

U.S. Tax Issues Relating To M&A Transactions

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Agenda

- Structuring M&A Transactions
- Section 338 Election
- Due Diligence
- Financing the Transaction
- Section 382 Limitation
- Section 280G – Golden Parachute

Structuring M&A Transactions

Taxable Transaction

	Asset Transaction	Stock Transaction
Seller	<ul style="list-style-type: none">• Double taxation – Corporate level tax & tax on dividend distributions to Target’s shareholders.	<ul style="list-style-type: none">• Tax on gain from the sale of stock (generally capital gain).
Purchaser	<ul style="list-style-type: none">• No carryover of tax attributes;• Basis “step-up” in the assets;• Administrative burden.	<ul style="list-style-type: none">• Carryover of tax attributes (subject to certain limitations);• No basis “step-up” in the assets.

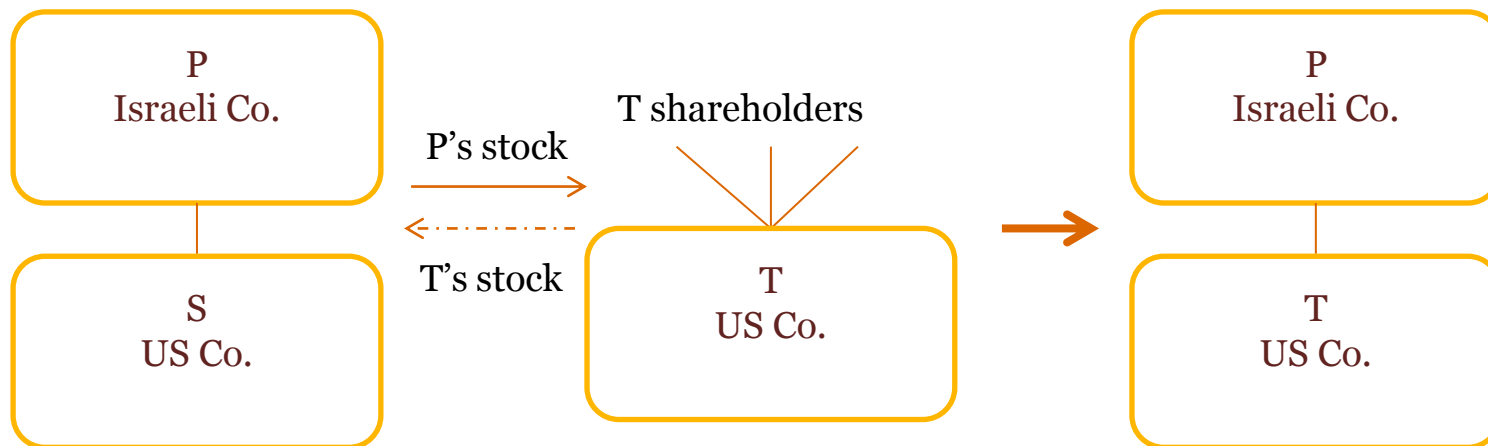
Structuring M&A Transactions

Tax-Free Transaction

	Asset Transaction	Stock Transaction
Seller	<ul style="list-style-type: none">• Target's Shareholders receive Purchaser's stock as consideration (up to 60% "boot").	<ul style="list-style-type: none">• Target's Shareholders receive Purchaser's stock as consideration (up to 20% "boot").
Purchaser	<ul style="list-style-type: none">• Carryover of tax attributes, e.g., no basis "step-up" in the assets;• Transfer of title in the assets.	<ul style="list-style-type: none">• Carryover of tax attributes e.g., no basis "step-up" in the assets.

