

Tax Due Diligence in the Mergers and Acquisitions Process

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Agenda

- Overview
- Domestic aspects
- International aspects
- Purchase accounting
- Key negotiation issues
- Trends



Overview | Paradigms and perspectives

- **Types of deals**
 - Taxable vs. non-taxable
 - Stock vs. asset acquisition – incl. “hybrid” deals (stock/asset deals combined)
 - Fusion deals – attributes carry-over
- **Perspectives of the parties**
 - Buyer / Acquirer
 - Goal is to maximize tax benefits and limit costs
 - Asset or similar gives most flexibility
 - Seller
 - If cashing out, stock sales generally most beneficial
 - Tax-free deals are good, but typically require continuing relationship



Overview

Buyer and seller tax focus in M&A

Buyer Considerations

- Representations regarding target attributes and historical filing positions (incl. support documents)
- Springing exposures, and quality of earnings
- Asset, stock basis and E&P studies
- Change-limited attributes (e.g., § 382)
- Ongoing effect of prior year audit adjustments
- Purchase accounting and/or cash flow
- Tax-efficient financing and structure

Seller Considerations

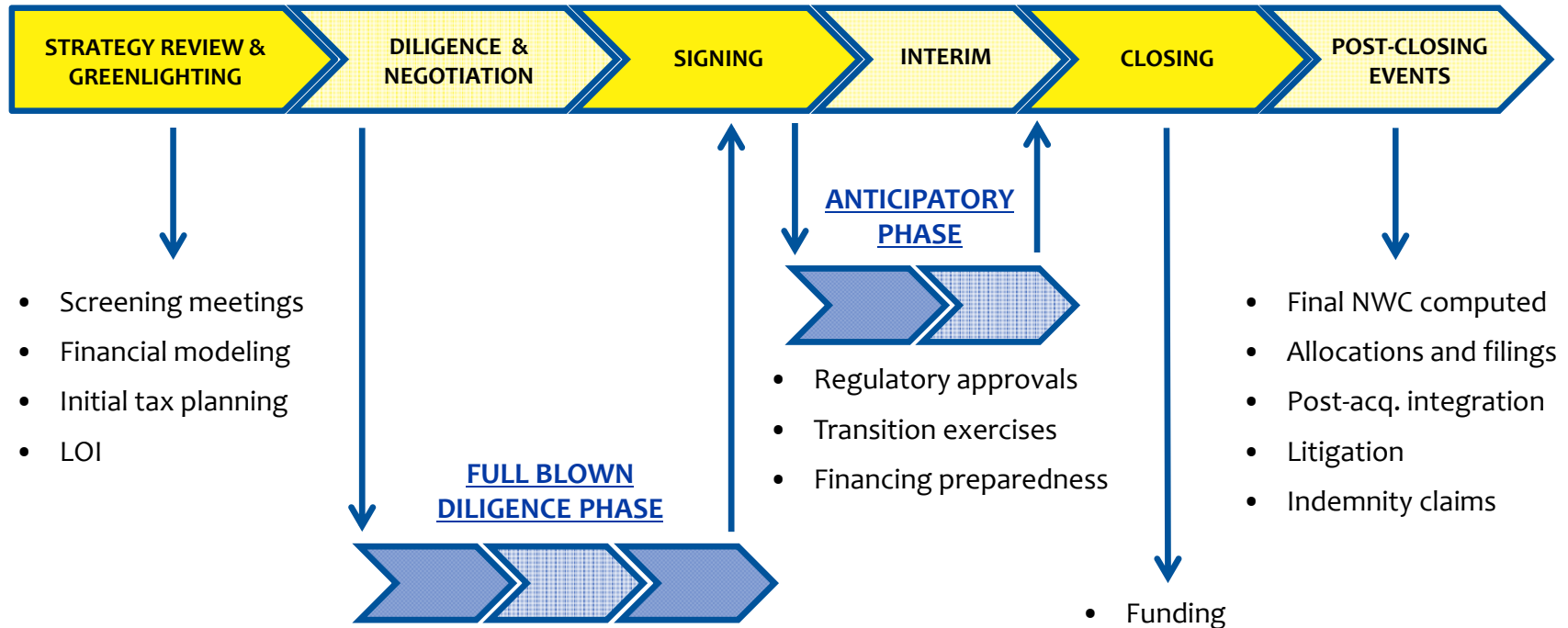
- Providing sufficient information for Buyer's diligence
- Ability to claim and use tax attributes (or obtain value via purchase price)
- Ability to exit particular investment in tax-efficient manner
- Potential for purchase price adjustment for audit adjustments from pre-sale tax years
- Payment on indemnity claims

