M&A transaction tax considerations

HCPEA 101 training

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Agenda

1. Why tax matters in M&A transactions
2. Buy-side tax due diligence objectives
3. Sell-side tax due diligence objectives
4. Structuring and modeling
5. Tax attributes
6. Other tax considerations

Why tax matters in M&A transactions

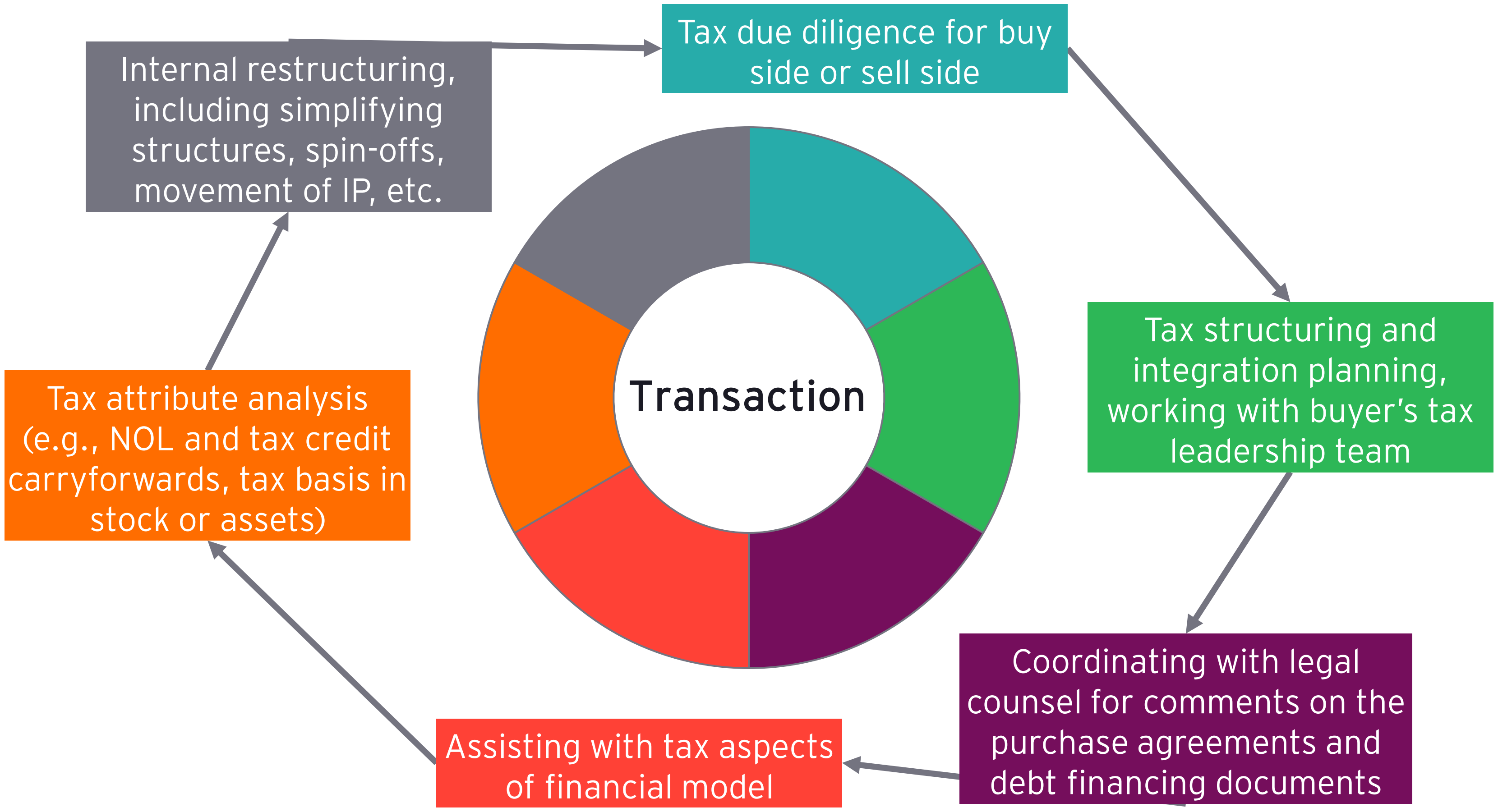
Why tax matters in M&A transactions

- 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, supply chain planning, integrate intangible property (IP)	Model cash tax requirements post-close, availability of net operating losses (NOLs), and toll charges on moving assets or legal entities