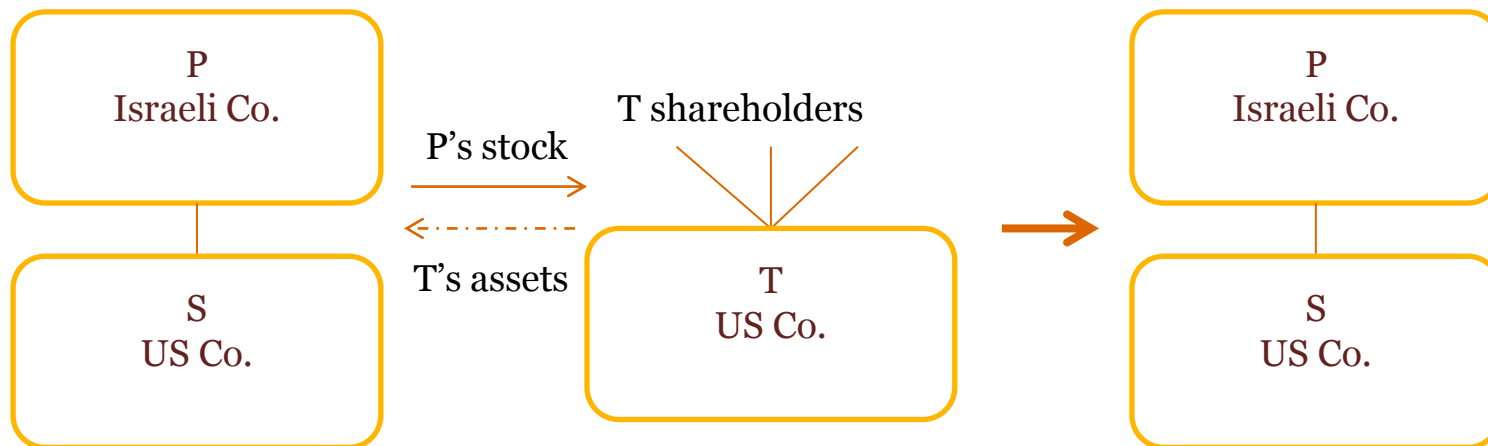
Structuring M&A Transactions

1. Tax Free Stock Transaction - Reverse Triangular Merger:



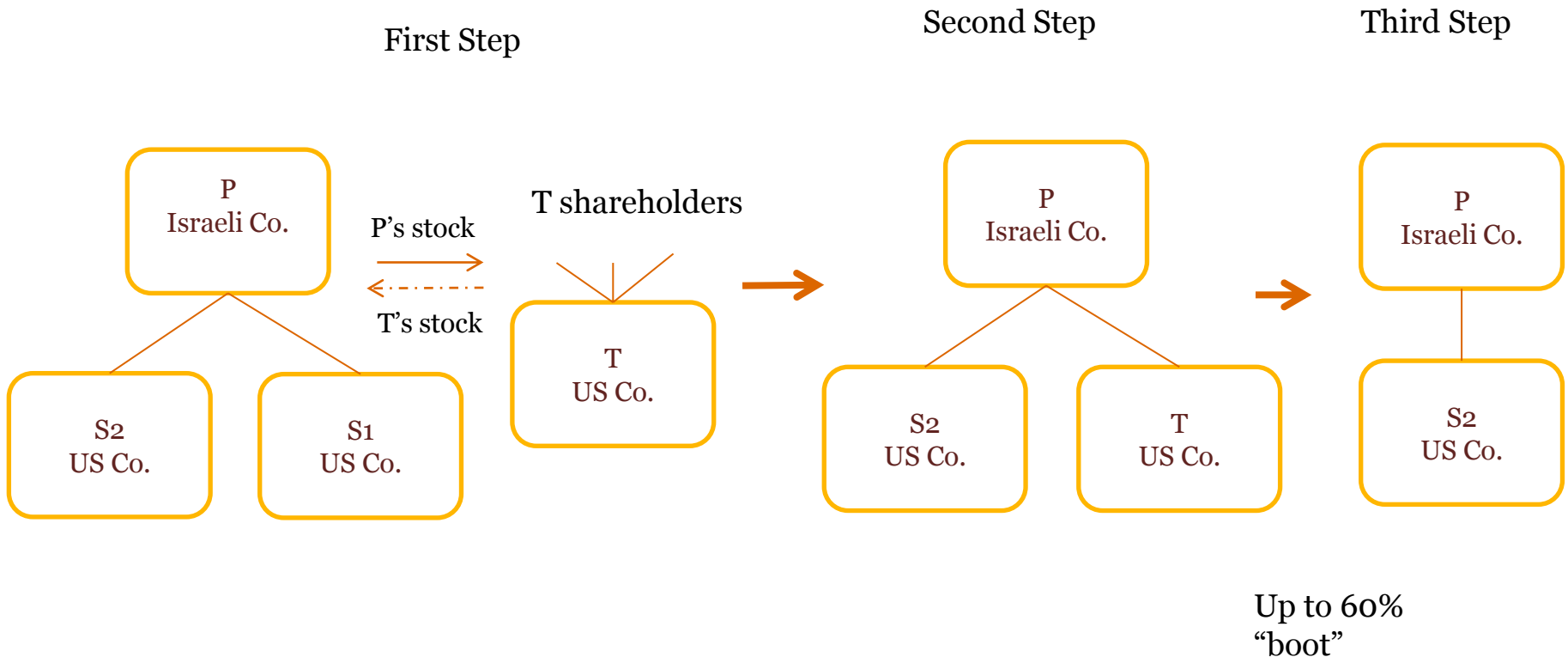
Structuring M&A Transactions

2. Tax Free Asset Transaction - Forward Triangular Merger:



Structuring M&A Transactions

3. Tax Free Asset Transaction - Forward Triangular Merger:

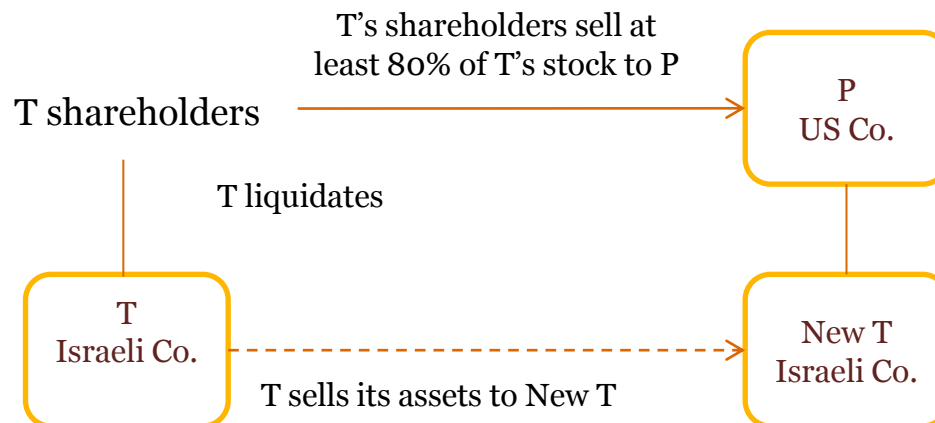


Section 338 Election

A regular section 338 election by Purchaser causes Target to be deemed to have sold its assets in a taxable transaction.

Consequences

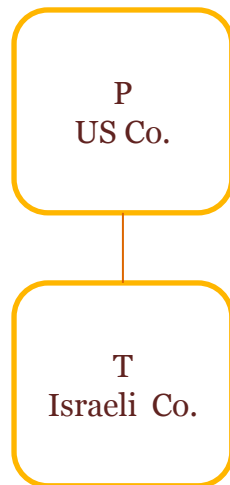
- Basis step-up in the assets and eliminates Target's historic attributes;
- It is rarely worthwhile to pay corporate tax in order to secure a stepped-up basis and thus tax benefits in the future.
- A section 338 election may be suitable when Target is a foreign corporation or Target has NOL carryover.



