

Welcome!

Tax Provisions in Business Acquisition Agreements

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Overview

- Perspectives of buyer and seller
- Form of transaction
 - Taxable or tax-free/tax-deferred
 - Asset purchase, stock purchase, direct merger, subsidiary merger

Principal Categories

- Representations and warranties
- Covenants and other agreements
 - Pre-closing
 - Post-closing
- Indemnification

Representations and Warranties

- Statements as to the existence or absence of a state of facts (regarding tax compliance, liabilities for tax, tax attributes, etc.)
- Made by seller/target to buyer
- As of date of signing, with bring-down to date of closing

Representations and Warranties

Purposes:

- Due diligence
 - Scheduled exceptions
 - Requested deletions/carve-backs
- Closing condition “out” for buyer
 - Only applicable if deferred closing
- Basis for indemnification claim

Representations and Warranties

Common Representations

- Tax returns that have become due have been filed and are correct and complete
- Taxes that are due have been paid
- No filing extensions other than as disclosed
- No audits or examinations pending or threatened; no proposed assessments
- No notices from jurisdictions in which returns have not been filed

Representations and Warranties

Common Representations (cont'd)

- No agreement to extend statute of limitations
- All required withholding taxes have been withheld and paid
- No tax sharing agreements or closing agreements
- Deal-specific reps (*e.g.*, relating to S corporation status)

Representations and Warranties

Negotiation Points

- Qualifiers and Scope Limitations:
 - Materiality
 - Knowledge
 - “No audits or examinations” rep
 - Identify specific individuals
 - Jurisdiction
 - Type of tax

Representations and Warranties

Negotiation Points (cont'd)

- Seller might wish to disclaim representations as to tax matters outside of “tax rep” section of agreement
 - Other applicable categories
 - Financial statement reps
 - “Compliance with law” reps
 - Allows tax team to focus on tax section

Representations and Warranties

Other items to consider

- Involvement of tax team
 - Seller/target
 - Internal and external
 - Scheduling exceptions and negotiating carve-backs
 - Buyer
 - Internal and external
 - Knowledge of industry-specific tax risks

Representations and Warranties

Other items to consider (cont'd)

- Consequences of disclosure
 - Eliminates closing condition “out” but buyer will generally require full indemnification
- Avoid creating audit roadmap
- Tax reps from buyer if part of consideration is buyer equity

Covenants and Other Agreements

Pre-Closing Covenants (Seller)

- Will not amend any tax return, make/revoke any tax election, settle any tax claim, change any accounting period, enter into a tax allocation agreement, enter into a closing agreement with any tax authority or waiving any statute of limitations
 - Seller should discuss with tax team any planned actions

Covenants and Other Agreements

Pre-Closing Covenants (Seller)

- Terminate tax sharing agreements
- Notify of tax proceedings

Covenants and Other Agreements

Post-Closing

- Buyer covenant not to amend (or file) pre-closing returns if doing so would result in seller obligation (to tax authority or buyer)
 - Buyer may request carve-out for actions required by law
 - Seller may request that carve-out be limited to situations where buyer has obtained a formal external opinion
 - Independent accounting firm
 - (Lack of) Confidence level → will, should, more likely than not

Covenants and Other Agreements

Post-Closing

- Preparation of tax returns
 - Typically not found in acquisition agreements for transactions structured as asset sales
 - Categories based on period covered and when return is due
 - Returns due between signing and closing
 - Seller/target prepares.
 - Buyer may review, but generally no right to comment

Covenants and Other Agreements

Post-Closing

- Preparation of tax returns (cont'd)
 - Categories based on period covered and when return is due (cont'd)
 - Returns for tax periods ending on or prior to closing and due after closing
 - Seller generally prefers to prepare since seller generally bears the burden for any associated tax
 - In small deals or where likelihood of dispute is low, seller may prefer not to prepare (or to only prepare income tax returns)
 - Non-preparing party generally has right to comment, but preparing party generally only required to accept comments that are necessary to conform to past practice (and perhaps comments not detrimental to preparing party)

