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MORGAN LEWIS 2018 M&A ACADEMY PRESENTS:
TAX ISSUES IN M&A TRANSACTIONS

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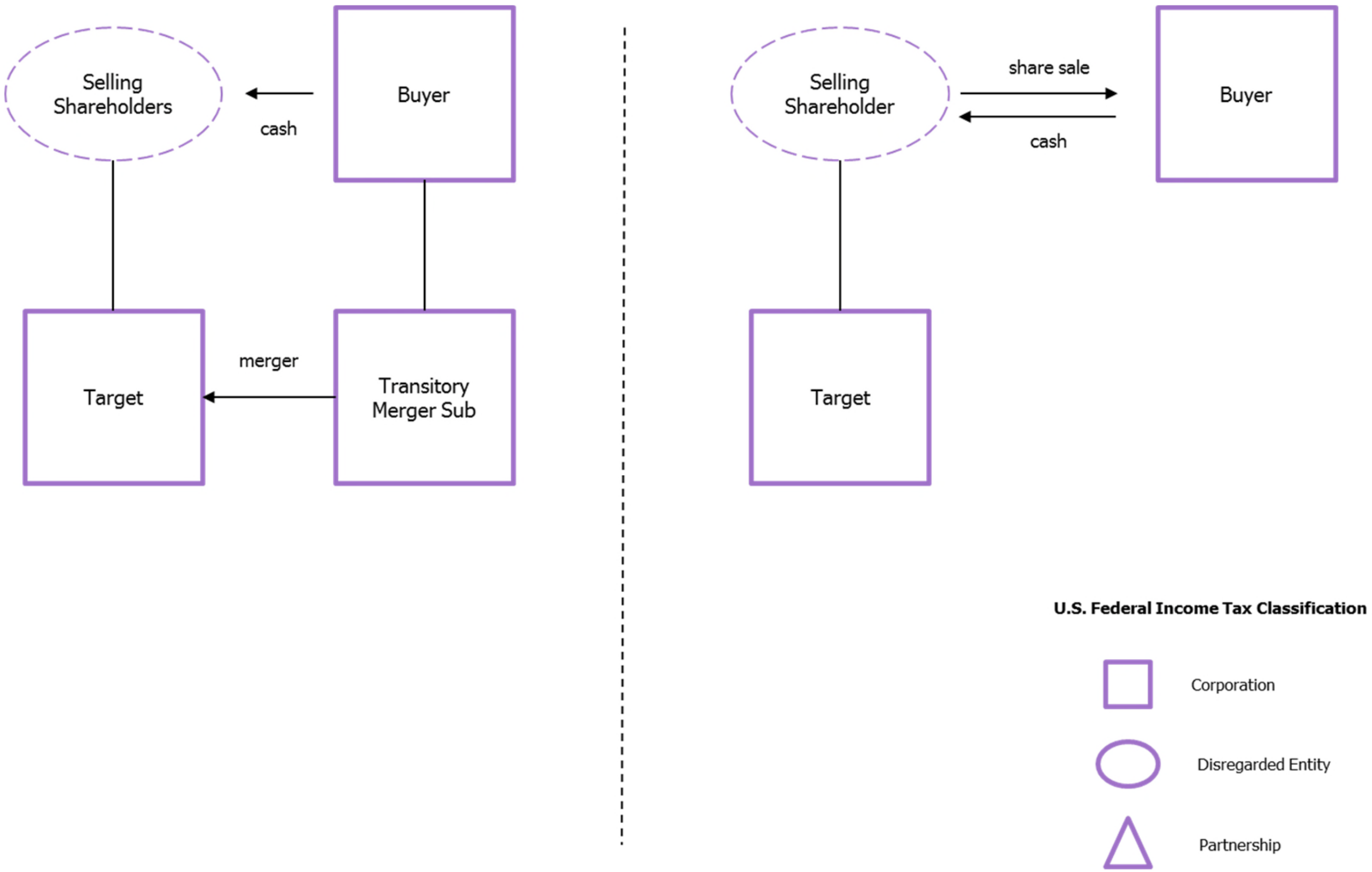
March 6, 2018

