Tax considerations

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Building a better working world

Tax considerations

1. Why tax matters in transactions
2. Tax structuring alternatives
3. Tax savings from net operating losses (NOLs) and cash tax modeling
4. Impact of evolving tax landscape

Question

- Why would a potential buyer want to undertake due diligence for taxes?

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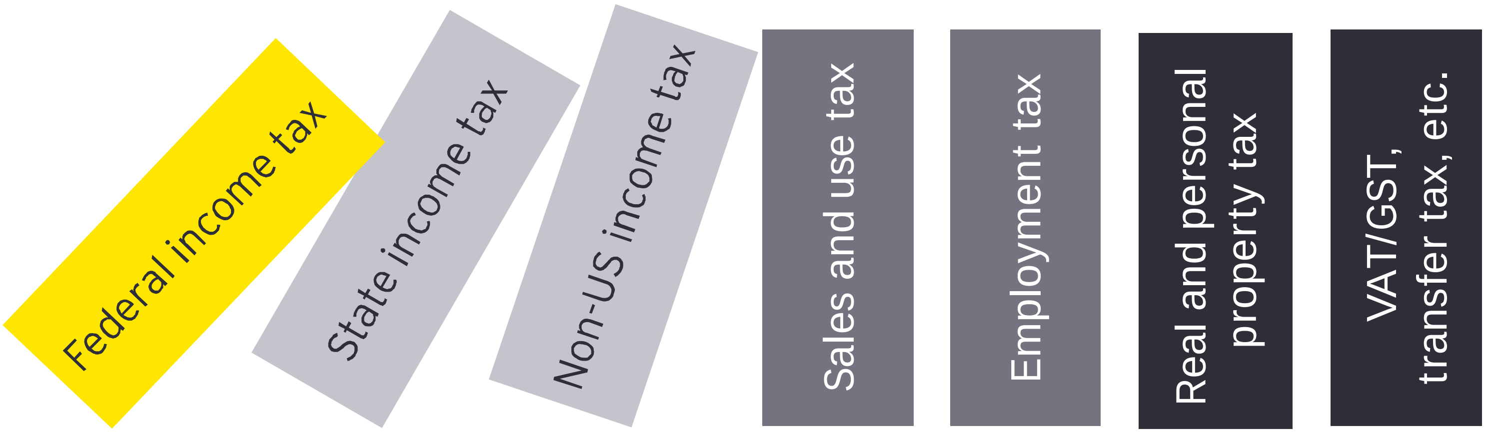
Why tax matters

- Taxes are one of the largest cash costs of a business
  - Corporate: 21% US federal income tax plus state tax
  - Pass-through entities: based on partners' individual income tax rates (e.g., could be up to ~54% federal and state for certain high-net worth individuals)
- Significant risk item and value driver in a transaction:

Past	Present	Future
• Due diligence to identify and quantify potential material tax exposures that may still be relevant to buyer post-close	• Structuring to implement tax-efficient combined legal entity structure, integrate IP, supply chain planning	• Model cash tax requirements post-close, availability of NOLs, and toll charges on moving assets or legal entities

- Taxes that a Seller will pay can have a significant impact on whether seller wants to sell stock or assets.

Tax due diligence objectives



Purpose of tax due diligence is to:

- Understand and quantify the risk of any potential material historical tax issues that may be inherited by a Buyer.
- Protect the Buyer through contracted indemnification or a deal price adjustment based on findings of tax due diligence.
- Gain an understanding of Target tax profile and past tax exam activity (whether pending, current or closed) to enable more efficient integration into Acquirer's business and tax reporting/accounting functions effectively post-close.

