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 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

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Overview | Birdseye view of M&A process

- Screening meetings
- Financial modeling
- Initial tax planning
- LOI

- Review target data
- Interview target personnel
- Further tax planning and deal / document negotiation (diligence findings are key)
- Signing of definitives

- Regulatory approvals
- Transition exercises
- Financing preparedness

- Funding

- Final NWC computed
- Allocations and filings
- Post-acq. integration
- Litigation
- Indemnity claims
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

### Diligence procedure

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<th>Review legal and organizational chart</th>
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<td>Review 10-K and tax workpapers</td>
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<td>Review income tax return filings</td>
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<td>Review tax examination history</td>
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<td>Management and Tax Advisor interviews</td>
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### Purpose

- 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
- 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)
- 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 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
- 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
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
• **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?
Other recent negotiation trends

- Unified loss rule elections
- Purchase price allocations in asset (or deemed asset) deals
- Tax receivable agreements
Thank you...

Questions?
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