Introductory Notes

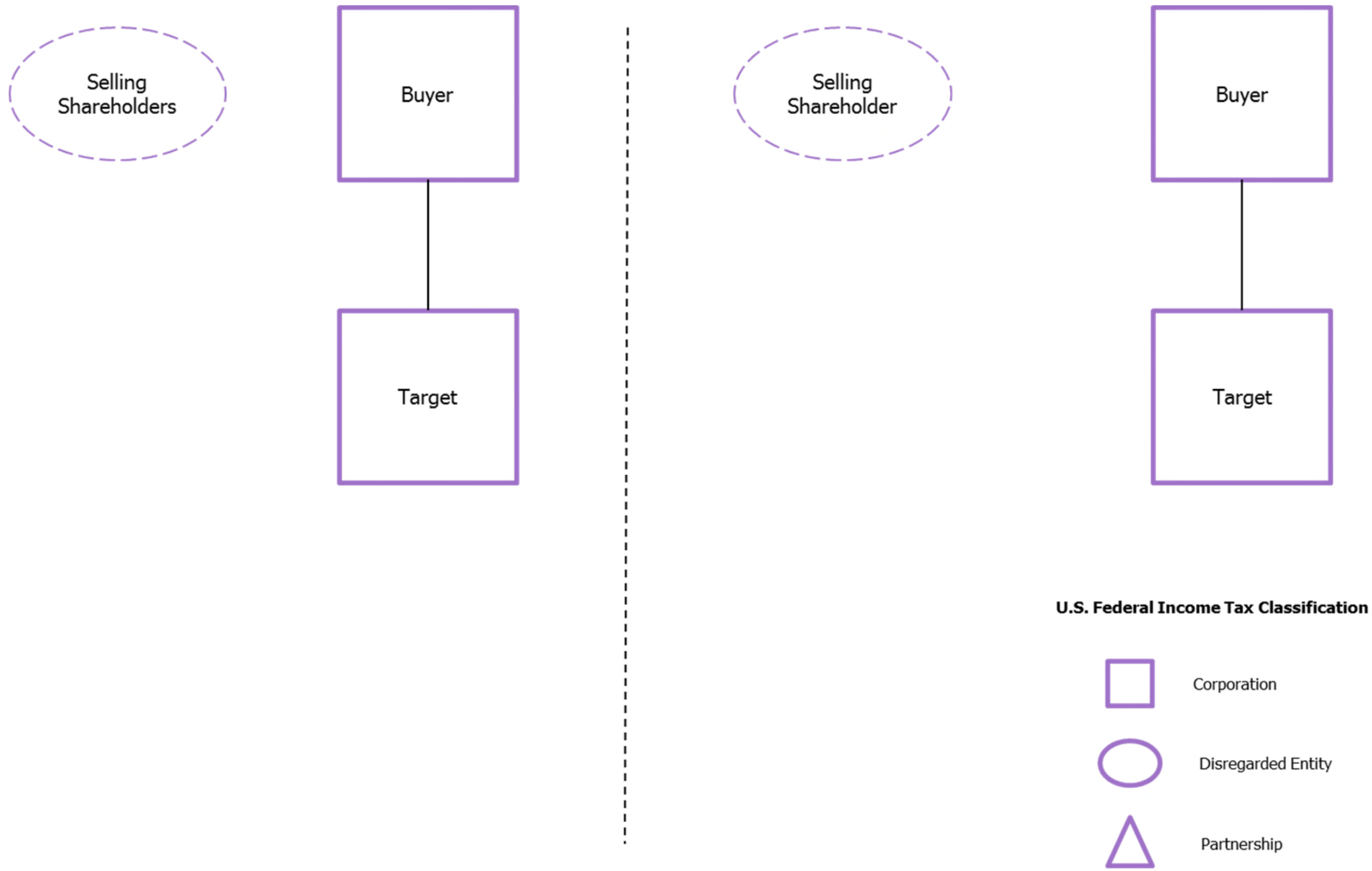
- Focus on domestic transactions
  - Cross-border M&A subject to special rules
- Treatment of non-U.S. selling shareholders differs from treatment of U.S. selling shareholders
- Focus on taxable acquisitions of a target entity treated as a corporation or a tax partnership (as opposed to asset acquisitions)
  - Asset purchases from Target "C corporation" generally unattractive, unless the Target has NOLs
- Note on LLCs in the M&A context
- General observations on impact of tax reform on M&A