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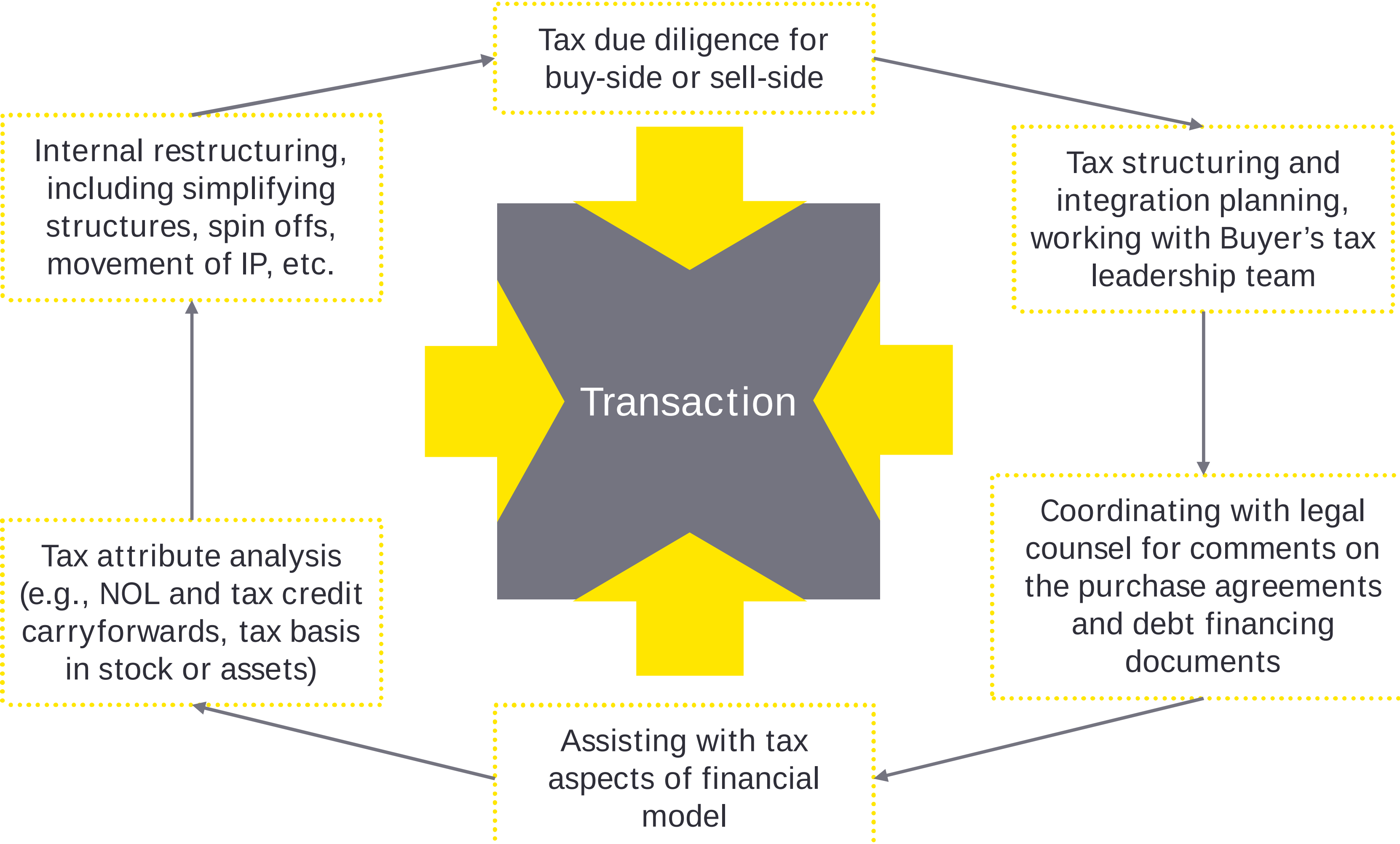
Level of tax due diligence is determined by

- Target's legal entity structure
  - Is the Target a corporation or flow-through partnership, S corp? (i.e., taxable acquisition stock or assets?)
  - Is this a carve-out, and will any legal liability carry over post-close?
  - How complex of legal entity organizational chart, number of entities?

