Tax Diligence, Representations, Covenants and Indemnifications in Business Acquisitions

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Part I

Overview of Tax Due Diligence

Parties to the Process

- Seller
- Buyer
- Seller’s accountants
- Buyer’s accountants
- Seller’s lawyers
- Buyer’s lawyers

Documents to Request

- Corporate structure chart
- Entity classification elections (Form 8832)
- Past income tax returns (all jurisdictions)
- Accountants' workpapers
- Tax reserves
- FIN 48 workpapers
- Information/materials regarding prior reorganizations
- State income tax allocation calculations
- Foreign tax credit calculations
- Review general accounting methods / elections
- Sales tax returns
- Payroll tax returns

Things to Consider – Return Positions

- Aggressive tax positions
  - Unreasonable compensation
  - Listed/reportable transactions
  - Disproportionate allocation to depreciable property/consulting agreements in prior acquisitions
- Adequate reserves

Accounting Method Considerations

- Maximizing accounting methods can add significant value to the deal
- Methods review during diligence may identify problems and/or opportunities
  - Are optimal methods being used?
  - Is there exposure? How to correct? Cost to correct?
- Form of the transaction may effect accounting methods
  - Whether new methods may be adopted
  - Note: section 381(c)(4) and (5)
- Include methods planning during integration

Transaction Costs

- Maximizing the favorable treatment of transaction costs can also add significant value to a deal
- Safe harbor election simplifies the process but is not available in all situations and may not produce the best result
  - Evaluate specifics
  - Develop strategy to address early in the process
  - Be aware of which party is engaging v. paying
- As vendors are engaged, include provision on transaction costs to minimize complications
- Alternative fee arrangements
  - How to allocate without hourly billing

Section 382 Impact

- Limits ability of a corporation to offset income using NOLs generated prior to a “change in ownership” and certain built-in losses recognized post-change
- Limitation is equal to the FMV of old loss corporation multiplied by a published IRS rate (long term tax- exempt rate) subject to certain adjustments
- Condition to close and cooperation
- Planning Tip: Close the books election versus apportioning the loss over the year
- Planning Tip: NUBIG and Notice 2003-65

Successive Ownership Changes

- If two or more successive ownership changes, then each Section 382 limitation is applied independently (Reg. Section 1.382-5(d))
- Application of rule may result in layers of NOLs where each layer is subject to different limitations
- Diligence Tip: A single low limitation can trap prior NOLs, and subsequent limitations can not create a higher limitation for previously limited NOLs
- Target may not have had 382 study done and DTA may be incorrect
- May require a permanent write-down of NOLs for financial statement purposes

Leaving a Consolidated Group

- Section 382 limitation is based on value of the loss group
- 1.1502-21 – Current NOL is apportioned to a subsidiary based on the subsidiary's ratable portion of the loss
- If the group underwent an ownership change while the member was part of the group, the limitation attributable to the departing member will be zero (automatic)
- Planning Tip: Common parent may file an election to apportion part or all of the Section 382 limitation to the departing member
  - Reduces limit for remaining members
  - Election requirements Treas. Reg. Section 1.1502-95(f)(1)
  - Must be signed by the common parent (not the loss subgroup parent) and former member
  - Only revocable by the Commissioner

Leaving a Consolidated Group

- For NOL purposes, a loss group refers to a group of affiliated companies (at least 2) that joined the present group and which has a common parent with one member carrying forward a non-SRLY loss
- Subgroup limitation is equal to the value of the subgroup
- Planning Tip: Brother/sister companies leaving a group without a common parent and joining another can file an election to be treated as a single loss subgroup parent
  - 1.1502-96(e) election requirements
  - Could increase the limitation by using more profitable members without NOLs for loss subgroup value

Things to Consider – Inheriting Liabilities

- Asset sale v. stock sale
  - Ability to leave behind liabilities
  - Transferee liability
  - Bulk sale issues
- Consolidated return liability
  - 1.1502-6
- 338 election – impact on liability

Things to Consider - Structure

- Integration issues
- Inefficiencies
- Classification of foreign entities

Things to Consider – 338 Election

- Availability
- Federal tax cost
- State tax cost
- International concerns
- Purchase price allocation

Sales Tax Considerations

- By far and away the most common type of state tax complication that arises on any transaction is sales tax issues
- Sales taxes are generally considered trust fund taxes, and unless proper tax notice and clearances are obtained from taxing authorities, they will transfer to purchasers
  - Regardless of the form of the deal (asset vs. stock)
  - Rushed nature of transactions make it very difficult to obtain tax clearance
    - Certain states (i.e. Florida) have such a backup for clearance that it is a practical impossibility

Typical Sales Tax Issues in a Deal

- Nexus
  - Is the company collecting tax everywhere it should be?
  - Footprint states – employees, property, independent contractors
- Taxability
  - Is the company collecting and remitting tax properly on its products?
  - Issue typically arises with treatment of software
  - Extrapolation of home state treatment to other states
- Documentation
  - Is the company documenting its exemptions properly, such that as a buyer, the exemptions will withstand audit scrutiny?

