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WHAT'S TAX HAVE TO DO WITH IT?

THE TAX ADVISORY ROLE IN BUY-SIDE TRANSACTIONS

As a strategic buyer, there can be a multitude of complexities you can run across when evaluating a target company for acquisition, which is why the due diligence process is so important. And while tax considerations play a significant role in most transactions, tax due diligence is often overlooked in the due diligence process. That can be a costly mistake. Tax advice on a buy-side transaction serves three primary purposes in that it: 1) reduces unexpected costs; 2) enhances savings; and 3) improves the value of the transaction. Below are some of the key areas for tax diligence that could impact a buy-side transaction.

Tax Differences of Asset and Stock Acquisitions

In an asset acquisition, the tax basis a buyer obtains in the target's assets equals the cash purchase price, plus the target liabilities assumed and certain transaction costs paid by the purchaser. Often, the purchaser obtains a step-up in the tax basis of the target assets. Accelerated tax depreciation may be claimed on fixed assets such as equipment and fixtures. The step-up may produce a tax basis in intangibles and goodwill which often is amortizable straight line over fifteen years.

In a stock acquisition, the purchaser typically obtains tax basis in the target stock equal to what was paid for it. The tax basis of the assets remain unchanged so the purchaser does not obtain the benefits of the additional depreciation or amortization deductions from a step-up of the company assets as with a purchase of assets. In some cases, an election may be made to treat a stock purchase as if it were an asset transaction to obtain the favorable step-up results for the purchaser.

If the seller is willing to receive a substantial amount of acquirer stock rather than cash, a transaction may be designed to be tax-deferred for the sellers in whole or in part rather than all taxable. For example, tax deferred treatment may be achieved for the seller if the acquirer agrees the target is to continue and at least 80% of the consideration is voting stock of the acquirer, assuming other important requirements are satisfied. As with a stock acquisition, the tax basis of the assets inside the target would remain unchanged for the purchaser.

Tax Diligence Goals and Benefits

Tax due diligence is designed to identify historic tax liabilities of a target that may be inherited by the purchaser. These tax liabilities generally accompany the target if its stock is acquired. Tax exposures not recorded on the target company balance sheet may result in an adjustment to purchase price, a holdback, or tax representations and indemnifications in the transaction agreement. It is possible the due diligence findings may be so significant they affect the transaction structure or in some cases may actually kill the deal.

Tax due diligence provides buyers with a snap shot of the tax costs and latent exposures inherent in the operations of the target company. Further, it provides a better understanding of how to: 1) address and provide for potential exposures identified during due diligence; 2) take reasonable steps to manage those exposures after the transaction, as necessary; and 3) potentially utilize the tax attributes of the target.

Successor Liabilities in Asset Deals

Even in asset transfers, transferee liability may be asserted by tax authorities on a purchaser for the unpaid taxes of the target company. An inquiry should be made into the tax rules of each state in which a transfer of assets is to take place. Some states require the purchaser to provide advance notification to the state tax authorities of an impending acquisition. If the purchaser does not provide the required notice, the purchaser may be liable for the tax. At the state tax level, an employer required to withhold and remit employment taxes may need to provide a tax clearance certificate to the purchaser prior to the sale. A purchaser may be required to withhold from purchase price the unpaid taxes unless it receives the certificate. A purchaser that does not withhold may become liable for payment of the taxes.

Tax Considerations for Transaction Documentation

The proposed transaction agreement should be read for tax implications. Key tax provisions include:

- Tax representations.
- A comprehensive definition of taxes to protect an acquirer from unknown tax exposures.
- If and how tax items are included in working capital adjustments.
- An estimate of indemnifiable tax amounts, with the difficulty of quantifying tax-effected or benefit amounts.
- Floors, collars, baskets and caps related to indemnifiable tax amounts.
- Escrows in part related to taxes.
- Period of time for indemnification and escrows related to taxes based on statutes of limitations, which may be longer than a general indemnity.
- Post-closing preparation and filing of target tax returns.
- Handling of disputes and examinations relating to pre-closing periods.
- Responsibility for or sharing of the payment of transfer taxes.
- Allocation of tax benefit items such as property tax allocations between pre-closing and post-closing periods.
- Tax purchase price allocation.
- Terms of employment agreements and covenants not to compete.
- Disclosure schedules covering exceptions from tax representations and indemnities.

