

Corporate Mergers and Acquisitions: Asset and Quasi Asset Acquisition Considerations and Rep and Warranty Update

Tax Executives Institute, Inc. New Jersey Chapter's February Full Day Seminar

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- ▶ Focuses his practice on domestic and international tax and private equity matters
- ▶ Handles a broad range of transactions, including asset, stock, cross-border and domestic acquisitions, recapitalizations and reorganizations
- ▶ Experienced in, and a significant portion of his practice is devoted to, the structuring of domestic and international transactions and is involved in the formation of private equity and hedge funds
- ▶ Regularly speaks and writes on tax topics.



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- ▶ Focuses practice on federal and international income tax, with a focus on the private equity arena and pass-throughs
- ▶ Represents clients in domestic and cross border M&A, fund formation and structuring, reorganizations and partnership agreements
- ▶ Chair of the Young Lawyers Forum of the Tax Section of the American Bar Association and a frequent speaker on a variety of transactional tax matters
- ▶ Named a Rising Star in Pennsylvania for tax law
- ▶ Resident in the Philadelphia office



Part I

- ▶ Asset versus Stock Deals
- ▶ Quasi Asset Deals

Buyer's Perspective

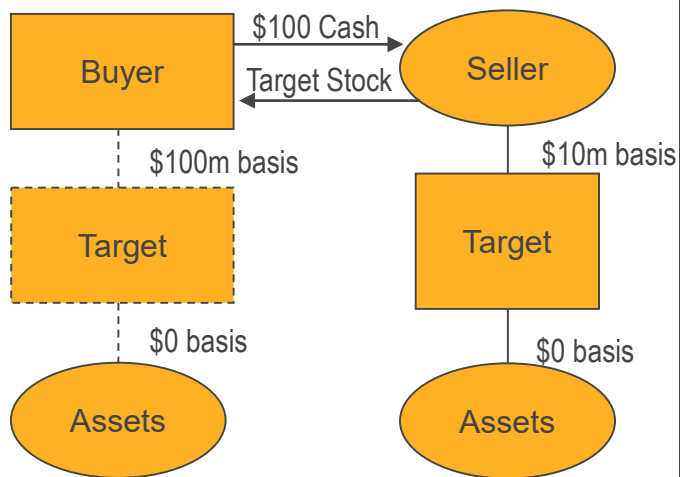
- ▶ Asset Acquisition
 - Preferred option
 - Avoid unknown liabilities
 - Get “step up” in tax basis
 - Added tax depreciation/amortization
 - Less tax on later sale of assets
- ▶ Stock Acquisition
 - Generally, no step up in tax basis of assets
 - May be good, however, if NOL exists

Seller's Perspective

- ▶ Asset Acquisition
 - Double level of tax
 - Pay full tax on appreciation
 - State and local taxes can also apply
- ▶ Stock Acquisition
 - Single level of tax - capital gains rates apply

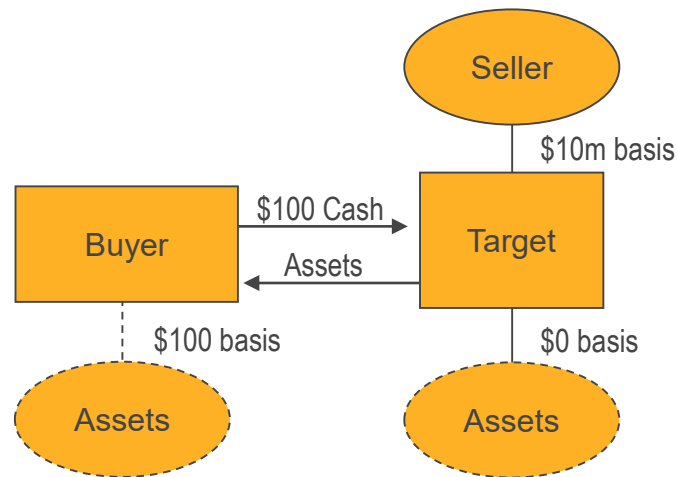
Inside vs. Outside Basis

Stock Sale



- \$90 Capital gain to Seller

Asset Sale



- \$100 gain to Target
- \$69 gain to Seller (\$79 after \$21 tax cash distribution – \$10 basis)