Things to Consider - Audits

- Revenue agent reports and requests for information
  - Consider hot points if known
  - Likelihood of success
  - Quantify down side risk

Transfer Taxes on the Transaction

- Stock sales generally avoid sales taxes on asset sales
  - Weyerhauser case in Colorado the exception
  - Can trigger indirect taxes on transfers involving real estate
- Asset sales are a little trickier
  - Applicability of occasional sales exemption to the transaction
  - If state has limited occasional/casual/isolated sales exemption, applicability of other exemptions
  - Papering inventory sales (resale certificates)
  - Motor vehicle transfers almost always taxable

Other State and Local Tax Issues

- Potential successor liability for other taxes (employee withholding)
- Quirky states that have successor liability for a broader array of taxes
- Availability of 338(h)(10) elections at a state level
- Conformity to 381/382 for loss companies
- Transaction potentially giving rise to gross receipts taxes in certain states
  - Typically exempt, but must be considered

Part II

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
- Tax attributes
- Tax agreements
- Special situations
  - International operations
  - S corporation target

Part III

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 IV

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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- 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.
- Advises business organizations on a variety of tax issues, and he is involved in the formation of private equity and hedge funds

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- Focuses his practice on advising clients on federal corporate tax law, simplifying corporate structures and minimizing the impact of complex consolidated return issues and tax due diligence.
- Has experience with corporate loss limitation studies (Section 382) and the tax aspects of bankruptcy and workouts.
- Experience with submitting successful private letter ruling requests to the Corporate Branch of the IRS National Office.

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- Focuses his practice on state and local tax matters, with an emphasis on state and local tax planning, controversies and audit defense.
- Worked for eight years as a senior tax manager at two “Big 4” accounting firms.
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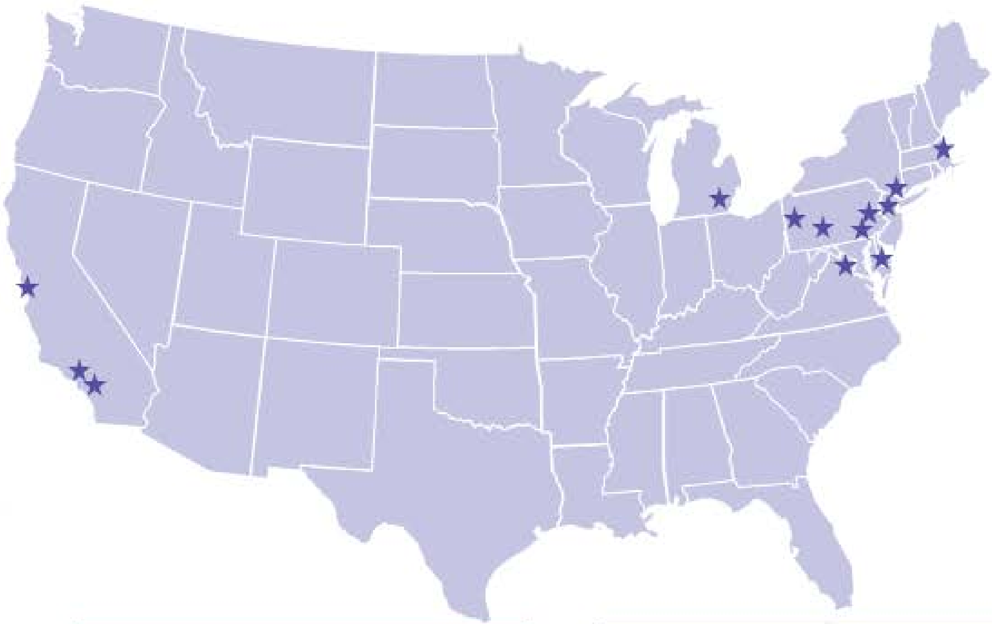

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