

Negotiating the Tax Provisions of Acquisition (Disposition) Agreements

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Role Of Various Professionals In The Negotiation Of The Agreement

- Outside legal advisor
 - M&A Attorney
 - Tax Attorney
- In-house professionals
 - Corporate General Counsel
 - Tax department Legal Counsel
 - Senior Vice President of “Deals”

Has this ever happened to you??

- “Read the tax section and give me your thoughts.”
- “Please review Section 1.05 of Article 7 and the Tax Section, Article 9”

**THERE IS NO “TAX”
SECTION**

There is No Tax Section

- True, portions of the contract will explicitly address various tax matters
- But almost any provision in the document can have significant financial impact stemming from taxation

POTENTIAL TAX ISSUES PERMEATE THE CONTRACT

- Line 1 on Page 1
 - Date contract is executed
 - Identity of Selling and Purchasing parties
- Closing Date
- Definitions
- Warranties and Indemnities
- “Peg” Balance Sheet mechanism
- Governing law provision

Negotiating the Contract

Always advantageous to prepare the first draft of the contract

- Generally, the Buyer prepares the first draft
- Seller should present draft contract with solicitation of offer whenever possible

Negotiating the Contract

- Never use final contract from another deal as first draft (final contract always represents a compromise)
- Always Start With a Pro Buyer or Pro Seller Draft

Building Tax Planning into the Contract

- Purchase price allocation
 - Inventory at Net Realizable Value
- Structure of the Purchase
- Buyer's Pre-transaction behavior

Structuring Conclusions

- Where to put T's business?
- Single or multiple purchasers?
 - Foreign / state tax planning

Managing Target's Behavior Prior to Closing

- Stock option exercises
- Payment of bonuses
- Timing of significant interest deductions
- Distributions and Prepayments from Foreign Subsidiaries

Financial Accounting Issues

- Role of PEG balance sheet
- Impact on deferred taxes
- Stock purchase v. asset purchase

Reps, Warranties and Indemnities

General Issues

- Survive closing
- Absolutely correct or materially correct
- Knowledge of the Company
- Minimums and Baskets
 - Separate basket for tax liabilities

Representations and Warranties

- Representations – statements about the parties and their businesses
 - Mechanism for abandoning transaction if undesirable facts emerge
- Warranties – statement of facts that the parties stand behind
 - Enable Buyer to find out important facts about Target
 - Mechanism for indemnification for a resulting loss if reps and warranties are inaccurate

Representations and Warranties

Knowledge

- Buyer will want representations to be absolute while Seller will want representations limited to Seller's knowledge
- Whose knowledge matters

Tax Reps and Warranties

- All returns have been filed
 - Buyer should push for word “timely”
 - Extensions to file should be allowed
 - Should be disclosed
 - Buyer’s diligence should probe deeply into states in which Target does not file

Tax Reps and Warranties

- Payment of taxes
 - All taxes have been paid v. taxes shown on return
- Accuracy of returns
 - Returns are correct and complete v. correct and complete in all material respects
- Tax audits
 - Audits completed through a specific year
 - Disclosure of issues raised that remain unresolved
 - Disclosure of statute of limitations extensions

Tax Reps and Warranties

- Consolidated and combined returns
 - Buyer will want Seller to disclose all consolidated and combined returns in any jurisdiction that can give rise to liability for taxes of other corporations
 - Disclosure of all tax sharing agreements
- Target not a USRPHC
- Tax-free reorganization representations

Definition of Taxes

- Taxes should be defined in the agreement
 - Buyer will want broad definition
 - Income, property, sales & use, payroll, foreign, excise and other
 - Definition should be broad enough such that based of tax is irrelevant (whether they be income or capital)

Tax Indemnification Provisions

- Indemnification for breaches of representations and warranties
- Basket avoids indemnification until total exceeds a certain amount. Amount is usually negotiated.
- Amount is to be paid could be the entire basket or the excess over the specified amount
- Tax indemnifications may fall outside of the basket for other indemnifications