- Target's tax profile
  - Tax audit history, reserves and Uncertain Tax Positions
  - Location of operations, IP, transfer pricing, and does it include significant offshore activities?
  - Reorganization/acquisition history and whether sufficient planning/due diligence was performed and external advice was given
  - Tax attributes – expiration and limitations on use

Tax focus areas in a transaction



Basic taxable acquisition structures

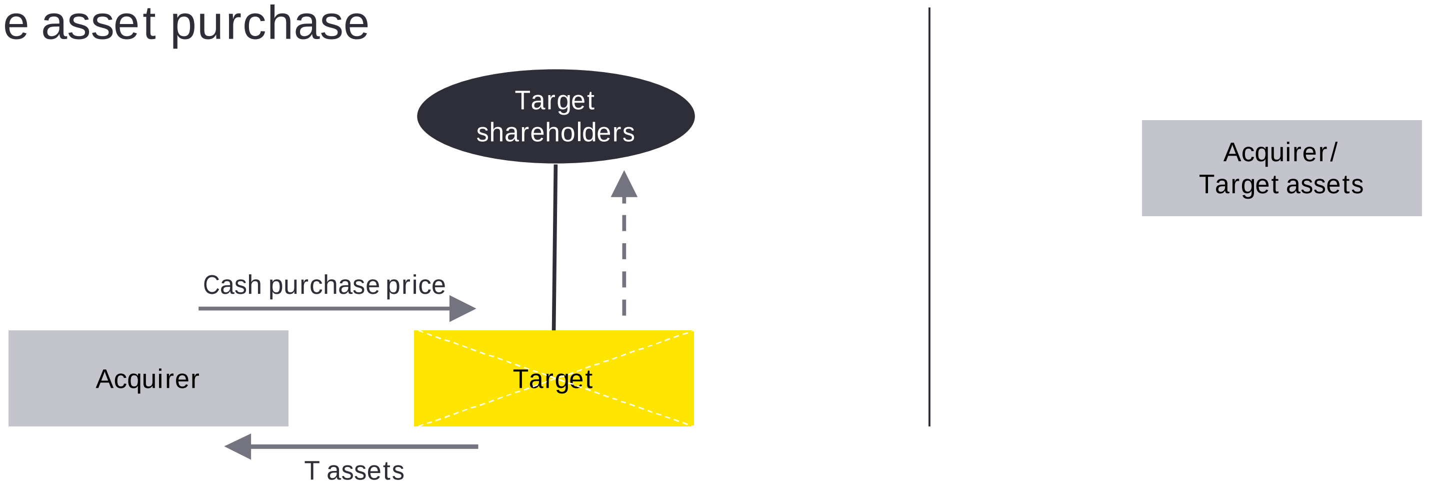
Taxable stock purchase

Considerations

- Cost basis in purchased stock, but generally no step-up in assets
  - Contrast to GAAP step-up in target's assets under purchase accounting
- Carryover of NOLs, but use of NOLs may be limited going forward
- Buyer inherits historical tax liabilities of target (whether disclosed, undisclosed or contingent)
- Sellers pay tax based on their gain in their stock (i.e., purchase price minus tax basis)