Section 338 Election

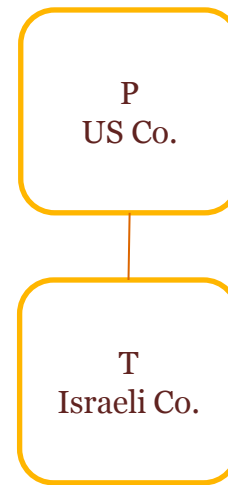
Consider section 901(m) : Generally disallows foreign tax credits in connection with “covered asset acquisitions,” including qualified stock purchase under section 338.

Under foreign tax law



T's assets have a carryover tax basis -> T's income for foreign income tax purposes is higher than for U.S. income tax purposes.

Under US tax law

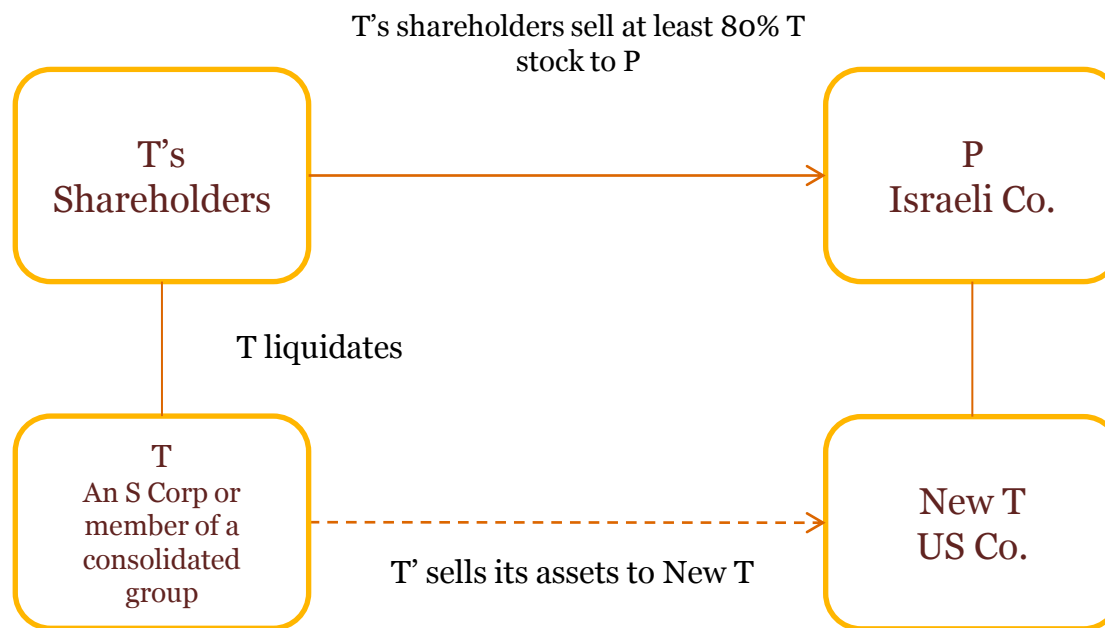


T's assets have a stepped-up tax basis -> T's income for U.S. income tax purposes is lower by reason of enhanced depreciation deductions.

Section 338 (h) (10) Election

Eligibility to make a section 338 (h) (10) election:

- Target is an S corporation or a member of a consolidated group;
- Purchaser must purchase at least 80% of Target's stock.



Section 338 (h) (10) Election

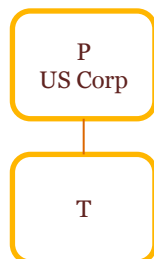
Consequences

- Basis “step-up” in assets and no carryover of tax; attributes;
- Only one level of tax;
- Seller may require compensation for making the election for the following reasons:
 - State tax liability;
 - Inside basis in assets lower than outside basis in stock;
 - Recognition of ordinary income rather than capital gain on the asset sale.

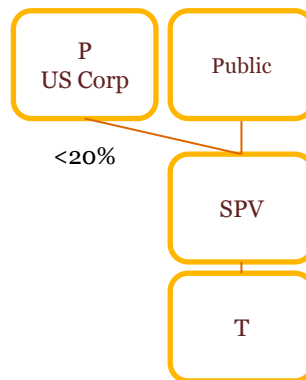
New Regulations Under Section 336 (e)

- Seller: a domestic corporation or an S corporation's shareholder;
- Target: a domestic corporation or an S corporation;
- Purchaser: cannot be a single domestic corporation.