The Big Deal About Step Up In Basis

- ▶ Reduced gain on sale of assets
- ▶ Increased depreciation/amortization on acquired assets
 - Goodwill, going concern value and similar intangibles amortizable over 15 years
 - Bonus (i.e. immediate 100%) depreciation available on certain assets
- ▶ Buyer likely to pay more for company with higher asset basis

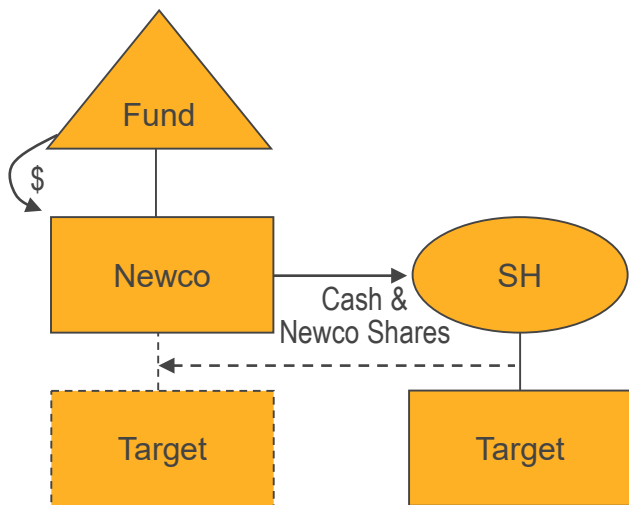
A Cross Between Stock and Asset Deals

- ▶ 338 Election
 - Treats a stock deal like an asset deal
 - Purchaser must be a corporation
 - Must acquire 80% of target “by purchase”
 - Fully taxable
 - Watch out for tax-free rollovers
 - Corporate and Shareholder taxation
 - Tax is on 100% even if bought only 80%

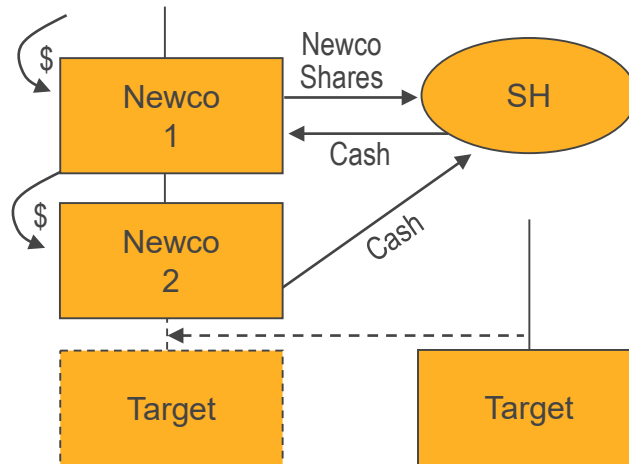
338 – S Corps and Consolidated Subs.

- ▶ Target is S Corporation or subsidiary that files consolidated return with seller
- ▶ Joint 338(h)(10) election is made
- ▶ Treated as asset sale
- ▶ Selling shareholders (in S Corp) or selling consolidated group pay tax
- ▶ Single tax with full basis step up!!
 - Higher tax if outside basis greater than inside basis and Target C corp. sub.
 - May convert some capital gain to ordinary income
 - Beware the S Corporation that was a C Corporation in past 5 years

Avoiding Accidental Tax-Free Rollover



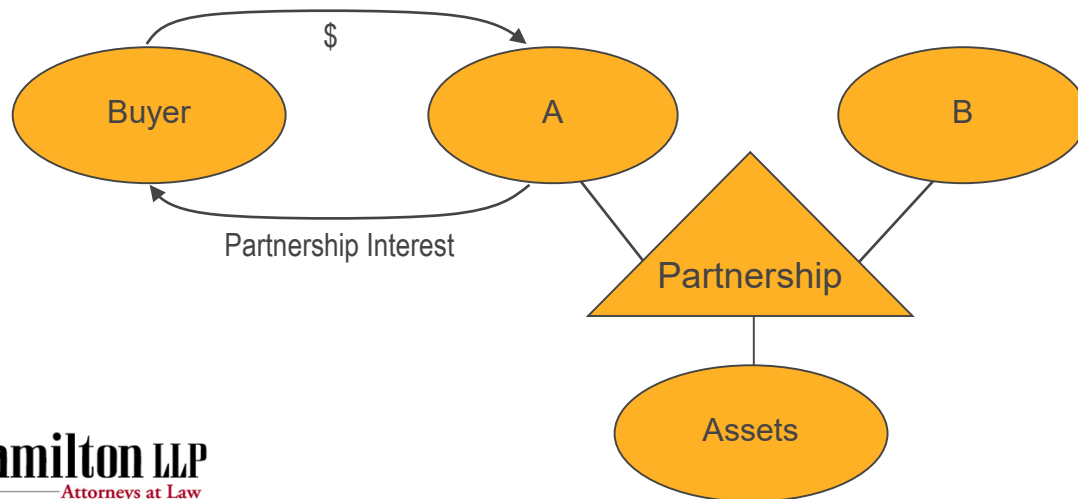
- Shares received by SH tax-free under 351
- Not fully taxable
- 338 not available