Tax Issues Should Have A Separate Deadline

- Deadline for indemnification
 - Contract normally provides for cut-off of time
 - Cut-off point for taxes and tax related claims should be the applicable statutes of limitations. This is often later than the cut-off time for other indemnifications
 - Consider statute extensions
 - Tax issues should have a separate deadline

Indemnity of Tax Exposures

- Limited availability of time and resources for tax due diligence can never equal full blown IRS audit with a multi-member IRS audit team, 18 month timeframe and subpoena power as well as multiple potential audits of state exposures
- Indemnity not available with purchase of public company
- Potential joint and several liability issues when purchasing private companies
- Complexities of calculating the indemnified amount

Indemnity of Tax Exposure Beneficial To Both Sides

- Avoids reduction of purchase price offered because of fear of unknown tax issues (principle applies to any potentially large contingency)
- Facilitates manageable tax due diligence process

Indemnification of Tax Exposures

Key Issues

- Potential road map for IRS auditor
- Indemnifying party should maintain control of audit
- Appropriate indemnity payment
 - Repairs v. capital

Indemnification of Tax Exposures

Potential leverage for the purchaser

Tax Audit & Litigation

- Seller should maintain control
 - Seller should have the right to conduct and control proceedings (e.g., the IRS) when a third party asserts a claim against a Buyer that could give rise to an obligation the Seller would be required to pay (reimburse the Buyer)
 - Seller is the real party-in-interest
 - Seller should bear the expense of defense
 - The Buyer may want some involvement – appropriately so

Tax Treatment of Indemnity Payment

Sale of Shares

- Indemnity payment by Seller is an adjustment to purchase price
 - Deducted as capital loss pursuant to Arrowsmith doctrine
- Purchaser reduces tax basis of acquired shares

Arrowsmith Doctrine

- Relation back to original transaction
- Adjustment of purchase price
- Contribution to capital

Tax Treatment of Indemnity Payment

Asset Transactions

- Direct sale of assets or Section 338(h)(10)
- Seller reduces proceeds
 - Character of deduction determined under Arrowsmith doctrine and application of IRC 1060
- Buyer reduces basis of acquired assets in accordance with IRC 1060

Tax Treatment of Indemnity Payment

- Buyer receives deduction (or asset basis) for expenditure resulting in indemnity payment
- Revenue Ruling 84-68
 - Expenses of one entity paid by another entity

Tax Treatment of Indemnity Payment

Tax Free Reorganizations (cont'd)

- Potential fatal impact on “B” reorg if Buyer makes subsequent indemnity payment to Seller – use 368(a)(1)(E) instead of “B” reorg structure
- Potential impact on non-stock consideration in “A” mergers
- Payments from Seller to Target do not have significant impact on Target but Seller would increase basis in shares received in the transaction

Dealing with Carry Back of Tax Attributes Generated by the Buyer

- Post-transaction Net Operating Losses and excess Foreign Tax Credits generated by a former member of a consolidated group (on a separate company basis) can be carried back into the pre-transaction consolidated return of the Seller
- Currently, Net Operating Losses are carried back to the two previous years and can be carried forward for up to 20 years (IRC Section 172(b))
 - However, certain specified liability losses can be carried back for ten years

Dealing with Carry Backs

- In recent years, Congress has permitted limited expansion of the carry back rules for periods of four to five years
- There are also special rules for farming losses and qualified disaster losses with potential increased carry back periods
- Taxpayer may waive the right to carry back NOLs pursuant to Section 172(b)(3) provided the election is made on a timely-filed return

Dealing with Carry Backs

- Currently, excess Foreign Tax Credits can be carried back one year and carried forward for up to ten years (IRC Section 904(c))
- Unlike NOLs, the one year carry back of Foreign Tax Credits is mandatory
- Capital losses can be carried back for three years and carried forward for five years (IRC Section 1212) – Carryback is mandatory

Post-Transaction Carry Backs

- A post-transaction carry back from a former subsidiary can be disruptive to the consolidated return
- Seller's optimum provision: Any refunds resulting from carry backs into a pre-acquisition year remain the property of the Seller
- Buyer's optimum provision: All refunds resulting from carry backs from the Target shall be paid immediately to the Buyer upon receipt

Post-Transaction Carry Backs

- Compromise provision: Buyer shall receive refunds resulting from carry backs net of adverse impact on the Seller's tax position
- See PLR 200518014
- Also see Prusiecki, "Brilliant Advocacy or Very Good Luck," Tax Notes Today, June 28, 2005

Often Overlooked Issue

Should seller indemnify buyer's
pre-tax or after-tax expense?

