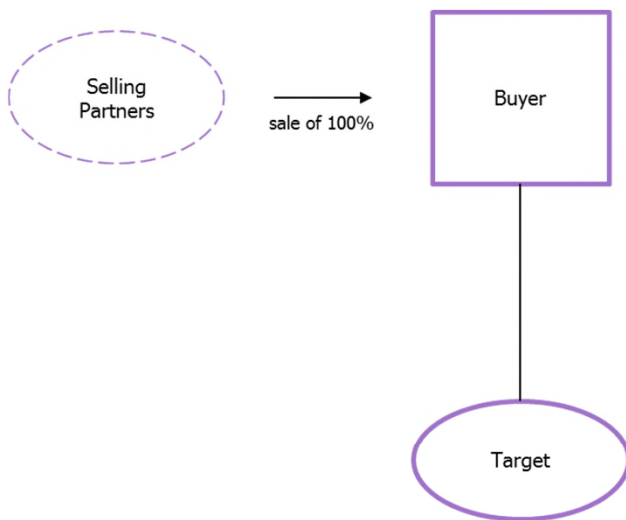


- Target
 - No gain or loss recognized at the Target level
- Selling Partners
 - Recognize gain / loss on sale of partnership interests
 - LTCG / STCG (depends on holding period)
 - Some gain that would otherwise be LTCG may be recharacterized as ordinary income if attributable to "hot assets" held by the Target (e.g., unrealized accounts receivable, inventory items, depreciation recapture)
 - Gain attributable to retained portion is deferred
- Buyer
 - If a Section 754 election is made, buyer can obtain a "special basis adjustment" in its share of Target assets
 - Target income and loss flows through to Buyer

U.S. Federal Income Tax Classification



Complete Acquisition – Basic Consequences



- Target
 - Terminates for tax purposes, which closes tax year
- Selling Partners
 - Recognize gain / loss on sale of partnership interests
 - LTCG / STCG (depends on holding period)
 - Some gain that would otherwise be LTCG may be recharacterized as ordinary income if attributable to "hot assets" held by the Target (e.g., unrealized accounts receivable, inventory items, depreciation recapture)
- Buyer
 - Treated as buying assets
 - Basis step-up without need for Section 754 election
 - Target becomes a disregarded subsidiary of Buyer post-closing