← Unified Loss Rules →



Overview

Birdseye view of M&A process





Overview | Planning for tax diligence

- **At outset, develop internal plan for tackling deal / diligence**
 - **Deal structure** – assess whether fixed or in flux
 - **Timeframes** – get in with BD and Strategy teams early
 - Avoid tax being afterthought (it will not be if something goes wrong)
 - **Objectives** – known what is (should be) important to internal stakeholders
- **Scope task and guide diligence teams**
 - Identify areas to cover (based on deal profile/timing)
 - Guide as to risk tolerance
 - Identify exposures / successor liability
 - Develop appreciation for tax attributes
 - Focus on industry relevant issues



Overview

Summary of key tax diligence tasks

Diligence procedure

Purpose

Review legal and organizational chart

- Understand the Target's tax structure, and obtain documentation for key elections (e.g., § 338, CTB, etc.)
- Identify where the Target operates jurisdictionally and where its group entities are resident
- Identify special purpose entities and existing tax planning strategies
- Copies of prior tax diligence reports, transactions (e.g., stock purchase agreements) and board minutes

Review 10-K and tax workpapers

- Analyze the effective tax rate to identify variances from expectations
- Analyze current and deferred taxes payable to identify significant differences b/t GAAP and taxable income
- Analyze the tax contingency reserve (provision) to understand management's view of tax exposures
- Review of FIN 48 documentation, analysis of UTPs (incl. former FAS 5 liabilities for non-income taxes)

Review income tax return filings

- Understand historical and prospective implications of tax reporting (e.g., tax accounting methods, special elections, permanent book/tax differences), and assess compliance with tax authority agreements (e.g., PLRs)
- Review appropriateness of tax reporting for historical transactions
- Reconcile tax reporting in GAAP financial statements to tax return reporting, including review of schedule M-3
- Understand Target's SALT / int'l nexus and income allocation / apportionment to ensure that it is reasonable

Review tax examination history

- Review the Target's examination history and supporting documentation for income taxes, non-income taxes (e.g., sales and use, property, payroll) and indirect taxes (e.g., customs, GST/VAT)
- Identify issues raised in historical examinations and assess prospective impact
- Understand current and historic relationship with exam teams

Management and Tax Advisor interviews

- Understand policies and procedures with re to non-income taxes (e.g., sales and use, property, payroll)
- Understand management's risk posture with respect to taxes
- Understand any prior or prospective tax planning



Overview

Initial information request

- **Any initial information request should include:**
 - Legal entity organizational chart
 - For all entities: need to identify jurisdiction of tax residency and US tax classification
 - Copies of all tax returns – all jurisdictions
 - Request for documentation supporting all elections, actg. method changes, credits and claims
 - Supporting schedules and materials for all material items (incl. FTCs, state income tax calcs., etc.)
 - Includes sales and payroll tax returns, withholding/FATCA compliance materials, etc.
 - Accountants' workpapers – provision and tax returns
 - All written analysis / documentation of positions and completed transactions
 - Legal opinions, FIN 48 workpapers, UTP analyses, FAS 5 positions, documents supplied to attest firm
 - All internally-initiated studies (basis, E&P, § 382, transfer pricing, etc.)
 - Materials, analyses and step-plans from prior M&A activities (incl. prior diligence reports, prior deal documents such as SPAs, list of areas of continuing liability, copies of tax sharing agreements, etc.)
 - Controversy / audit files and all correspondence with tax authorities
 - All agreements with tax authorities (e.g., closing agreements, etc.)
 - Filings with any tribunal regarding tax matters (incl. matters in arbitration)