- Transaction fully taxable
- 338 available

Partnership Acquisitions

- ▶ Buyer takes cost basis in partnership interest
- ▶ 754 – basis step up in assets of partnership for Buyer
- ▶ No tax to B
- ▶ A gets capital gain (except for “hot” assets)



Part II

GILTI – Impact of 338

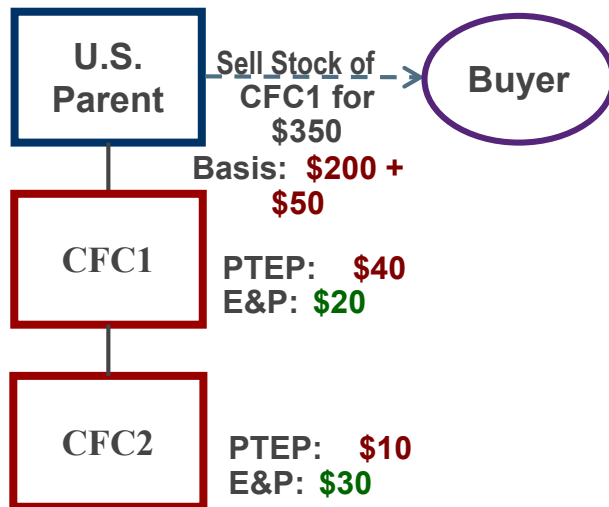
GILTI Overview

- ▶ GILTI = Global Intangible Low Taxed Income
 - BUT does not apply only to intangible income
- ▶ Effectively, most CFC income is immediately includible in gross income of a US person, similar to Subpart F Income.
 - Corporate shareholders: Entitled to a 50% deduction before 2026 and an 80% FTC
 - Individual shareholders: No special deduction or partial FTC

Sale of a CFC

- ▶ U.S. shareholder sells stock in a first-tier CFC
 - At the end of the year
 - Mid-year
- ▶ Impact of a 338 Election
- ▶ The examples assume no foreign income taxes are imposed on the gain (e.g., participation exemption).

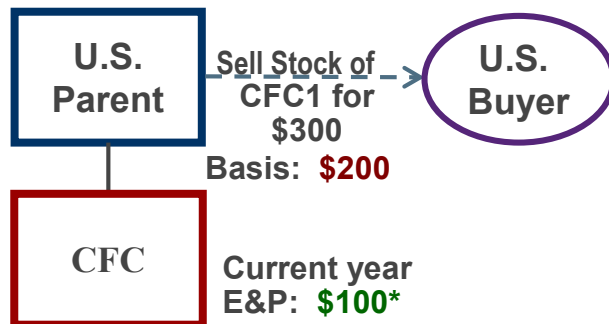
Sale of First-Tier CFC



Comments

- ▶ Sell stock on 1/1 (calendar year CFCs)
- ▶ Price: **\$350**
- ▶ Basis: **\$250**
- ▶ Gain: **\$100**
- ▶ §1248: **\$50** of gain recharacterized as a dividend
- ▶ §245A—100% of §1248 deemed dividend is deductible (1 year holding period)
- ▶ Thus, \$50 of capital gain is subject to 21% tax rate (\$10.50 tax cost)
- ▶ Note: Foreign tax credits no longer relevant for §1248 dividend

Sale During Year: U.S. Buyer

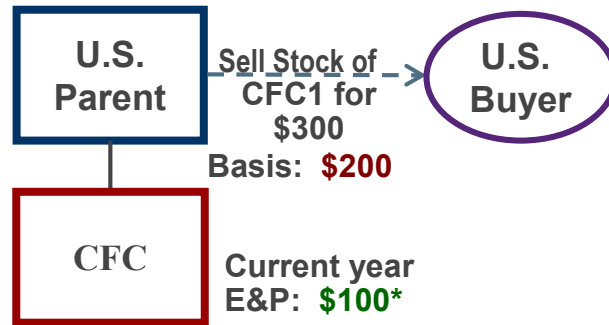


*\$100 of GILTI tested income; assume CFC does not have prior-year E&P.