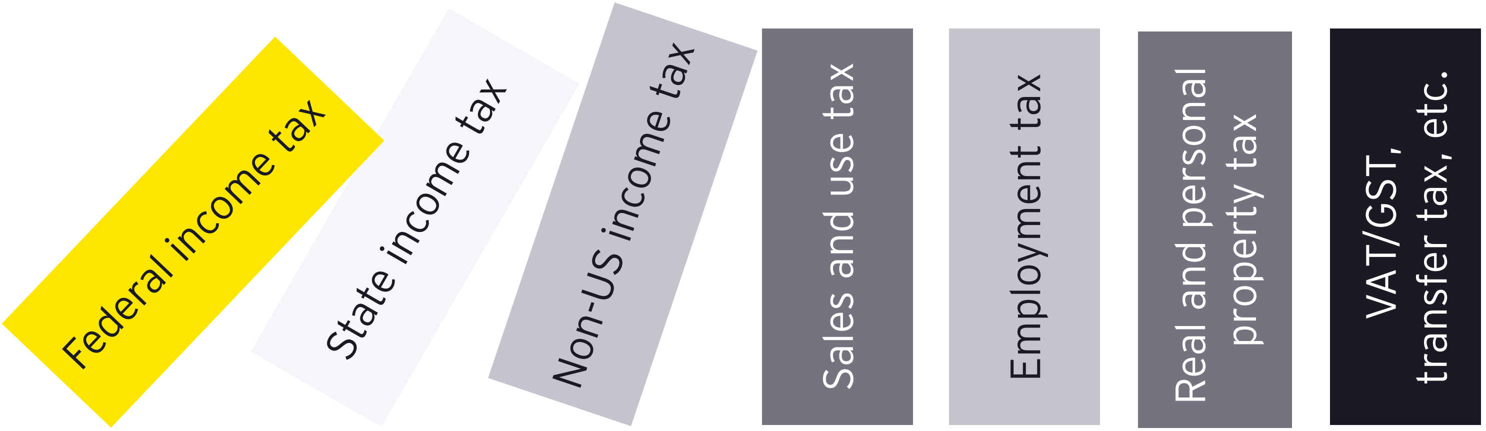
- Taxes that a seller will pay can have a significant impact on whether seller wants to sell stock or assets.

Tax focus areas in a transaction



Buy-side tax due diligence objectives

Buy-side tax due diligence objectives



Purpose of tax due diligence

- 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 examination activity (pending, current or closed) to enable more efficient integration into acquirer's business and tax reporting/accounting functions effectively post-close

Factors in determining level of tax due diligence

- **Target's legal entity structure:**
  - Is the target a corporation or flow-through partnership, S corporation (i.e., taxable acquisition stock or assets)?
  - Is this a carve-out, and will any legal liability carry over post-close?
  - How complex is the 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 obtained
  - Tax attributes – expiration and limitations on use