TAXABLE TRANSACTIONS – CORPORATE TARGET

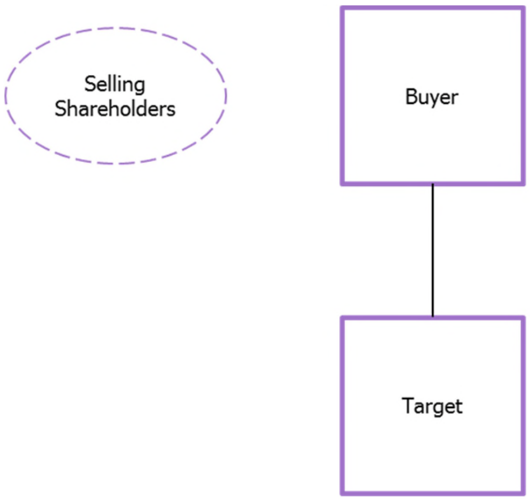
Reverse Cash Merger / Taxable Stock Purchase – Transaction Structure



Reverse Cash Merger / Taxable Stock Purchase – Result

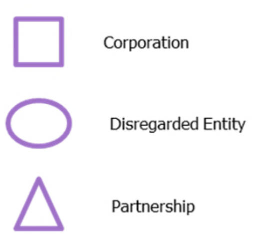


Basic Consequences

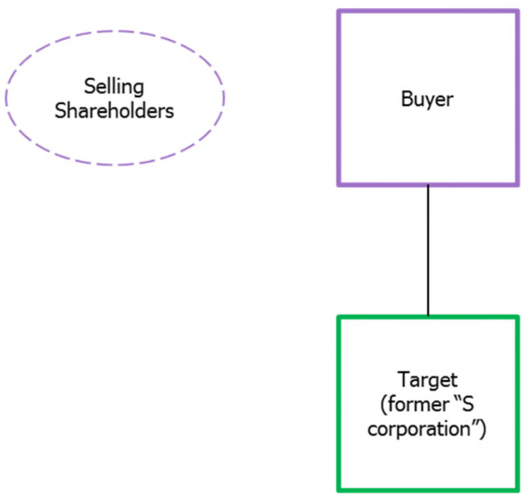


- Selling Shareholders
  - Recognize gain / loss on sale of shares for cash
  - Special issues for non-corporate shareholders
    - LTCG / STCG (depends on holding period and assumes shares are held as capital assets)
    - Potential reduction in rate or rollover of gain under Code Sections 1202 / 1045 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

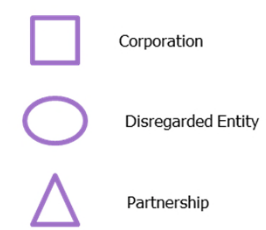


Basic Consequences – "S Corporation" Target w/ Section 338(h)(10) election

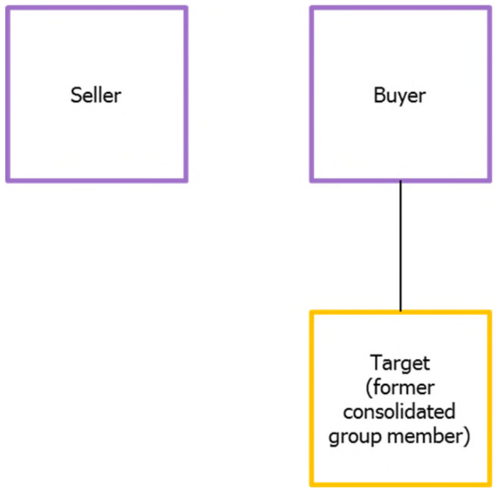


- Target
  - Deemed for tax purposes to sell assets and liquidate
  - Gain or loss recognized at Target level
    - Generally flows through to selling shareholders
    - However, may be Target level consequences (e.g., built-in gain tax, state income tax) – pricing point
- Selling Shareholders
  - Recognize 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