Comments

- ▶ Sell stock on 6/30/19 (CFC is calendar year)
- ▶ Price: **\$300**
- ▶ Basis: **\$200**
- ▶ Gain: **\$100**
- ▶ §1248: **\$50** deemed dividend (but **no** DRD – 21% tax) (\$10.50 tax cost)
- ▶ \$50 of capital gain is subject to 21% tax rate (\$10.50 tax cost)
- ▶ GILTI for year included in income of U.S. Buyer, reduced by §1248 inclusion (thus, U.S. Buyer includes only \$50 of GILTI tested income)

Sale During Year: U.S. Buyer – Extraordinary Reduction Rule – Elective Closing of Tax Year

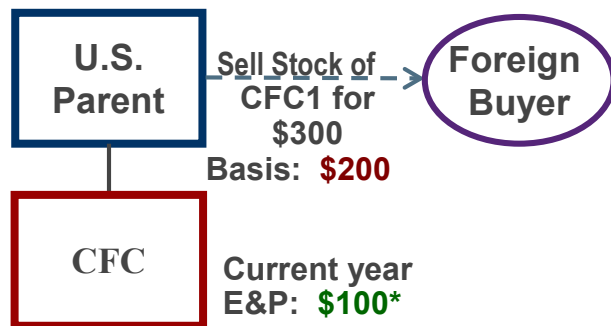


*\$100 of GILTI tested income (earned ratably over year); assume CFC does not have prior-year E&P.

Comments

- ▶ CFC's tax year ends 6/30/19 (date of sale)
- ▶ Seller's GILTI: **\$50 (\$5.25)** (10.5% rate)
 - Reduces §1248 amount to \$0
 - Increases Basis by \$50 to **\$250**
- ▶ Gain: **\$50 (\$10.50)** (21% rate)
- ▶ Total tax of **\$15.75 (\$5.25 + \$10.50)**
- ▶ Note: election to close tax year generally beneficial if CFC earns tested income rather than subpart F income (10.5% vs. 21%)

Sale During Year: Foreign Buyer; CFC Status Ends



*\$100 of GILTI tested income; assume CFC does not have prior-year E&P.

Comments

- ▶ Sell stock on 10/31/19 (CFC is calendar year)
- ▶ Seller's GILTI: **\$50 (\$5.25)** (10.5% rate)
- ▶ Reduces §1248 amount to \$0
 - Increases Basis by \$50 to **\$250**
- ▶ Gain: **\$50 (\$10.50)** (21% rate)
- ▶ Total tax of **\$15.75 (\$5.25 + \$10.50)**
- ▶ Note: CFC status may continue with a foreign buyer as a result of the repeal of §958(b)(4) (e.g., the foreign buyer has a U.S. subsidiary)
- ▶ No ER amount under these facts - \$50 tested income inclusion by U.S. Parent reduces amount constituting ER

Total Tax: \$15.75

U.S. Taxation of Seller's Gain With §338 Election—Ex 1[^]

		<u>w/o § 338</u>	<u>w/ § 338</u>
<div style="display: flex; align-items: center;"> <div style="border: 2px solid blue; padding: 5px; margin-right: 10px;">U.S. Parent</div> <div style="border: 2px solid red; padding: 5px; margin-right: 10px;">CFC</div> <div style="text-align: center;"> Basis: \$0 </div> </div>	§1248 Amount (0%)	\$300	\$300
	§338 GILTI* (10.5%)	0	\$500
	Capital Gain* (21%)	\$700	\$200
	Gross-up	0	0
	Taxable Income	<u><u>\$1,000</u></u>	<u><u>\$1,000</u></u>
	U.S. Taxes	\$147	\$94.50
	Foreign Tax Credits	(0)	(0)
	Net U.S. Tax	<u><u>\$147</u></u>	<u><u>\$94.50</u></u>