General guide for pre-assessment of buyer/seller tax position

	C corporation (stand-alone)	S corporation	C corporation subsidiary of tax consolidated group	Partnership[1]
Taxable asset purchase ▪ (Revalues target's tax basis in assets to fair market value (FMV))	▪ **Generally undesirable for sellers:** Potential for double tax on exit (at corporate and shareholder levels) ▪ Sellers may not be adverse if target has significant NOLs to shield corporate tax gains on asset sale	▪ **Possible if legal conditions allow:** Sellers generally pay only one level of tax[2] ▪ If target (or predecessor) was a C corporation within past five years, some (or all) of the gains could be subject to built-in gains (BIG) taxes at the corporate level ▪ Buyer might gross up seller for incremental taxes	▪ **Possible if legal conditions allow:** Depends on, among other things, whether target has equal or higher tax basis in its assets than seller has in its target stock ▪ Buyer might gross up seller for incremental taxes	▪ **Possible if legal conditions allow:** Sellers generally pay one level of tax[2]
Taxable stock purchase ▪ (Carryover of target's historical tax basis in assets)	▪ **Typically, the preferred exit for sellers:** Because of one level of tax at capital gains rates) ▪ Target's tax attributes (e.g., NOLs) carry over post-close, subject to change-in-control limitations	▪ May not result in significantly lower taxes to seller than asset sale (or 338(h)(10) transaction) ▪ Prior C corporation attributes (e.g., NOLs) carry over post-close, subject to change-in-control limitations	▪ **Could be preferred exit for seller:** If seller's tax basis in target stock exceeds target's tax basis in its assets or seller has expiring capital losses ▪ Target's tax attributes (e.g., NOLs) may carry over post-close (depends on seller's NOL position), subject to change-in-control limitations	▪ Buyer treats acquisition of 100% of partnership interests as asset purchase (i.e., basis revaluation) ▪ Potential step-up (Section 754 election) for purchase of less than 100% ▪ Seller treats as sale of partnership interest (i.e., capital gain), except to extent of ordinary income-type assets[2]
338(h)(10) transaction ▪ (Stock purchase treated as taxable asset purchase)	▪ **Unavailable for stand-alone "C" corporations:** If target has significant NOLs or capital losses, a "338(g)" election may be possible	▪ **Often the preferred approach:** Transaction is legal stock purchase but is treated as an asset purchase for tax purposes ▪ Similar factors as in asset sale	▪ May be preferable to legal asset sale ▪ Similar factors as in asset sale	▪ Inapplicable

1. Does not address tax-free rollovers, cross-border seller issues, or state and local tax considerations.
2. Includes LLCs treated as partnerships for tax purposes.
3. Some portion of the gains recognized by target in the asset sale could be subject to ordinary income taxes because of recapture of previous tax depreciation/amortization deductions or sales of appreciated ordinary income assets (e.g., inventory).

Sell-side tax due diligence objectives

Sell-side tax due diligence objectives

- **Scrub portfolio company to be sold so no tax surprises for seller:**
  - Prepare a tax factbook (US) or vendor diligence report (non-US) to tell the tax story and assist buyers in understanding the company — may include:
    - Detailed history of how the company came together (helpful in roll-up situations where the company has had a lengthy acquisition history)
    - Summary of valuable corporate tax attributes that a seller may expect a buyer to consider in bid price
    - Summary of tax basis step-up that may be realized by a buyer and that should be considered in bid price
    - Summary of other key tax drivers or matters impacting the company, such as:
      - Transfer pricing policies
      - Intercompany transactions
      - US international tax profile (global intangible low-taxed income (GILTI), base erosion and anti-abuse tax (BEAT), etc.)
      - Non-US tax matters

Structuring and modeling

Top five common tax modeling misconceptions

1	2	3	4	5
▪ Target's book/ effective tax rate equals target's cash tax rate (almost never): ▪ Corporate cash income tax rate (statutory rates – federal and state): federal – 21%; average state and city – 9% (7% after federal benefit) ▪ Does not include above-the-line taxes (VAT, gross receipt taxes, etc.)	▪ Transaction expenses are fully deductible (unlikely).	▪ Target's pre-closing NOLs are available without limitation to offset post-closing taxable income on a worldwide basis (unlikely – Section 382).	▪ Post-closing interest expense is freely available as a shield against taxable income (multiple limitations may exist).	▪ International operations will have no material impact on the company's cash tax position. (often, the cost of repatriation, phantom dividends and the mechanics of the US foreign tax credit will impose an element of double taxation on non-US earnings).

Common book-tax differences

- Book accruals and contingent liability reserves
- Stock option deductions
- Transaction expenses (investment banking fees, advisor fees, etc.)
- Book vs. tax basis differences:
  - Purchase accounting with no tax basis step-up
- Depreciation
- Amortization:
  - Research and development costs
  - Identified intangibles with useful life
  - Goodwill

Purchase agreement considerations

- Tax representations, warranties and indemnities
- Responsibility for filing tax returns and conducting IRS audits
- Purchase price allocation
- Tax components of working capital adjustment
- Transfer taxes
- Transaction expenses
- Post-close structure limitations/prohibitions
- Tax elections