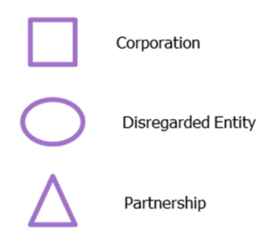


Basic Consequences – Consolidated Group Target w/ Section 338(h)(10) election

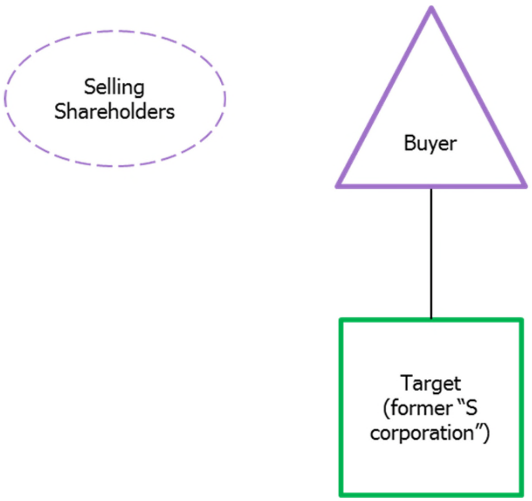


- Target
  - Deemed for tax purposes to sell assets and liquidate
  - Gain or loss recognized at Target level
    - Generally flows through to selling group
    - Target remains liable for group tax liability under Treasury Regulations Section 1.1502-6
    - Tax year ends at the close of business on 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

U.S. Federal Income Tax Classification

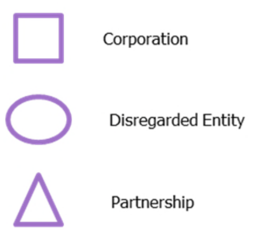


Basic Consequences – "S corporation" Target w/ Section 336(e) election

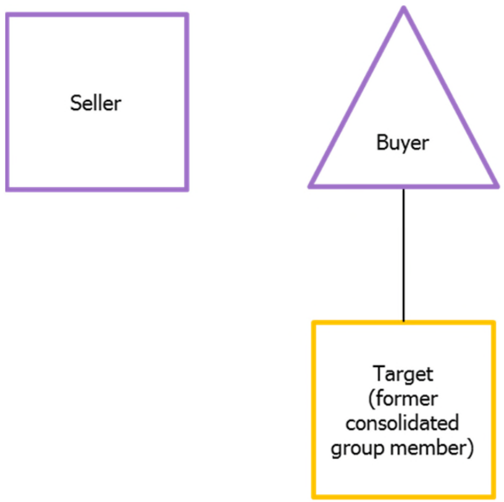


- Same basic consequences as Section 338(h)(10) election
  - Buyer not required to be a corporation
  - Immediately after acquisition, Target can be converted into a tax transparent entity (e.g., a disregarded LLC) if desired (because the Target has a stepped-up basis in its assets)
- Mechanics of the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