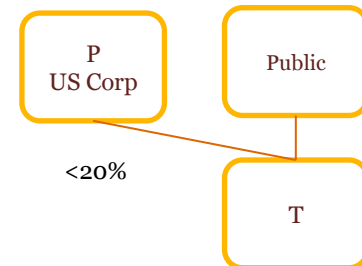
Example 1: Target's IPO



Section 338 (h)(10)

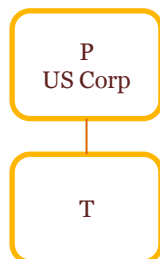


Section 336(e)



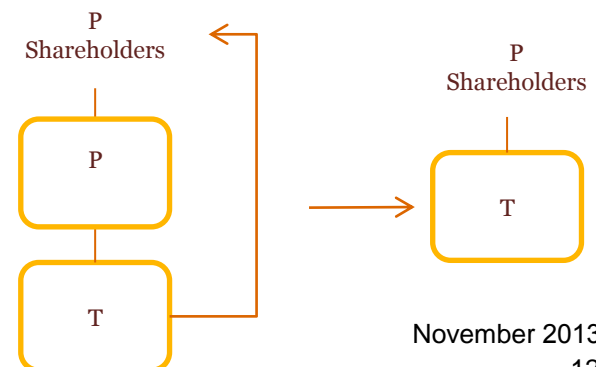
Example 2: Distribution of Target's stock

(assuming section 355 is not applicable)



Section 338 (h)(10) is not available.

Section 336(e)



The Due-Diligence Process

Preliminary review of available information

Scoping the due diligence (e.g. is SALT included). Preparing Document request list.

Review tax returns, financial statements, IRS reports and related tax material

Attention to the reconciliation between financial and tax reports

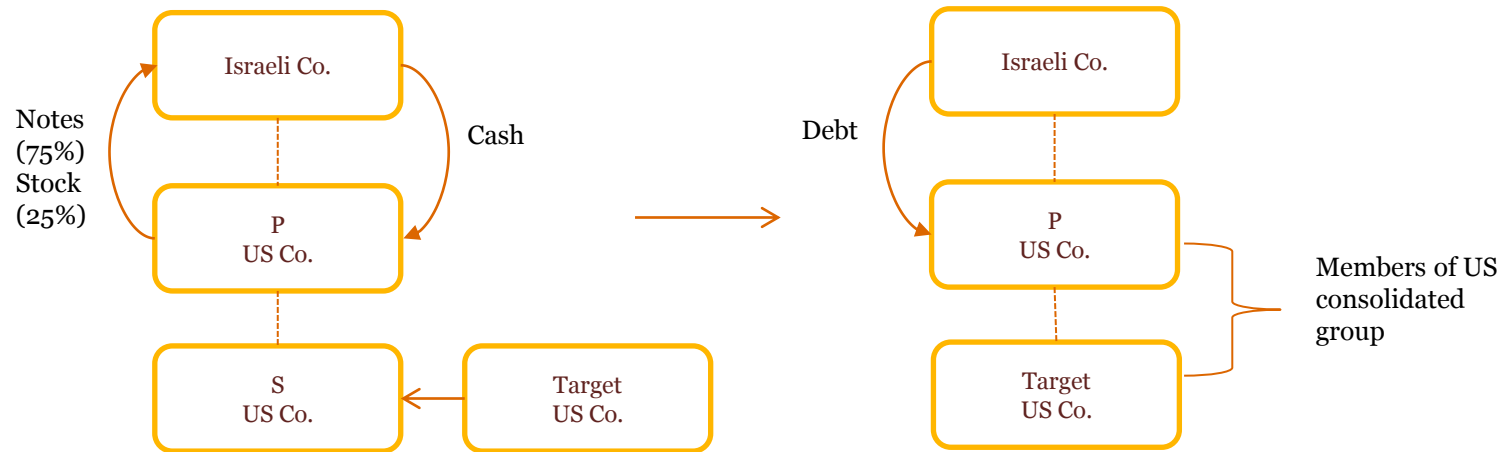
The Due-Diligence Process

Identify open issues

Discuss open issues with the target company's tax director/controller

Consider effect on purchase agreement: tax reps, tax covenants, tax indemnities or purchase price adjustments.