Basic taxable acquisition structures

Taxable asset purchase

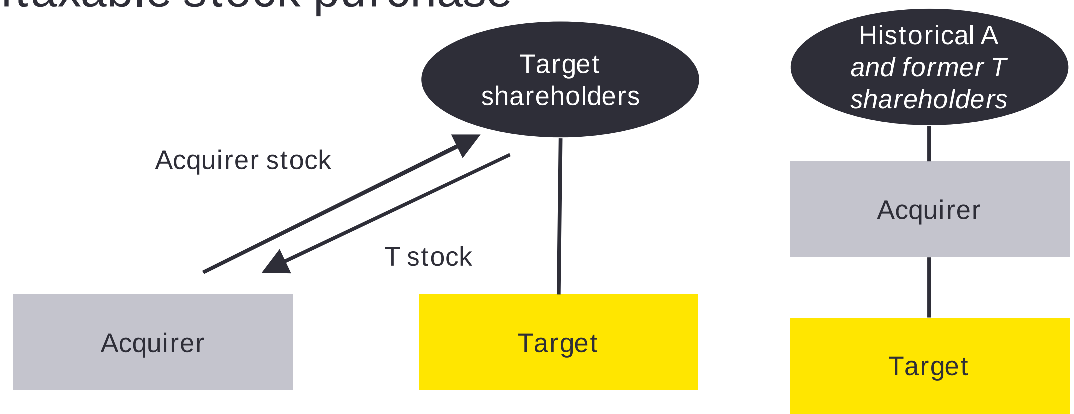


Considerations

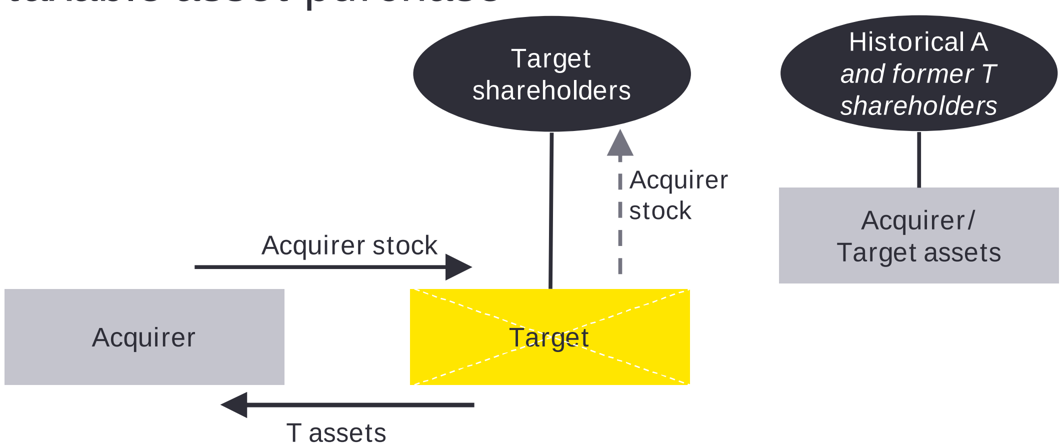
- Double taxation (corporate and shareholder level) often makes a sale of all assets cost prohibitive for a Seller
  - Target pays tax on asset sale gain (21% US federal income tax plus state income tax)
  - Seller receives cash in liquidation of Target and has additional capital gain (20% US federal income tax plus state income tax)
- Buyer may get step-up in assets' tax basis (often a real value driver)
- No carryover of NOL or tax credit carryforwards

Basic non-taxable acquisition structure

Nontaxable stock purchase



Nontaxable asset purchase



Why are these transactions tax deferred?

After the reorganization, Target shareholders maintain a direct or indirect interest in Target's business (e.g., through ownership of Acquirer stock).

Deferral is achieved through:

- Substituted basis rule for Acquirer stock received in the exchange
- Carryover basis rule for property received (i.e., no step-up in basis of Target assets). Generally, to get a "step-up" in basis, gain must be recognized on the transaction.

Tax attributes (NOLs) and income events

- Corporations that spend significantly on R&D over years often generate tax attributes (e.g., NOL, R&D credit, orphan drug credit, foreign tax credit and capital loss carryforwards) and may have a significant amounts pre-acquisition.
- These “tax attributes” allow for a future benefit to the taxpayer to offset against taxable income.
  - NOL limitations for post-2017 losses. For NOLs generated after tax years beginning after December 31, 2017, NOLs in the amount of 80% of the taxable income may be utilized. The NOL may be carried forward indefinitely, but not carried back.
    - However, note that the CARES Act made changes to the NOL provisions including: (1) changing the carryback period to five years for any NOLs arising in 2018, 2019 or 2020; (2) temporarily removed the 80% limitation on the use of NOLs; and (3) pass-through business owners may use NOLs to offset their nonbusiness income above the previous limit of $250,000 (single) or $500,000 (married, filing jointly) for 2018, 2019 and 2020.
  - NOL limitations for pre-2018 losses. For NOLs generated prior to tax years beginning prior to December 31, 2017, NOLs are not limited by a percentage of taxable income. The NOL may be carried back 2 years but carried forward only 20 years.
- Examples of income events that may create a need to use NOLs

Collaboration upfront payments	• Received upon signing of the collaboration agreement or closing of sale of an asset
Milestones	• Contingent on research or commercialization achieving certain goals
Royalties	• Due based on future monetization or use of certain assets

Section 382 limitations and impact on value

- “Section 382 limitations” arise when a company with NOLs experiences an “ownership change,” defined per tax rules as a greater-than-50% cumulative owner shift, in terms of value, over a rolling three-year period.
  - Limitations may be restrictive such that some NOLs/credits may expire unutilized.
  - It may be that these tax attributes are available over time, subject to an annual Section 382 limitation, which may mismatch with significant income events from collaborative arrangements.
  - Annual limit based on FMV of equity multiplied by a ~2%–4% monthly AFR.
  - Reduction for debt-funding of transaction if debt is placed on books of Target or serviced by Target operations.
  - Potential increase for certain built-in gains at the time of the ownership change.