U.S. Federal Income Tax Classification

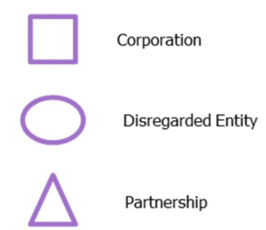


Basic Consequences – Consolidated Group Target w/ Section 336(e) election



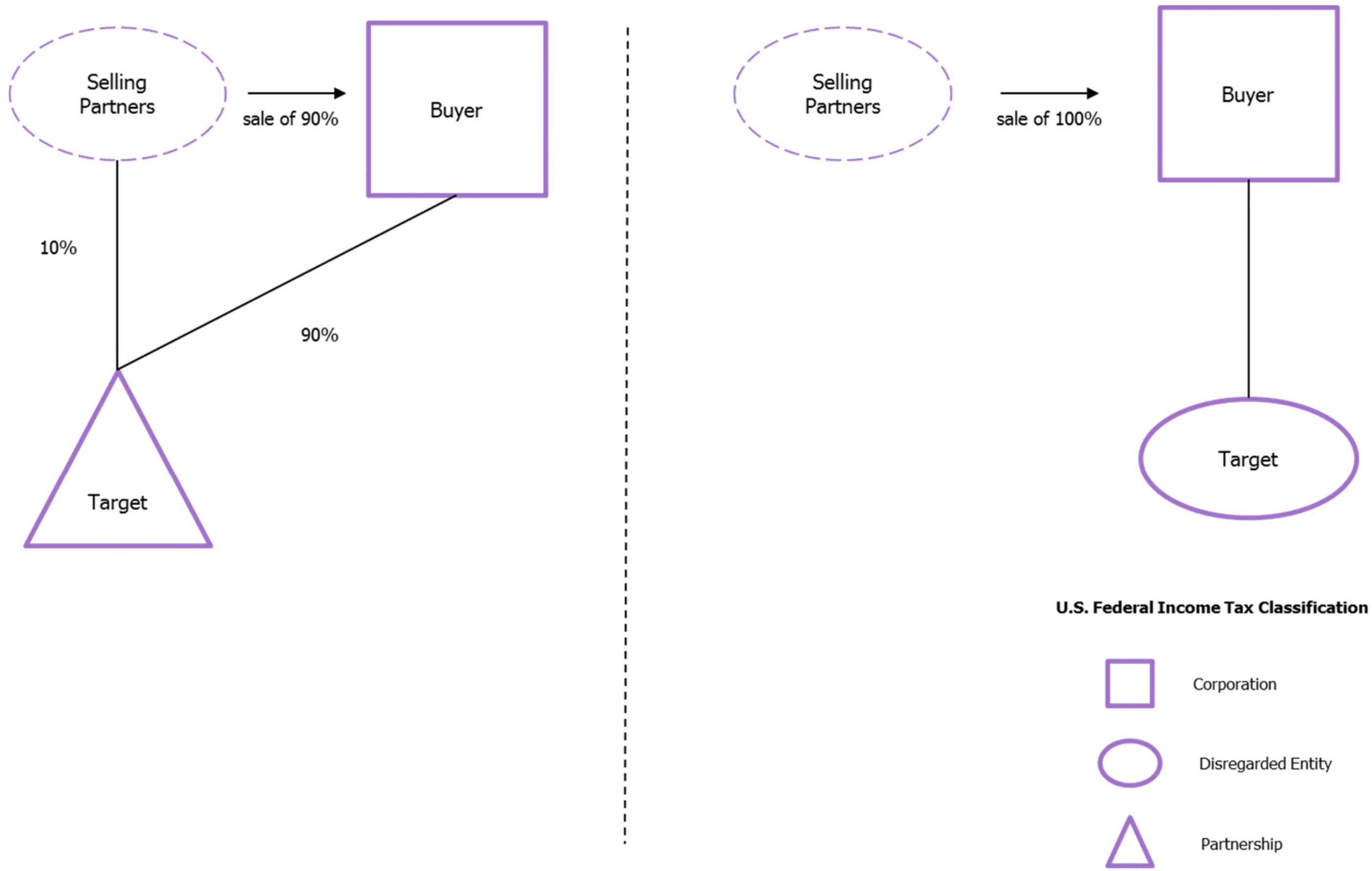
- Same basic consequences as Section 338(h)(10) election
  - Buyer not required to be a corporation
  - Immediately after acquisition, Target can be converted into a tax transparent entity (e.g., a disregarded LLC) if desired (because the Target has a stepped-up basis in its assets)