Asset Value: \$1,000
 Inside Basis: **\$500**
 959(c)(3) E&P: **\$300**

[^]Assume sale on 1/1 for calendar year CFC

*Assume no deemed FTCs and U.S. source or passive basket

U.S. Taxation of Seller's Gain With §338 Election—Ex 2[^]

		<u>w/o § 338</u>	<u>w/ § 338</u>
<div style="display: flex; align-items: center;"> <div style="border: 2px solid blue; padding: 5px; margin-right: 10px;">U.S. Parent</div> <div style="border: 2px solid red; padding: 5px; margin-right: 10px;">CFC</div> <div style="margin-left: 10px;">Basis: \$0</div> </div>	§1248 Amount (0%)	\$700	\$100
	§338 GILTI* (10.5%)	0	\$900
	Capital Gain* (21%)	\$300	0
	Gross-up	0	0
	Taxable Income	<u>\$1,000</u>	<u>\$1,000</u>
Asset Value: \$1,000	U.S. Taxes	\$63	\$94.50
Inside Basis: \$100	Foreign Tax Credits	<u>(0)</u>	<u>(0)</u>
959(c)(3) E&P: \$700	Net U.S. Tax	<u>\$63</u>	<u>\$94.50</u>

[^]Assumes same amount of gain in CFC stock as *Ex. 1*, but different amounts of §1248 dividend and §338 gain

*Assume no deemed paid FTCs and U.S. source or passive basket

Part III

Corporate Owned Life Insurance

Section 101

- ▶ Amounts received under a life insurance contract that are paid by reason of the death of the insured are excluded from federal income tax
- ▶ Two exceptions:
 - if a life insurance contract is sold or otherwise transferred for valuable consideration, the “*transfer for value rule*,” the excludable amount is the sum of:
 - (1) the actual value of the consideration paid by the transferee to acquire the life insurance contract; and
 - (2) the premiums and other amounts subsequently paid by the transferee
 - Exceptions to the “transfer for value rule”
 - Certain persons exception
 - ***Carryover basis exception***
- ▶ New Section 101(a)(3) defines the term “reportable policy sale” and imposes information reporting obligations that overrides transfer for value exceptions

Section 6050Y

- ▶ New reporting requirement part of TCJA:
 - Requires information reporting obligations on every person who acquires a life insurance contract (or an interest in a life insurance contract) related to reportable policy sales of life insurance contracts
 - Imposes information reporting obligations on every person who makes a payment of reportable death benefits
- ▶ Intended to thwart tax avoidance techniques used in transactions involving sale of life insurance to unrelated investors

Final 1.101-1 Regulations

- ▶ Effective October 31, 2019 (proposed regulations were released in March)
- ▶ Applies to sales after December 31, 2018
- ▶ Under Section 101(a)(3)(B) and Treas. Reg. Section 1.101-1(c)(1) of the proposed regulations, a reportable policy sale is, as a general matter, any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, **no** substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract

Final 1.101-1 Regulations (cont'd)

- ▶ The transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer)
- ▶ An **indirect** acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (directly or indirectly) an interest in the life insurance contract
- ▶ Persons that acquire shares in a C corporation that hold an interest in a life insurance contract generally will be considered to have an indirect acquisition of an interest in such contract
- ▶ Excludes transfers between members of consolidated group

Final 1.101-1 Regulations (cont'd)

- ▶ The transfer of a life insurance contract occurs in a carryover basis transaction qualifying under Section 101(a)(2)(A) (such as a tax-free reorganization) is **no** longer sufficient to avoid the limit on the amount of life insurance policy proceeds that are excludable from gross income under the Section 101(a)(1) transfer for value rule
- ▶ Target corporation merged out of existence: Section 368(a)(1)(A), (C), (D) or 368(a)(2)(D)
- ▶ Financial statement implication – Does a deferred tax liability need to be recorded?