Overview

Overarching things to remember

- **Inheriting risk**

- Asset deals
 - Typically able to leave liabilities behind, but consider bulk sale
- Stock and fusion deals
 - Consolidated return liability (incl. under Treas. reg. § 1.1502-6)
 - Transferee / successor liability (e.g., § 381 transactions), tax sharing agreements
 - Impact of § 338

- **Typical value items**

- NOLs – but change of ownership considerations
- Credits and credit carryforwards
- Deferred deductions
- Booked refunds
- Low ETRs and tax holidays



Domestic | Common US tax exposures

- **Existing § 382 limitations**
 - In many cases, acquisition targets were subject to various rounds of financing; however, ownership changes have not been tracked
- **Intragroup transactions (e.g., DITs, ELAs, etc.)**
- **§ 481, § 108(i) and other large book-to-tax differences**
- **Treatment of deferred revenue**
- **Withholding taxes (e.g., bank debt, distributions)**
- **State nexus**
- **Sales and similar indirect taxes**



Domestic | Common US tax exposures (cont.)

- **Nexus**
 - SALT issues are increasingly important and, in some cases, can constitute a more significant exposure than federal tax liabilities
- **Sales & use tax**
 - Target's compliance with sales and use taxes in the applicable states in which it does business should be reviewed by specialists.
 - Above the line exposures may be considered a quality of earnings issue
- **Employee compensation matters**
 - Golden parachute rules
 - Deferred compensation



International | Generic and foreign tax diligence

- **Transfer pricing**
 - Policies / documentation
 - Dovetailing
- **Permanent establishment**
 - Restructurings / existing structures
 - Mobile workforce
- **Local tax attributes and limitations**
 - NOLs and debt
 - Withholding taxes
 - Tax rulings / holidays
- **Indirect taxes**



International | US specific diligence

- **E&P and FTCs**
- **Post-acquisition planning considerations**
 - Inside / outside basis (local and US)
 - Cash pools
- **Blocked income**
- **Hook stock**
- **If previously foreign-owned**
 - Treaty-based return positions
- **If previously US-owned**
 - General US compliance / documentation
 - Specific attribute profiles (e.g., PTI, OFL)



International | Practical considerations

- **Consider deal and financing impact on present operations**
- **Opportunities for greater benefit?**
 - Foreign cash / other working capital assets
 - Argument for change
 - Local incentives
- **Transition issues**
 - Extracting from prior systems / operations
 - Renewing beneficial items
- **Develop appreciation of local tax environment**
 - Does the local administration have a particular reputation?



Purchase accounting | Diligence considerations

- **General framework and background**
- **Reserves for uncertain tax positions**
 - Mirror Accounting for Tax Indemnifications
 - Subsequent Adjustments
- **Recognition of deferred tax assets / reversal of deferred tax liabilities**
 - Jurisdictional change in control tax rules
 - Cash tax modeling
- **Acquisition / integration structuring**



Negotiation | Process

- **Typically runs in parallel with diligence**
 - LOI
 - Process for signaling findings to deal teams / stakeholders?
- **Posture of deal is key**
 - Public vs. private seller
 - Auction vs. exclusive / no-shop
 - Standard vs. simultaneous sign-and-close
- **Mind other aspects of agreement**
 - Bake-in desired structuring (but remain flexible)
 - How is acquisition price conceptualized?
 - Balance sheet date and bring-down timing
 - Dividend stripping? Other provisions providing value?