U.S. Federal Income Tax Classification

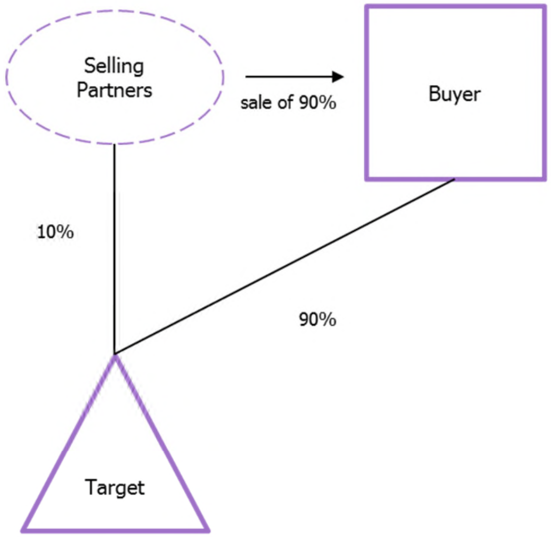


TAXABLE TRANSACTIONS – PARTNERSHIP TARGET

Partnership Target – Partial or Complete Acquisition

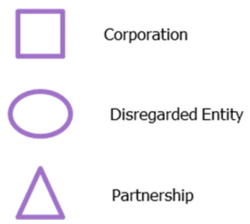


Partial Acquisition – Basic Consequences

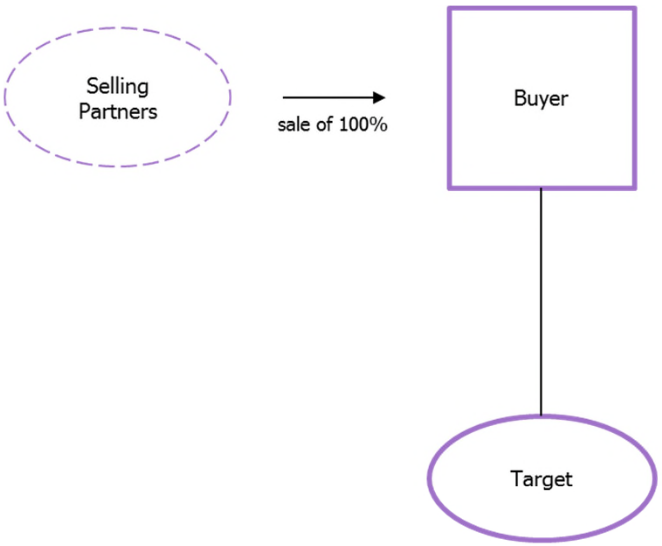


- Target
  - No gain or loss recognized at the Target level
- Selling Partners
  - Recognize gain / loss on sale of partnership interests
  - LTCG / STCG (depends on holding period)
  - Some gain that would otherwise be LTCG may be recharacterized as ordinary income if attributable to "hot assets" held 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

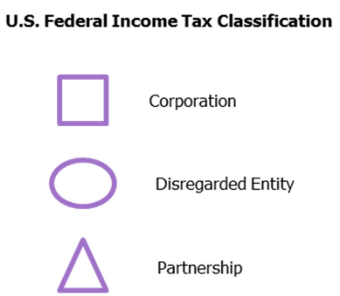
U.S. Federal Income Tax Classification



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



TAX ASPECTS OF ACQUISITION AGREEMENTS

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
- R&W insurance and special tax insurance

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 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

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TAX FREE REORGANIZATIONS

Key Characteristics

- Multiple transaction structures
  - Direct merger
  - Reverse subsidiary merger
  - Forward subsidiary merger
  - Direct stock acquisition
  - Hybrid approaches: double mergers / double drop-down transactions
- Consideration
  - All equity, or a mix of equity and cash
    - Amount of cash permitted will vary, depending on the structure
- Basic consequences
  - No recognition of gain or loss for the corporate parties to the reorganization
  - Shareholder gain or loss deferred, except that shareholder would recognize gain to the extent of "boot" (e.g., cash) received
    - Shareholder holding periods in target stock "tack" onto buyer stock received in the nonrecognition exchange

OVERVIEW OF TAX REFORM IMPACT ON M&A

Overview of Tax Reform Impact on 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
- Deemed repatriation of untaxed foreign earnings

QUESTIONS?

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.

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*Our Beijing office operates as a representative office of Morgan, Lewis & Bockius LLP. In Shanghai, we operate as a branch of Morgan Lewis Consulting (Beijing) Company Limited, and an application to establish a representative office of the firm is pending before the Ministry of Justice. In Hong Kong, Morgan Lewis has filed an application to become a registered foreign law firm and is seeking approval with The Law Society of Hong Kong to associate with Luk & Partners.

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