Covenants and Other Agreements

Post-Closing

- Preparation of tax returns (cont'd)
 - Categories based on period covered and when return is due (cont'd)
 - Returns for tax periods beginning on or before closing date and ending after closing date (“straddle periods”)
 - Applicable where target survives and is owned by buyer (e.g., stock purchase or reverse subsidiary merger)
 - Seller generally bears the burden for the portion of the tax attributable to the portion of the straddle period ending on the closing date
 - Generally buyer prepares
 - Non-preparing party generally has right to comment, but preparing party generally only required to accept comments that are necessary to conform to past practice

Covenants and Other Agreements

Post-Closing

- Preparation of tax returns (cont'd)
 - Resolution of disagreements
 - Refer to independent accounting firm
 - Whose version to use if not resolved by due date
- Control of tax proceedings relating to pre-closing or straddle periods
 - Typically buyer will have the right to control unless seller concedes that it is obligated to or indemnify for the assessed tax
 - If seller assumes control, buyer may want the right to participate with own counsel if outcome could affect post-closing periods

Covenants and Other Agreements

Post-Closing

- Purchase price allocation
 - Applicable asset acquisitions (Sec. 1060)
 - Relevant for seller's gain/loss, buyer's basis
 - Timing
 - Attach allocation schedule at signing?
 - Determine allocation post-closing?
 - Consider setting forth parameters in acquisition agreement (e.g., inventory and FFE to be valued at seller's tax basis)
 - Dispute resolution
 - Don't forget liabilities assumed or deemed to be assumed

Covenants and Other Agreements

Post-Closing

- Covenants relating to intended tax treatment
 - Reorganization under Sec. 368
 - Joint elections under Sec. 338(h)(10) or Sec. 336(e)
- Refunds
 - Buyer to pay over to seller (if not reflected in purchase price and not resulting from carrybacks from post-closing periods)
- Cooperation on Tax Matters/Record Retention

Indemnification

Scope of tax indemnity

- Pre-closing taxes of target business
- Losses from breaches of tax reps

Indemnification

Pre-closing taxes of target business

- Particularly important where target survives and is owned by buyer (e.g., stock purchase or reverse subsidiary merger) or buyer or its subsidiary assumes target's tax liabilities by operation of law (e.g., direct merger or forward subsidiary merger)
- Includes:
 - Taxes for tax periods that ended on or before the closing date
 - Taxes attributable to pre-closing portion of any straddle period

Indemnification

Pre-closing taxes of target business

- Allocation of straddle period taxes
 - Property taxes → pro rata based on days
 - Consider using days property was actually owned by target during tax period
 - All other taxes → closing of the books

Indemnification

Losses from breaches of tax reps

- Can result in seller indemnifying buyer for post-closing taxes
 - Ex.: Where buyer (incorrectly) assumes lack of nexus, based on seller's failure to file with same contacts
 - Ex.: Overstated basis or loss carryforwards

Indemnification

Survival period

- Generally applicable statute of limitations plus 30/60/90 days
- Seller may be able to negotiate shorter survival period

Indemnification

Amount-Based Limitations

- True deductible
- Tipping basket
- Cap
 - Often only capped at total deal consideration

Indemnification

Carve-Outs

- Taxes taken into account in purchase price
 - Taxes on balance sheet where price was determined based on net book value of equity
 - Taxes deducted in calculating net working capital adjustment
- Closing date transactions under buyer's control and not in the ordinary course of business

Indemnification

Carve-Outs (cont'd)

- Taxes resulting from elections by buyer
 - Ex.: Unilateral 338 election
- Taxes resulting from breach of buyer covenant
 - Ex.: Covenant not to amend/file returns for pre-closing periods
- Penalties (and interest?) not caused by seller (e.g., where buyer is responsible for preparing return and files late)

Miscellaneous Other Tax Issues

Withholding on payments of deal consideration

- Backup or foreign withholding
- Seller should consider requiring advance notice

Losses calculated net of tax benefit

Miscellaneous Other Tax Issues

Burden of employer payroll taxes on cash-out of stock options

Escrow

- Which party is taxed on earnings?
- Is deemed owner entitled to disbursements to pay taxes on earnings?

Burden for transfer taxes

Miscellaneous Other Tax Issues

Payroll Reporting

- Consider agreeing to use “alternate procedure” under Rev. Proc. 2004-53
 - Single W-2 for transferred employees where buyer acquires substantially all the property used in the target’s business or a separate unit of the target’s business
 - State law equivalent?

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