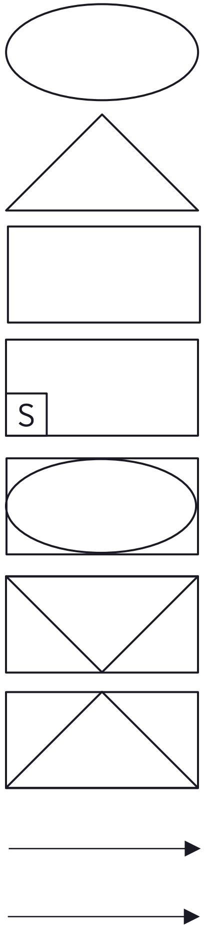
Tax structuring and planning matters to consider

- Legal forms of targets
- Asset vs. stock acquisitions
- Achieving tax basis step-up
- NOL limitations
- Other tax attribute limitations
- Interest deductibility
- Investor issues under UBIT (unrelated business income tax)/ECI (effectively connected income)/FIRPTA (Foreign Investment in Real Property Tax Act) rules
- Blocker planning
- Executive compensation planning
- Fund investment considerations

Legal forms of targets

- **Corporation:**
  - Subject to entity-level income tax
  - Exceptions: regulated investment companies (RICs), REITs
- **S corporation:**
  - Electing small business corporation, income/loss is passed through and taxed at shareholders' level
  - Treatment may differ for state purposes
  - Shareholder requirements prevent target from retaining S corporation status after private equity (PE) investment
- **Partnerships:**
  - Income/loss passed through and taxed at partners' level
  - Treatment may differ for state purposes (e.g., Texas)
- **Disregarded entities:**
  - Transparent for federal income tax purposes, considered as a division of the parent company (e.g., single member limited liability company (LLC))

Typical EY tax structure chart legal entity depiction



Individuals, trusts or, if below a legal entity, assets

Partnership

Corporation

S corporation

Disregarded entity for US tax purposes

A corporation for US tax purposes, a partnership for local tax purposes

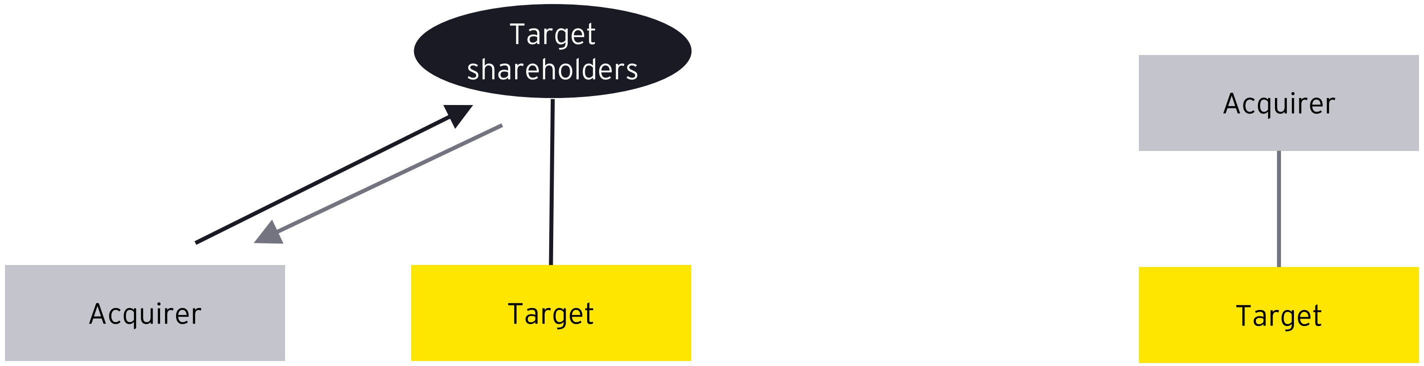
A partnership for US tax purposes, a corporation for local tax purposes