Negotiation | Representations & warranties

- **Functions**
 - Confirmatory diligence
 - Termination rights
 - Buyer protection
- **Laundry list**
 - All advisors have list
 - Watch out for duplicative / repetitive
- **Talk it out with counterparty**
- **Qualifiers**
 - Materiality / knowledge
 - Schedules or data room



Negotiation | Covenants

- **Pre-closing**
 - No elections / settlements / changes / etc. without permission
 - In special situations, will take steps...
 - Continued access and cooperation
- **Post-closing**
 - Preparation and filing of returns
 - Payment of taxes (incl. re straddle periods)
 - Joining in elections
 - Steps to fully effectuate separation; continued access / cooperation
 - Handling disputes
 - Consultation rights
 - Consistency



Negotiation | Tax indemnity

- **Inevitably is last thing negotiated**
 - Availability?
- **Seller's responsibility**
 - Pre-closing periods and breaches
 - Taxes of other persons (as successor, by contract or otherwise)
- **Limitations / carve-backs**
 - Usually no baskets / caps
 - Notification requirement
 - Offset with tax benefits
- **Survival period**
 - Should be statute of limitations in most cases



Negotiation | Miscellaneous

- **Control of disputes / refund claims**
 - Typically purchaser controls, subject to seller participation if indemnity
 - Exception perhaps for refund claims relating to indemnified period
- **Withholding taxes on purchase price**
 - Consider *Vodafone*
- **Escrows, earnouts and purchase price adjustments**
 - Consider impact of payments from escrows, earnouts, etc.
 - Characterization of indemnity payments
 - Reporting purchase price adjustments for tax and GAAP purposes



Trends | Working capital strategy

- **Definition of working capital**

- “**Working capital**” = current assets minus current liabilities
- **Adjustments** – purchase price is typically adjusted based on the degree to which WC on the closing date differs from the “target WC” (the amount that was agreed between the parties)
- Important to **consider tax impact** as the language often not drafted by tax professionals and may be written in a way that has unintended tax consequences
- **Interplay** with tax matters section and tax indemnities
- **Options to consider** – because WC is generally a GAAP balance sheet concept, it is important to consider how taxes reflected on the balance sheet are accounted for in the WC adjustment. Some options:
 - Exclude *all* taxes (income, non-income)
 - Include *all* taxes (income, non-income)
 - Exclude only *deferred* income taxes
 - Include only *non-income* taxes
- In any event, **floors and ceilings** on WC should be considered



Trends | Transaction-related deductions

- **Tax benefits for transaction-related deductions**
 - **Generally** – Capitalize amounts paid to facilitate certain transactions:
 - Acquisition of assets constituting a trade or business
 - Acquisition where two parties are related immediately after the transaction
 - Acquisition of an ownership interest of the taxpayer
 - Restructurings, recapitalizations, reorganization of capital structure
 - Transfers described in § 351 or § 721
 - Formation or organization of a disregarded entity
 - Acquisition of capital, borrowing, writing an option, etc.
 - **Bright-line test** for certain acquisitive transactions
 - **Capitalize** any inherently facilitative amount
 - **Capitalize** any amount related to activities performed after the earlier of:
 - The date on which a LOI or exclusivity agreement is executed by representatives of the buyer and the seller; or
 - The date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors



Trends | Transaction-related deductions (cont.)

- **Factors to consider**

- **Target employee items** – cash-out options, change in control payments, bonuses, and plan rollovers
- **Success fees** – Rev. Proc. 2011-29 creates a safe-harbor election for taxpayers seeking to allocate success-based fees between facilitative and non-facilitative amount. Under the safe-harbor, an election is available to treat 70% of all success-based fees incurred as non-facilitative (i.e., deductible) and to treat the remaining 30% as facilitative (i.e., non-deductible and capitalized)
- **Target reporting of deductions** – consider AM-2012-010, addressing the “end-of-the-day rule” and the “next-day rule” of Treas. reg. § 1.1502-76(b) in determining when a target corporation should report certain deduction items with respect to liabilities incurred on the day it joins or leaves a consolidated group

- **Key questions**

- Who gets the benefit for transaction-related deductions?
- When is the benefit realized?
- How is the benefit determined?
- Interplay with escrow agreement and WC definition?



Trends | Other

- **Other recent negotiation trends**
 - Unified loss rule elections
 - Purchase price allocations in asset (or deemed asset) deals
 - Tax receivable agreements



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Thank you...

Questions?



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