U.S. Federal Income Tax Classification



Corporation



Disregarded Entity

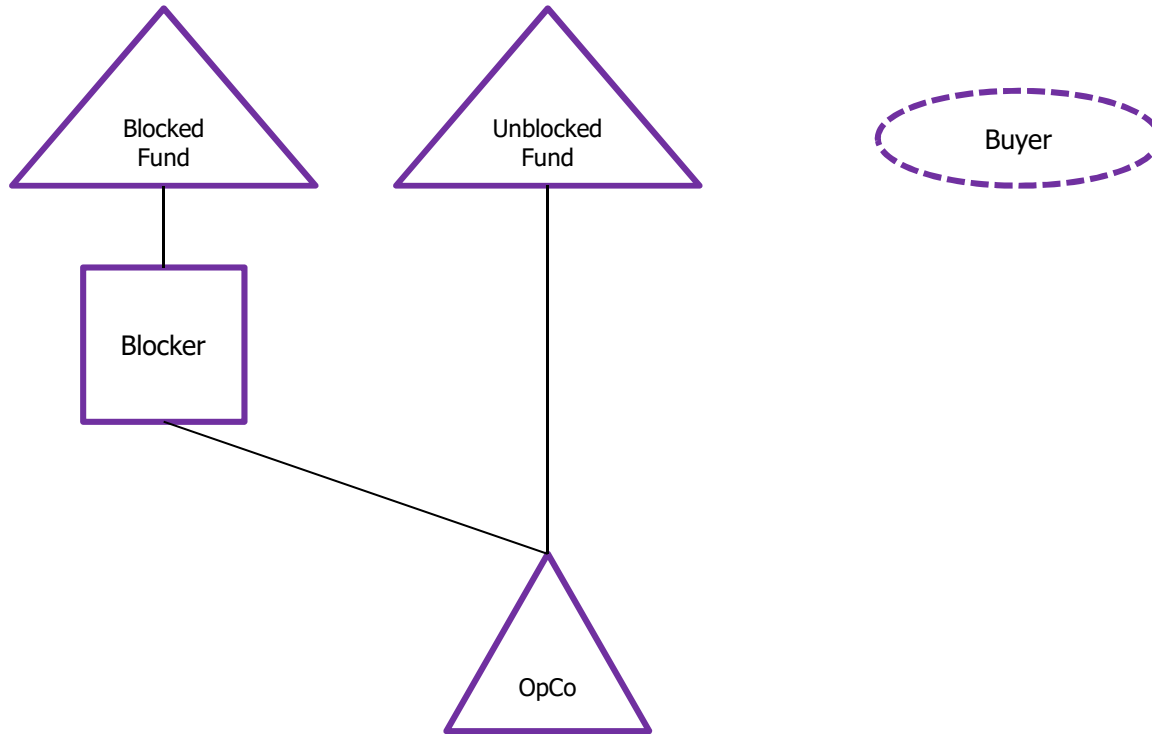


Partnership

The background features a dark blue gradient with dynamic, diagonal light trails. The upper portion is dominated by numerous thin, overlapping lines of red and orange, creating a sense of motion and energy. Below these, there are thicker, more prominent streaks of bright blue and white, which appear to be light trails from a fast-moving object or a digital data stream. The overall effect is one of speed and modern technology.

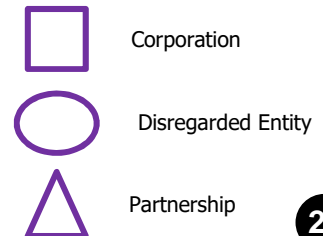
SALE OF A PARTNERSHIP TARGET INVOLVING A BLOCKER

Partnership Target – Partial Blocker Sale

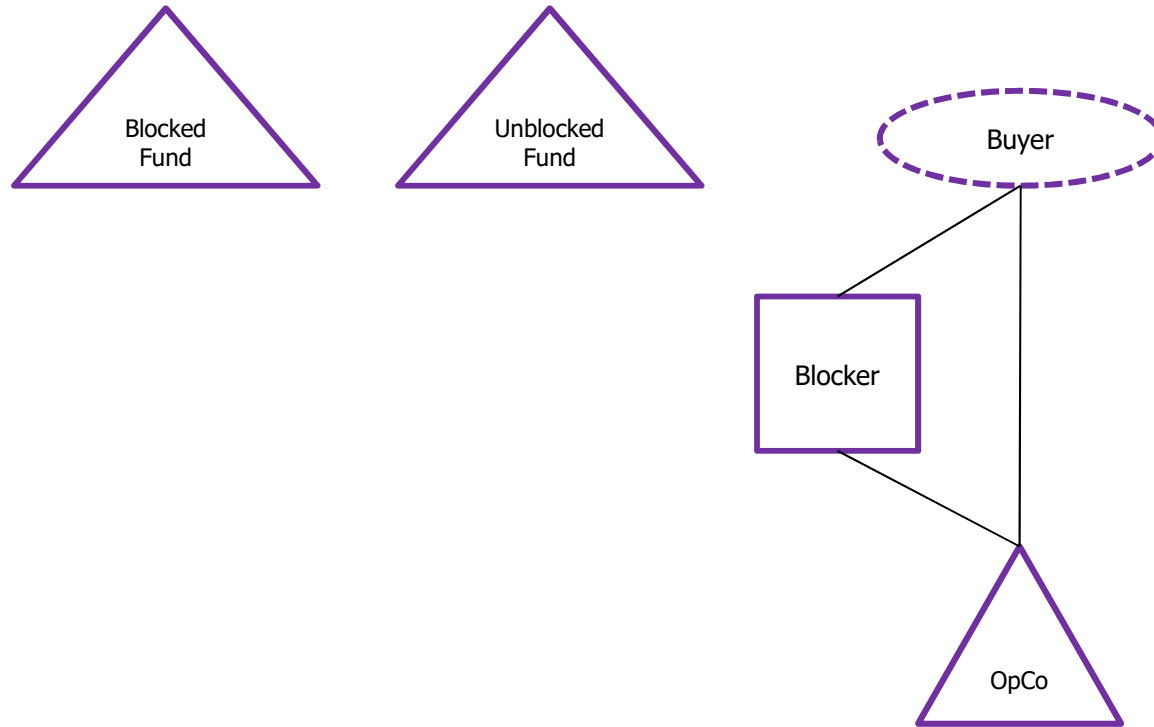


- In private equity and other ownership structures, some owners of partnership operating companies will hold their interests through a corporate “blocker”
- At exit, the owners of the “blocker” will often seek to sell their “blocker” equity, so that there is no taxable gain triggered at the “blocker” level by reason of the “blocker” selling its direct interest in OpCo
 - For investor categories that typically require a “blocker”, the gain from the sale of the “blocker” would not be taxable provided that the “blocker” is not a “United States real property holding corporation” under FIRPTA