Financing the transaction – Debt v. Equity



- Foreign Company (e.g., Israeli company) funded US Purchaser with debt and equity;
- Following the acquisition the US Purchaser and Target will file a US consolidated return -> US Purchaser's interest expense may be used against Target's income.

Financing the transaction – Debt v. Equity

Issues to consider

- Debt v. Equity (e.g., see - Scottish Power);
- Earnings stripping (limitation on the deductibility of interest expense);
- Deduction of interest expense based on cash method of accounting, (in the case of an Israeli parent, inclusion of interest income based on accrual method);
- US withholding tax on interest payment.

Section 382 Loss Limitation

Acquisition Price	\$100m
LTTER (i.e., applicable interest rate)	3%
Pre-Acquisition NOLs	\$80m

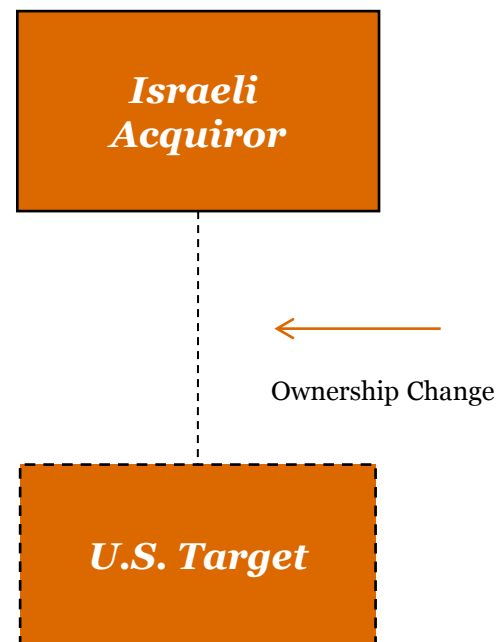
Annual base limitation ($3\% \times \$100m =$) \$3m



**Limited to 20
years!**



**\$20m of NOLs –
permanently
lost!**



Increase of Section 382 Loss Limitation

- “Built-in gain” assets may increase the section 382 loss limitation under the NUBIG rules;
- Pre-ownership change NOLs carryover may be used against gain recognized on the disposition of the “built-in gain” asset;
- The disposition of the “built-in gain” asset has to occur within 5 years of the time of the ownership change;
- Alternative section 338 method – Increase of section 382 limitation in an amount equal to a notional enhanced depreciation / amortization deduction, following a notional asset sale.

Increase of Section 382 Loss Limitation

Acquisition Price	\$100m
LTTR	3%
FMV of Goodwill	\$60m
Basis of Goodwill	0

Notional enhanced amortization (\$60m/15 years)	\$4m
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Annual increase in section 382 loss limitation under NUBIG rules of	\$4m
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**Over the
course of 5
years!**



**\$20m increase
in available
NOL!**



*Israeli
Acquiror*



Ownership Change



U.S. Target

Section 280G “Golden Parachute”

- A “golden parachute” payment is any payment in the nature of compensation if the following conditions are met:
 1. Payment is contingent on a change in ownership; and
 2. The aggregate present value of such contingent payments equals or exceeds three times a disqualified individual’s “base amount” (e.g., annual salary).
- Disqualified individual - meaning an employee/contractor who performs personal services and is officer / shareholder etc., of the Company;
- Deduction of excess parachute payment is disallowed;
- Excise tax of 20%;
- May apply in the case of stock options acceleration.

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Thank you!

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