Calculating the Appropriate Amount of Indemnity Payments

- Many Purchase and Sale Agreements and Tax Separation Agreements are silent on the tax impact of indemnified losses
- Many others contain only broad language
 - “The amount of any Loss shall be reduced ... to take into account any net tax benefit arising from the recognition of the Loss ...
- Very few agreements contain detailed language and examples to address the issues that may arise

Calculating the Appropriate Amount of Indemnity Payments

Examples of pre-transaction tax exposures

- Target failed to pay state income tax in various states in which it had nexus but did not file returns
- Target deducted significant repair expenses which IRS later determined to be capital in nature and increased Target's basis in an office building
- Target erroneously deducted supply expense twice

Calculating the Appropriate Amount of Indemnity Payments

- In all three situations, Target could be entitled to an indemnification payment from Seller
- In the first situation, Target will receive an immediate tax deduction for the state taxes paid
 - There may be non-deductible penalties as well
- In the second situation, Target will recover the tax deficiency over the remaining useful life of the building
- Situation three, no Target tax benefit resulting from the payment

Calculating the Appropriate Amount of Indemnity Payments

- A full pre-tax indemnity would clearly give Target a windfall in situation 1 and a lesser windfall in situation 2
- A sophisticated indemnification clause would distinguish situation 1 and situation 2 by taking time value of money into account

Indemnification of Non-Tax Liabilities

- Environmental clean up
- Product liability
- Employee issues

In many cases, payment of liabilities of this nature will result in an immediate tax deduction for the indemnified party (stock purchase) with loss of basis in Target shares or loss of basis in amortizable Goodwill (asset purchase)

Tax Effected Indemnity

Determining Value of Buyer's
offsetting tax benefit when
determining after-tax indemnity
payment

Potential offset of Seller's tax benefit
of paying indemnity

Impact of Indemnified Party's Tax Situation

Compensating indemnified losses on an after-tax basis assumes that the indemnified party is able to fully utilize any tax deductions taken into account in determining the indemnity payment

Impact of Indemnified Party's Tax Situation

However, buyer may not be able to fully utilize the offsetting tax benefit of incurring the indemnified expense currently or at all

- Lack of sufficient taxable income
- Offset of foreign source income
- Offset of Foreign Tax Credit utilization
- Interference of capital loss carry forward
- Preventing utilization of future carry backs?

Determining the Tax Benefit of the Indemnified Party

- Indemnified losses will have potential multiple impacts on the indemnified party's tax position
- Losses could reduce Foreign Tax Credit utilization or offset capital gain income preventing carry back of future capital losses
- Sophisticated provisions address displacement of otherwise utilized attributes

Indemnity of Foreign Tax Exposures

- Direct tax imposed on U.S. taxpayer (Section 901)
 - Redetermination of foreign tax is reflected in the year to which the original tax relates
 - De minimis exception for redeterminations based solely on currency fluctuations and
 - Less than \$10,000 or less than 2% of the tax initially accrued
 - Impact reflected on Seller's pre-transaction returns

Foreign Tax Exposures

- Redetermination of indirect foreign taxes (Section 902)
 - Generally adjustments do not impact deemed paid credits stemming from distributions in previous years but are simply reflected in the tax pool and Earnings and Profits pools of the company (>10% exception)
 - Impact reflected only in post-transaction distributions

Other Tax Issues

- Sale or spinoff of a subsidiary when consolidated group has FTC and/or NOL carryovers—Regs 1.1502-21 and -79(d)
- Buyer's windfall – stock options
- Cost of planning to utilize attributes displaced by indemnified loss
- Special provisions for purchase of an S Corporation

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