U.S. Federal Income Tax Classification

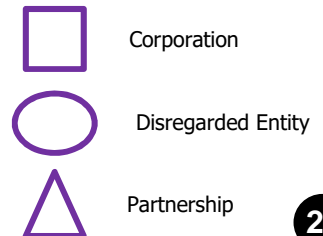


Partnership Target – Partial Blocker Sale



- In this situation, the Buyer would purchase a portion of the OpCo equity directly, and a portion indirectly through the purchase of the “blocker”
- The Buyer will obtain only a partial tax basis step-up at the OpCo level (under Code Section 743(b), with a Section 754 election)
- The sell-side of the transaction must determine how the overall transaction consideration will be shared (taking into account the possibility that the Buyer may pay less because it obtains only a partial tax basis step-up)

U.S. Federal Income Tax Classification



The background features a dynamic, abstract design with numerous light trails in shades of blue and red, creating a sense of motion and energy. The trails are most prominent on the right side, where they appear to converge or radiate from a point, giving the impression of a high-speed environment or a data visualization.

**TAX ASPECTS OF
ACQUISITION AGREEMENTS
/ MARKET TRENDS FOR DEALS
THAT USE REPRESENTATION
AND WARRANTY INSURANCE**

Representations and Warranties

- Major topics
 - Basic tax compliance (returns filed, income taxes paid, no audits, no waivers of statute of limitations, withholding tax compliance, sales tax compliance, etc.)
 - Structural issues (S corporation status, partnership status, no liability under Treasury Regulation Section 1.1502-6, etc.)
 - Post-closing tax position (no accounting method adjustments or settlement agreements that will require income inclusions post-closing, no potential exposure under contractual tax indemnities, etc.)
 - Specialized issues (no recapture of state tax grants, etc.)
- Relationship with indemnity
 - Is there a stand-alone tax indemnity for pre-closing periods, or are breaches of representations the sole basis for indemnification?
 - How are current period taxes addressed?
- Survival period (private deal vs. public deal) and treatment for baskets, thresholds and caps

Representations and Warranties Insurance – Issues and Trends

The use of buy side RWI policies continues to increase in deals involving private companies

- With more market participants, RWI premiums are generally below 3% of coverage limits, and retention/deductible amounts are generally 1% of deal value
- RWI policies typically cover claims for breaches of representations and warranties **and** claims for losses under a stand-alone tax indemnity
 - Tax claims typically survive for 3 or 6 years
 - RWI policies generally excluded from coverage known exposures, current period taxes, loss of tax attributes (e.g., NOLs)
 - RWI policies will often include a synthetic tax indemnity when the underlying transaction documents do not include a stand-alone tax indemnity

Effect of RWI policies on transaction documents

- Sellers are often willing to give broader representations and warranties
 - The use of RWI puts pressure on pre-transaction diligence, including tax diligence
- No survival deals
 - RWI is increasingly replacing seller indemnities such that RWI is the sole source of recovery
 - When a transaction also includes a seller indemnity, it is often linked to the retention amount (1% of deal value) and only in certain instances will sellers be responsible for losses in excess of the retention amount
- RWI can help a buyer's bid in an auction process

Covenants and Indemnities

- Tax matters post-signing and pre-closing
- Post-closing tax covenants and indemnities
 - Indemnification for pre-closing taxes
 - Manner of addressing “straddle periods”
 - Relationship with working capital adjustment
 - Recourse
 - Procedures for controlling tax return filings and refund claims
 - Procedures for controlling tax contests
 - Mechanisms for ensuring payments (e.g., tax escrows)
 - Purchase price allocations (actual or deemed asset deals or Section 754 election deals)
 - Required elections (e.g., 338(h)(10), 336(e), 754)
- Transfer taxes
- Deliveries
 - E.g., FIRPTA certificates, Section 1446(f) certificates, Section 338(h)(10) election forms
- Withholding
- Tax benefit offset to indemnities; indemnification payments as purchase price adjustments

Miscellaneous Issues

- Stock option cash out payments
 - Withholding
 - Information reporting
- Escrows / Earnouts
 - Reporting of earnings on escrow
 - Imputed interest
 - Installment sale reporting / basis recovery
- Post-closing transactions on the closing date (interaction with indemnity / covenant protection)
- Post-closing restructuring