Guarantee

Bank debt

Basic taxable acquisition structures illustration

Taxable stock purchase

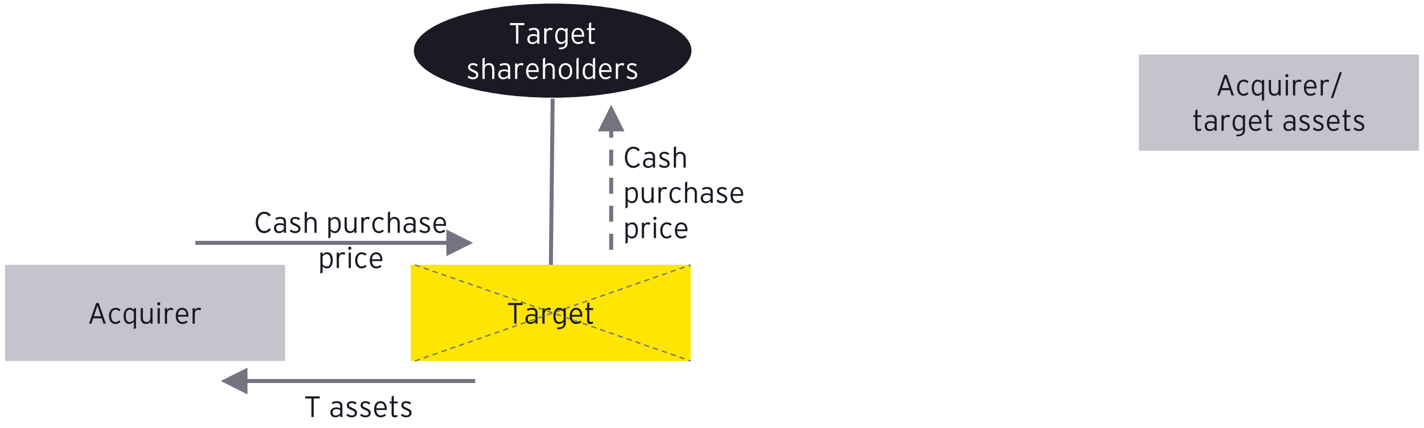


Considerations

- 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 illustration

Taxable asset purchase

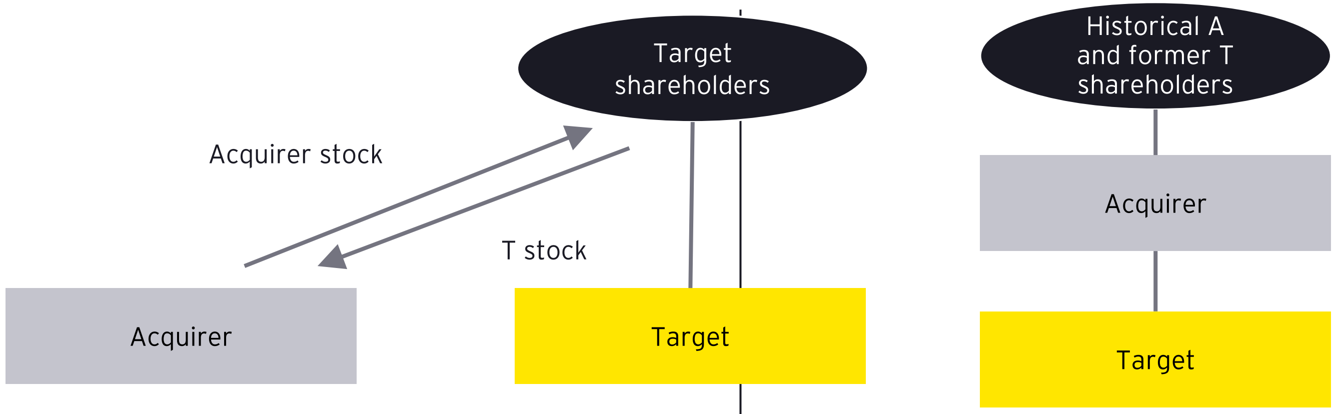


Considerations

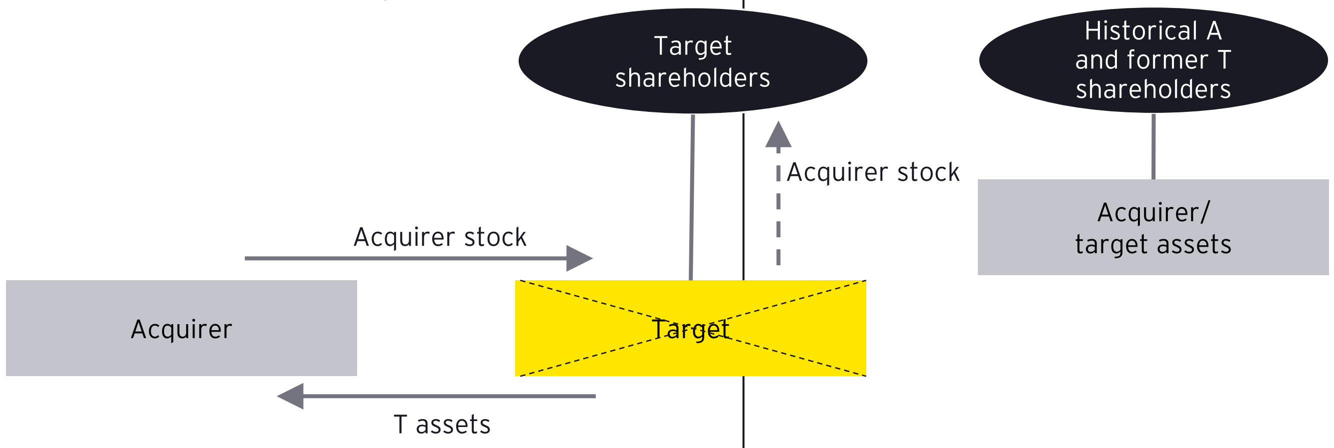
- Double taxation (corporate and shareholder level) often makes a sale of all assets cost prohibitive for a seller:
  - Target pays tax on asset sale gain (21% US federal income tax plus state income tax).
  - Seller receives cash in liquidation of target and has additional capital gain (20% US federal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

Basic nontaxable acquisition structure illustration

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, must recognize gain on the transaction

Achieving tax basis step-up

- **Stock acquisitions treated as asset acquisitions:**
  - Section 338(h)(10), Section 338(g) and Section 336(e) elections:
    - Benefits
    - Mechanical requirements
  - Buyer tax consequences:
    - Generally, tax basis step-up in target's assets
    - Generally, increase in after-tax cash flow resulting from increased tax depreciation/amortization
  - Seller tax consequences:
    - May result in additional taxes (federal + state) – gross-ups
    - Complications with rolling shareholders

- Complicating factors:
  - State taxes
  - Built-in gains taxes (S corporations)
  - Rolling shareholders/management:
    - S corporation shareholders are taxed as if sold 100%.
  - Inside/outside tax basis differences
  - Character of taxable gains (ordinary vs. capital)

Achieving tax basis step-up

- **Section 754 elections for partnership/LLC target:**
  - Election to achieve FMV basis in assets in a partnership/LLC target where the buyer acquires a partnership interest:
    - Step-up is unique to the buyer.
    - Rollover investors and buyers may have disproportionate need for tax distributions (fact that may be of interest to the lenders when negotiating tax distribution carve-out).
  - In order to achieve a step-up in the partnership assets under Section 754, the partnership interest should be acquired by sale from an existing partner.
  - The basis step-up achieved from a Section 754 election does not apply to a partnership interest acquired by a contribution of property, including money, to the partnership.