- In general, a buyer should assume $0 value for the tax attributes of Target unless Target can prove that such tax attributes have value.
  - A Section 382 analysis or study on the other hand might support significant potential NOL/cost savings available to a potential Buyer.

Due diligence questions around NOLs

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- First question to ask is whether Target has undergone any historical ownership changes (which place Section 382 limitations on the availability to use such attributes).
  - Have they ever prepared an owner shift calculation?
  - Is the information available to prepare an owner shift calculation?
- If there have been historical ownership changes, which tax attributes are limited and to what extent?
- What will the base limitation be in the current transaction?
- Additionally, consider if the tax attributes are valid in the first place.
  - Were NOLs generated by valid deductions, or were any such deductions improperly taken (e.g., disallowance of interest expense, nondeductible transaction costs, etc.)?
  - Have they undertaken a detailed R&D tax credit study to justify the validity of tax credits?

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Example: If $300m of NOLs were limited by a $40m annual Section 382 limitation

- The Company would have cash taxes due in Years 2 and 3 because the Target may have more taxable income than available Section 382 limitation.
- Target can only use $60m in Year 2 (e.g., $40m annual limitation plus $20m unused excess limitation from Year 1) and $40m in Year 3 (e.g., $40m of limitation that became available in Year 3).

Cash tax calculation (assuming no restrictions on NOLs)						
	2019	2020	2021	2022	2023	Total
US cash taxes						
US taxable income	25	100	75	20	100	320
NOL utilization	(20)	(80)	(60)	(16)	(80)	(256)
US taxable income after NOL	5	20	15	4	20	64
Tax rate 26%						
US cash taxes	1.3	5.2	3.9	1.04	5.2	16.64

Cash tax calculation (assuming NOLs restricted to $40m annually)						
	2019	2020	2021	2022	2023	Total
US cash taxes						
US taxable income	25	100	75	20	100	320
NOL utilization	(20)	(60)	(40)	(16)	(64)	(200)
US taxable income after NOL	5	40	35	4	36	120
Tax rate 26%						
US cash taxes	1.3	10.4	9.1	1.04	9.36	31.2

Interest deductibility limitations

- Applicable high yield discount obligation (AHYDO)
  - Defers tax deductions for original issue discount (OID), including payment in kind (PIK) interest, until interest is actually paid in cash if the yield-to-maturity (YTM) of the debenture exceeds the applicable federal rate (AFR) + 5%
  - Permanently disallows OID deductions to the extent YTM exceeds the AFR + 6%
  - Planning surrounding terms may help avoid limitation (i.e., bullet payment of interest in year five)
- Corporate acquisition indebtedness rules – § 279
  - Disallows interest deduction for the lesser of:
    - Total acquisition interest greater than $5m in such year
    - Interest for such year on tainted acquisition debt
  - Test is applied cumulatively to multiple acquisitions
- Disqualified interest rules – § 163(j)
  - For tax years beginning on or after January 1, 2022, § 163(j) limits the interest expense deduction to 30% of adjusted taxable income (i.e., the taxable income computed without regard to any NOL deduction, any item of gain, income, deduction or loss which is not properly allocable to a trade or business, and any deduction allowable for depreciation, amortization and depletion, etc.).
    - Note: laws applicable to prior years were different, which could impact the carryover of any disqualified interest.

Flow-through deduction generally not available for the medical practice

- As a result of tax reform, Congress provided a tax benefit to individuals with qualified business income from a partnership, limited liability company, S corporation or a sole proprietorship. Section 199A provides a deduction of up to 20% of the US federal taxable income of a domestic business operated in flow-through form.
- The amount determined to be deductible is based on the qualified business income from a qualified trade or business.
  - Qualified trade or business does not include a trade or business that involves the performance of services in the health fields.

