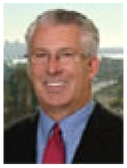

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Top 10 Merger and Acquisition Tax Issues

The tax impact of properly structuring the disposition and acquisition of a company can have a very material impact on the economics of the transaction to both parties. Here's why.

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Despite the slowing U.S. economy, there is still a significant amount of merger, acquisition and divestiture activity in the marketplace.

The current transaction volume is driven by a number of factors including: general company restructurings which include divestitures of unprofitable divisions or subsidiaries, strategic acquisitions by competitors or investment funds and the weakened dollar combined with the relative attractiveness of U.S. companies to foreign buyers.

Whether the sale is a "lifetime event" for the founding sole-owner of a business or the disposition of a public company's subsidiary, the tax impact of properly structuring the disposition and acquisition can have a very material impact on the economics of the transaction to both parties. And while the parties must generally report the transaction on a consistent basis, there are numerous tax planning opportunities that allow each party to obtain its specific tax and economic objectives without harming the other party.

10 Issues to Consider *Before* M&A

Following is a non-exhaustive list of the more common issues which should be considered when acquiring or disposing of a business entity or the underlying assets:

1. **Tax Attribute Carryovers** — Does the entity being disposed of have tax attributes, such as high tax basis in its operating assets, Net Operating Loss Carryovers, tax credit carryovers? If so, a tax-free reorganization under IRC Section 368, or a taxable purchase/sale of C Corp stock will often be preferable to an asset purchase. Section 382 may limit the annual utilization of the loss, and may limit the overall value of the net operating loss (NOL) to the extent utilization is deferred or capped during the 20 year carryover period. State limits may be even more restrictive.
2. **Financing Structure** — How will the transaction be financed? With cash, notes and/or the Buyer's stock (common or preferred)? A higher concentration of the purchaser's common stock and/or notes may allow for a tax-free reorganization to be structured. If the Buyer is foreign, debt financing may require the domestic debtor to withhold taxes on payments. This issue can

also arise in a multi-state context. In addition, the "interest stripping" rules of IRC Section 163(j) may limit the amount of the current year interest deduction. "Thinly Capitalized" companies may also be denied interest deductions to the extent a portion of the debt financing is re-characterized.

3. **Legal Status of Target —** Is the acquired entity an S Corp, LLC or Partnership? If so, the tax basis of its assets may be revalued through the use of an IRC Section 338(g) or 338(h)(10), or an IRC Section 754 election in the case of a partnership. The stock of a C Corp target company may also be acquired utilizing a Section 338(g) or (h)(10) election; however, the overall tax burden will generally be much higher for the seller. in order to allow the 338 election, at least 80 percent of the Seller's stock must be sold. Special, and complex 338 rules apply when asset transfers take place before or after the stock sale occurs, in order to make sure the Buyer and Seller are not allowed to obtain added step-up or loss benefits on selected assets, while obtaining capital gains breaks on all other assets retained in the Corporation.
4. **Ordinary vs. Capital Gain —** If the assets being sold include inventory, depreciated assets, or other "ordinary" income assets, ordinary tax rates will apply to net gains associated with the prior depreciation allowed or allowable (versus treating the entire gain as capital gains, which would be the case with an outright C or S Corp stock sale (without an 338 election). The sale of a partnership assets or partnership interests can trigger ordinary gain to the extent of "hot assets" such as cash basis accounts receivable, depreciation recapture, etc.
5. **Purchase Price Allocation —** The allocation of purchase price by the buyer and seller is of critical importance in an asset or 338 transaction. See IRC Section 1060. If the Buyer or Seller is a public company they may be more focused on GAAP treatment and the Seller may have more flexibility on structuring and purchase price allocation. For maximum tax benefits, the Seller in an asset or 338(h)(10) transaction will want to allocate as much of the sales price to assets which generate capital gain, such as goodwill, land, or other assets with fair market values higher than original tax cost (thereby generating Section 1231 gain). The buyer on the other hand will generally want to allocate as much as possible to short-lived assets such as machinery and equipment, inventory, prepaid expenses, etc. rather than goodwill or covenants not-to-compete, which are amortized under Section 197 over 15 years for tax purposes.
6. **Sales and Other Transfer Taxes —** These costs are often overlooked until the 11th hour or in some cases after the close. Since these taxes are generally applied to the gross allocations (versus taxable gain amounts) made to certain asset types (e.g. machinery & equipment, certain software, vehicles, and other assets), these taxes and fees can often raise the cost of asset sale transactions by five percent to 10 percent. It is important for the parties to carefully define which party will bear the transfer tax costs of the transaction.
7. **Post-Transaction Filing Requirement/Elections —** Generally a taxable asset purchase will allow the new owner to make new tax elections of accounting periods and methods, while a stock purchase or reorganization will require the new owner to continue to use the former entity's tax elections. Year-end conformity with affiliated companies' year-end will often be required, and "short-period" returns for the pre-acquisition period may be required. It is important for the parties to include in the acquisition documents the responsibility for the pre- and post-acquisition income tax, payroll tax, property tax and other filings, as well as the allocation of the related liabilities.
8. **Transaction Costs —** Each party's separate legal, accounting and other transaction costs will generally reduce the reportable capital gains or ordinary income reportable by the Seller and the Buyer will generally add the costs to their basis of assets or entities acquired. Some costs related to pre- and post-acquisition periods may be deductible as general operating costs for the period incurred.

9. **Accrued Liabilities/Contingent Expenses —** Care must be taken to document all pre-acquisition liabilities incurred by the Seller and assumed by the Buyer. The tax deductibility of payments made post-acquisition can result in either the Seller or Buyer or in some cases neither party, getting the tax deduction for the payments. Generally the tax deductibility is a bit clearer when stock, LLC or partnership interests are sold versus assets. Significant efforts are spent by Buyers in evaluating whether unrecorded liabilities may be present. Time should also be spent evaluating whether the Seller has unrecorded assets such as unclaimed tax refunds associated with loss carryback potential, unclaimed tax credits and other assets that may not be reflected on the balance sheet.
10. **S Corp Targets and Related Issues —** A frequently encountered structure involves the acquisition of an S Corp by a public company or another taxpayer that desires to make a Section 338(h)(10) election in order to step-up the acquired assets, thereby allowing the write-off of the re-valued assets over a one year (inventory), three to 10 year (most machinery and equipment) to 15-year (intangibles, including goodwill) period or 39 years in the case of real estate. It is critically important for both parties to make sure that the Target's S Corp election and operations are valid and the entity is a valid S Corp at the time the election is made — otherwise a stock acquisition followed by a 338 election can trigger unintended double taxation, since the Target entity will be treated as a C Corp and will be saddled with extra taxes.

If the S Corp was originally formed as a C Corp and it elected S Corp status less than 10 years before the taxable stock sale, additional care and documentation are necessary to quantify the "Built-in-Gain" (BIG) tax exposure associated with pre-S election appreciation in the underlying assets. This BIG tax exposure can have a material impact on whether or not to make the 338(h)(10) election.

The aforementioned corporate transactions can present both Buyers and Sellers with very significant tax issues and tax planning opportunities. It's critical that you perform careful technical analysis and financial modeling to evaluate the pros and cons of alternative structures. And memorializing both parties' tax and financial objectives in the Purchase Agreement or related documents will minimize disputes down the road.

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