Key Takeaways

- In the domestic taxable M&A setting, there are a variety of transaction structures that can achieve full or partial tax basis step-ups, which are valuable to a Buyer
- Similarly, there are transaction structures that can allow Sellers to receive or retain “rollover” equity on a tax-deferred basis
- The use of entities treated as partnerships for tax purposes (including LLCs treated as partnerships) is becoming increasingly common, especially in the case of private equity owners. Partnerships present both opportunities to maximize value on exit, as well as challenges from an ownership structuring perspective.
 - Tax basis step-ups for future buyers on exit
 - Favorable treatment of partnership “profits interests” for management team
- Representation and warranty insurance has made a significant impact on the manner in which tax indemnification and tax risk allocation is being handled

Biography



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Daniel A. Nelson advises clients on the US and international tax and commercial considerations related to the efficient structuring of transactions and business relationships. He counsels global institutional investors—including investment managers for some of the world’s largest pension funds, sovereign wealth funds, and insurance companies—in connection with investments in real estate, infrastructure projects, and other real assets. Dan also advises sponsors regarding the formation and operation of customized investment platforms, private investment funds, and joint ventures involving pension funds, sovereign wealth funds, insurance companies, and other institutional investors.

Biography



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Casey S. August's practice focuses on US federal tax planning and implementation matters. Representing clients across industries, he advises on structuring and documentation issues for mergers and acquisitions, energy project financings, joint venture collaborations, and intellectual property transfers. Casey also counsels clients on issues involving choice of entity and cross-border structuring and planning, as well as on IRS private letter ruling submissions and securities filings.

Biography



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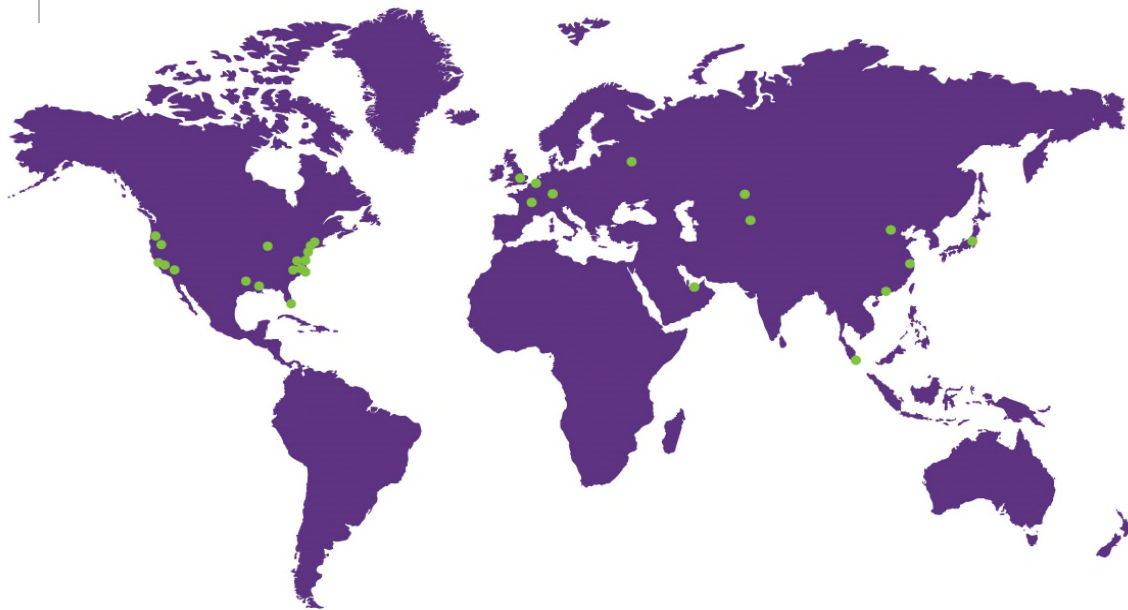
Meghan E. McCarthy focuses her practice on US tax matters and commercial considerations related to the efficient structuring and implementation of transactions and business relationships. She counsels institutional investors, including sovereign wealth funds, in connection with their investments in the private equity sector, including investments in underlying real estate and infrastructure assets. Meghan also advises clients on tax issues that accompany merger and acquisition transactions, capital markets transactions, the formation and operation of joint ventures and closely held operating partnerships, and the formation and operation of private and regulated funds.

Our Global Reach

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Asia Pacific
Europe
Latin America
Middle East
North America

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