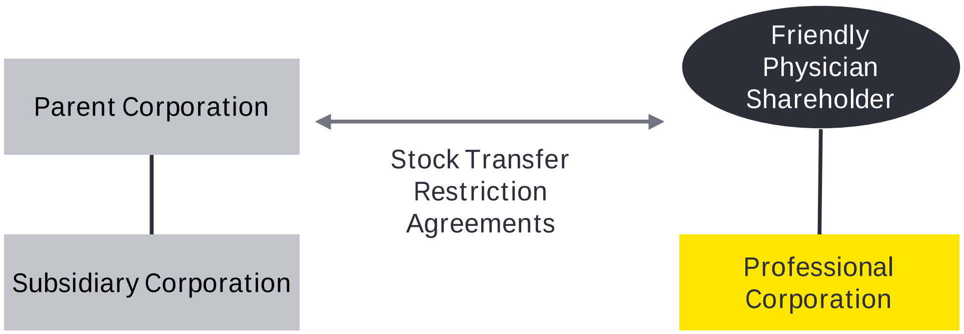
Carried interest

- As a result of tax reform, certain partnership interests held by the taxpayer or a related person in connection with the performance of services (i.e., carried interest) is subject to a three-year holding period to obtain long term capital gain treatment.
- Limited exceptions
  - An applicable partnership interest does not include a partnership interest held by a corporation.
  - An applicable partnership interest does not include a capital interest that provides the partner with a right to share in partnership capital commensurate with: (1) the amount of capital contributed (determined at the time of receipt of the partnership interest); or (2) the value of the interest included in income under section 83 upon receipt or vesting.

US international income tax considerations

- Passive foreign investment company (PFIC) rules
  - Anti-deferral rules – result in immediate taxation to US taxable investors or interest charge on deferred tax on PFIC income
  - PFIC is any foreign corporation if either:
    - Passive income is 75% or more of total
    - Passive assets are 50% or more of total
- Subpart F income
  - Anti-deferral provisions – result in immediate taxation to US taxable investors on certain types of income of a controlled foreign corporation (CFC), including:
    - Investment income
    - Foreign base company sales, service and oil-related income
    - Investment in US property
  - Certain exceptions may apply (e.g., same country activity, manufacturing)
  - CFC includes: any foreign corporation that is more than 50% owned by US shareholders (vote or value test, does not have to be direct ownership – indirect and constructive ownership taken into account)
- Global intangible low-taxed income (GILTI)
  - Newly enacted anti-deferral provisions – causes the US shareholder to include its proportionate share of any income earned by various non-US subsidiaries (i.e., CFCs) that earn a return in excess of a return on capital invested in tangible assets of 10% of such tangible investment.
  - GILTI will apply to most multinational companies where there is significant value and earnings in CFCs attributable to intangible assets.
    - A US shareholder that is a corporate entity is generally entitled to a deduction of 50% of the GILTI inclusion (the deduction goes down to 37.5% in tax years beginning after December 31, 2025)

Consolidation in the medical practice



- The Professional Corporation may be permitted to join in the filing of the Parent Corporation's consolidated US federal income tax return.
  - Generally, under applicable state law, the stock of the professional corporation must be owned by a licensed physician. The Friendly Physician Shareholder (Shareholder) and Parent Corporation have entered into a Directors Agreement and Stock Transfer Agreement (PLR 2014-51009).
    - The Shareholder is named Director of the Professional Corporation, but the Directors Agreement can be terminated at any time by Parent Corporation.
    - The Stock Transfer Agreement prohibits Shareholder from transferring or disposing of the stock of Professional Corporation or paying a dividend or consenting to the liquidation of Professional Corporation. Parent Corporation can terminate the agreement and liquidate Professional Corporation.

Common tax modeling misconceptions to watch out for in estimating after-tax cash flow

Tax should equal book …

Interest is always deductible …

I can use NOLs, to offset EBT, no problem …

Cash can be moved around from country to country or entity to entity tax-free …

Transaction costs can all be expensed …

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