Transfer Tax Minimization

Many tax jurisdictions impose taxes on the sale or transfer of assets. A sales tax may apply to a sale of tangible personal property, other than inventory held for resale. Many states and localities impose transfer taxes on the conveyance of real property located in their jurisdictions. These taxes are imposed either on the amount paid for the property or on the value of the property at the time of transfer. These taxes generally do not apply to stock sales in which legal title to the property of the target does not change. Since real estate transfer taxes usually are imposed on direct transfers of real estate, transfers of equity interests of entities that own the real property generally are not subject to tax. Nevertheless, some states tax transfers of entities that own real estate, such as New York.

Tax Attribute Maximization

Stock acquisitions may preserve the tax attributes of a target corporation, such as its NOL and tax credit carryforwards. An acquirer may be interested in their value. Tax attributes may be considered to be an asset in that they may offset future taxes. Without analysis, a purchaser could make some incorrect assumptions as to the value of the tax attributes. This analysis is a matter for tax due diligence, tax planning and tax modelling.

A contemplated transaction involving a target corporation could have an impact on the preservation and use of the attributes. Change of ownership rules may operate to limit the use of NOL and tax credit carry forwards. These apply as a corporation undergoes a greater than 50% change in its stock ownership over a moving three-year look-back period as tested with each shift in ownership. An annual limitation on the use of tax attributes against taxable income is imposed based on the value of the stock of the corporation before the ownership change multiplied by a long-term tax exempt rate published monthly by the IRS. The stock value is subject to adjustments for tax purposes. Often the annual limitation used to offset future taxable income is lower than expected. Opportunities exist to increase this annual limitation under certain circumstances.

Other limitations may apply to NOL carry backs. Also, certain states may be more restrictive as to tax attribute preservation and utilization. For example, some states provide for a shorter carry forward period. Others do not permit NOL carry forwards of a merged target to survive a transaction.

Importance of Tax Purchase Price Allocation and Transaction Cost Analysis

For income tax purposes, purchase price is allocated to asset classes in a descending order to the extent of the value of the assets in each asset class. Goodwill is the last class under a residual method. The seller and the acquirer should agree on the allocation principles. A schedule should be attached to the transaction agreement to outline and clarify the approach. Transaction expenses should be reviewed to determine if the costs can be deducted, amortized or only capitalized for income tax purposes. For certain qualifying success-based fees, a taxpayer may elect to treat 70% of the amount of the fees as deductible in facilitating a transaction, and capitalize the remaining 30% as not facilitating the transaction.

So, What Does a Tax Analysis Have to Do with Your Transaction?

A complete tax analysis should be undertaken early on in the deal process to address the advantages and disadvantages of acquiring stock or assets of the target. There are several components of tax due diligence to be performed related to potential tax exposures of the target. Due to successor liability principles, tax diligence should be performed whether or not the transaction is a stock deal or an asset deal. In a stock acquisition, the quality and quantity of target tax attributes should be identified.

Finally, the potential impact of transfer taxes should be assessed for discussion with the seller. Estimating and obtaining tax benefits from a purchase price allocation and a transaction cost analysis are other ways for a tax analysis to add value. Tax advisors should be actively involved in the drafting of deal documents providing guidance to ensure the optimal structure is achieved and tax risks are appropriately minimized. In addition, tax advisors should continue their involvement after the transaction closes to ensure actions identified during the due diligence process to minimize tax exposures are taken as required.