Part IV

Tax Representations and Warranties

Purpose

- ▶ Further diligence process
- ▶ Ability to terminate agreement
- ▶ Buyer protection

Tax Returns

- ▶ All tax returns timely filed and are true, correct and complete
 - Material tax returns or all?
 - Materially, true, correct and complete
 - What if just purchasing one division or subsidiary?
- ▶ No position that would be subject to penalties under 6662 (or state, local or foreign)
 - Redundant

All Taxes Paid

- ▶ Paid all taxes required to have been paid
 - Materiality
 - Whether or not shown on a tax return
- ▶ Reserves for tax liability adequate up to date of agreement and through closing

All Taxes Paid

- ▶ No indication from jurisdiction in which don't file that may be subject to tax there
 - Duplicative
 - Materiality
 - Written notice
- ▶ Complied with obligations to withhold and remit taxes
 - Employee, contractor, foreign person, other
 - FATCA
- ▶ No liens for taxes
 - Permitted liens

Other Common Representations

- ▶ Audit history
- ▶ No lost deductions (e.g., 162(m))
- ▶ Any post-closing tax detriments?
- ▶ FIRPTA concerns (FIRPTA and 1446(f) certificates)
- ▶ Tax attributes
- ▶ Tax agreements
- ▶ Special situations
 - International operations
 - Subpart F, GILTI inclusions / Deferred 965 payments
 - S corporation target
- ▶ Stronger state tax after Wayfair

Part V

Tax Covenants

Tax Return Preparation

- ▶ Who prepares returns filed post closing
 - Consolidated, stand alone, S corporation, Straddle period
- ▶ Review rights
- ▶ Consistency with prior returns
- ▶ Handling disagreements

Payment of Taxes with Returns

- ▶ Seller to pay all taxes paid with final returns (and straddle period to extent allocated to pre-closing period)
 - Integrate with working capital adjustment
 - Seller prefers to run through indemnification section
- ▶ Straddle period – pre/post closing allocation
 - Allocate based on deemed closing of the books method for taxes based on income, receipts, expenditures, wages
- ▶ Who pays transfer taxes

Cooperation

- ▶ Filings tax returns, audits, litigations, proceedings
- ▶ Who controls audits
- ▶ Document retention and provision of records though end of statute of limitations
- ▶ Notification before destruction
- ▶ Dealing with costs
- ▶ Obtain certificates (e.g., bulk sale) to reduce tax

Prohibited Actions

- ▶ Seller will not (and will cause Target not to)
 - Make, revoke, change any tax election
 - Waive/extend any time/restriction for assessment or collection
 - Agree/modify agreement with respect to taxes /settle any tax matter

Voluntary Disclosure Agreements

- ▶ Voluntary disclosures as a means of coming into compliance post-closing
 - Timing of paramount importance

Part VI

Tax Indemnification

Sellers' Liability

- ▶ Sellers pay:
 - All taxes to the extent related to pre-closing periods
 - Include pre-closing portion of straddle period
 - Loss resulting from the breach of a representation
 - Taxes of any person other than the target and subsidiaries under applicable law (including 1.1502-6), as transferee, successor, by contract or otherwise

Limitations

- ▶ Coordinate with working capital or other adjustments to avoid double counting
- ▶ Baskets / caps
- ▶ Public target – usually no indemnity
- ▶ Failure to notify indemnifying party of potential liability
- ▶ Survival periods

Securing the Indemnification Obligation

- ▶ Right only as good as ability to collect
- ▶ Holdbacks
- ▶ Escrows
 - Who taxed on earnings if cross tax years