  - The partnership makes the election (if one is not in effect) by filing a written statement with the partnership tax return for the taxable year during which the transfer of the partnership interest occurs.

Tax attributes

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:
    - Note: The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) made changes to the NOL provisions, including (1) changed 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 two years but carried forward only 20 years.
- Examples of income events that may create a need to use NOLs:

Collaboration up-front 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 applicable federal rate (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

- 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):
  - Has target 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 (disallowance of interest expense, non-deductible transaction costs, etc.)?
  - Has target undertaken a detailed R&D tax credit study to justify the validity of tax credits?

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

- The company would have cash taxes due in years two and three because the target may have more taxable income than available Section 382 limitation.
- Target can only use $60m in year two (e.g., $40m annual limitation plus $20m unused excess limitation from year one) and $40m in year three (e.g., $40m of limitation that became available in year three).

Cash tax calculation (assuming no restrictions on NOLs)						
	Year 1	Year 2	Year 3	Year 4	Year 5	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)						
	Year 1	Year 2	Year 3	Year 4	Year 5	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

Other tax considerations

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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) plus 5%
  - Permanently disallows OID deductions to the extent YTM exceeds the AFR plus 6%
  - Planning surrounding terms may help avoid limitation (i.e., bullet payment of interest in year five)
- **Corporate acquisition indebtedness rules – Section 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 – Section 163(j):**
  - For tax years beginning on or after January 1, 2022, Section 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 that 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.

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:**
  - Anti-deferral provisions cause 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 applies 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).

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