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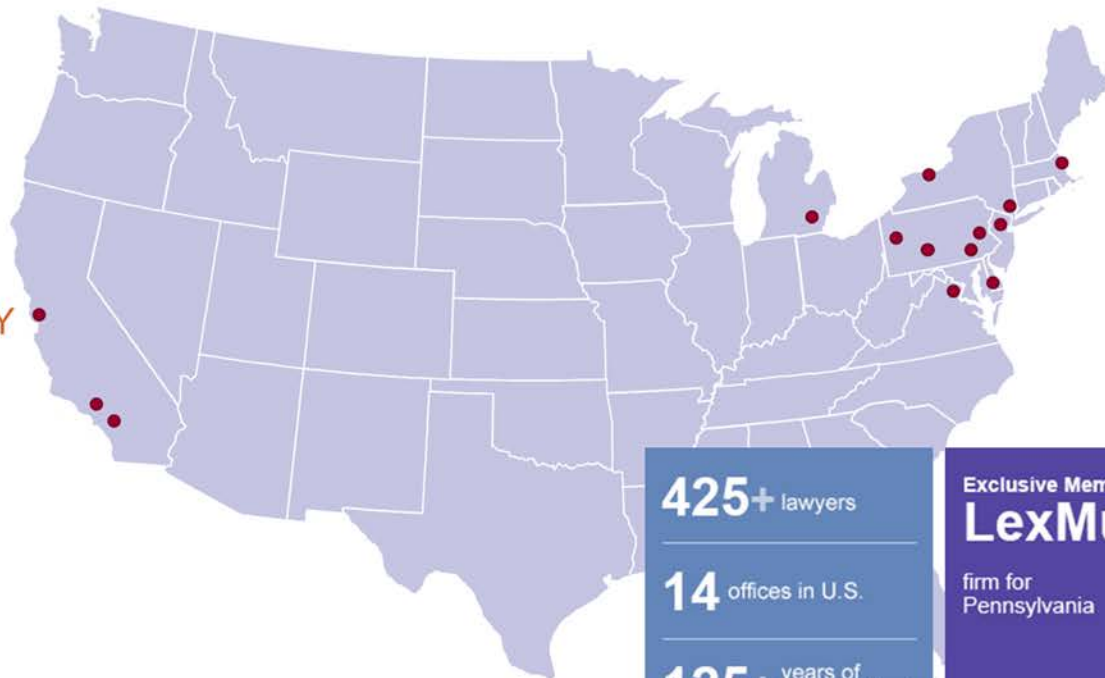
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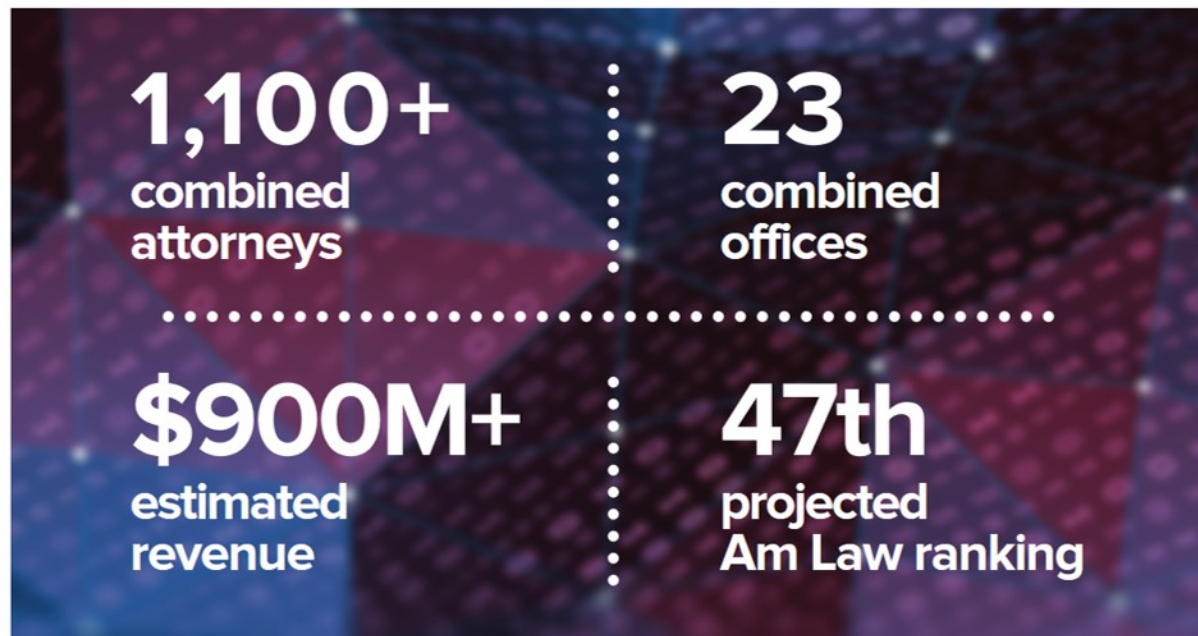
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Troutman Sanders and Pepper Hamilton Announce Plans to Combine

Troutman Sanders and Pepper Hamilton LLP have agreed to merge effective April 1, 2020. Troutman Pepper will offer expanded capabilities and practice strengths, with a hallmark focus on client care.



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