

M&A Tax Aspects for Portfolio Companies

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- The purpose of this document is to highlight certain U.S. Federal¹ tax issues and Israeli tax issues.
- The information contained in this presentation is for general guidance on matters of interest only. As such, it should not be used as a substitute for consultation with professional tax advisers.
- This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding any federal, state or local tax penalties.

1 The scope of this document does not intended to cover any U.S. state or local tax aspects nor does it intend to cover any non-U.S. tax aspects.

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Part I: Background



Background

- In the face of poor economic conditions, alternative investment funds are facing a sharp decline in exit opportunities and lack of liquidity, yet they are continuing to raise funds and invest.
- There is an ‘exit drought’ under current market conditions. The VC-backed IPO market is at a 30 year low. M&A may still be (although the reduction in number of transactions) the most relevant exit alternative.
- For U.S. tax purposes, a transaction can be taxable or tax free. Whether a transaction is taxable or tax-free is determined in accordance with the Internal Revenue Code, and is not elective.

Part II: Taxable Transaction – U.S. Tax Aspects



Type of Transactions

As a general rule, if a transaction does not qualify as a tax free transaction it will be taxable. If taxable, it will be taxable for both the seller and the Buyer.

Types of transaction:

- Stock transaction
- Asset transaction
- A combined transaction
- IRC §338(h)(10) acquisition of stock with characterization of asset purchase.

Typical Stock Purchase (with No Section 338 Election)

- Seller's gain based on tax basis in stock (i.e., "outside basis").
- Buyer does not obtain a step-up in tax basis (absent Section 338 election).
- Under purchase accounting, book basis step-up recorded with no corresponding tax step-up. The book/tax disparities on depreciation and amortization can negatively impact earnings.
- Buyer may inherit tax attributes of Target (may be subject to certain limitations).
- Disposition of unwanted assets may result in tax cost.

Tax Aspects relating to Planning an Acquisition Transaction

ISSUE

In many cases, the Seller prefers a stock acquisition and the Buyer prefers an asset acquisition.

POSSIBLE SOLUTION

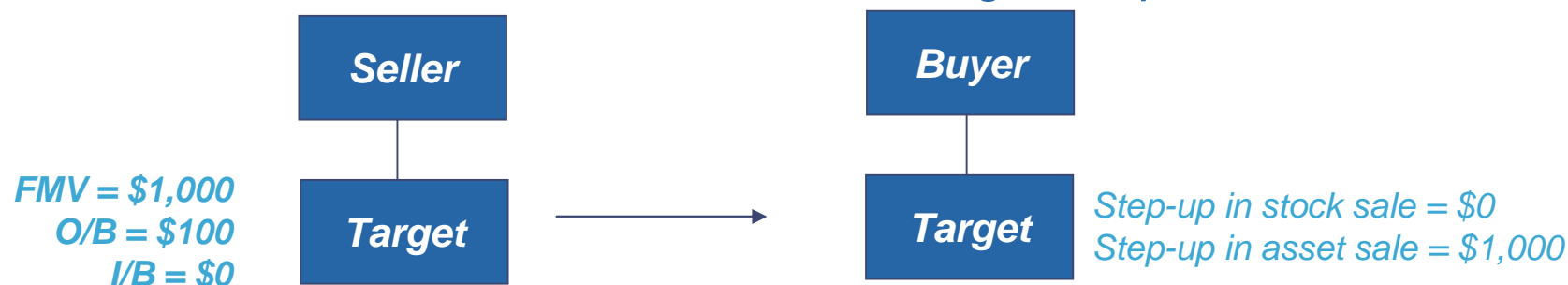
A Section 338(h)(10) election is an election to treat the acquisition of stock, for US tax purposes, as an acquisition of the target's assets.

Section 338(h) (10) Election

- What is it?
 - Joint election by buyer and seller
 - Treats seller of stock as having sold assets in a taxable transaction.
 - Seller, therefore, recognizes gain or loss on deemed asset sale.
 - Buyer gets “stepped-up” basis in assets and, therefore, additional future tax deductions.

Section 338(h)(10) Election

Where the seller’s outside basis (basis in the stock) equals inside basis (target corporation’s basis in the assets), the seller is generally no better or worse off by entering into a Sec. 338(h)(10) transaction. On the other hand, if the outside basis is higher than inside basis, the seller’s tax cost would be greater in a Sec. 338(h)(10) transaction, thus would prefer a stock sale or seek compensation for the increased tax cost of 338(h)(10). There are circumstances in which the buyer’s benefit of the Sec. 338(h)(10) election exceeds the seller’s detriment. See the following example.



Gain in stock sale = \$900
Gain in asset sale = \$1,000
Assuming 40% tax rate,
Seller is \$40 worse off.

Assuming the entire step-up is for goodwill (generally amortized straight line over 15 years, in the US), a 40 % tax rate and 10% discount rate, NPV of Buyer’s benefit is approximately \$200.

Net Operating Losses (“NOLs”) - General

- General carryback and carryforward rules.
 - 2 years back
 - 20 years forward
- No regular tax, but may incur Alternative Minimum Tax (“AMT”).
- A US company may have NOLs but due to the applicable attribution rules of its relevant State may nevertheless levy State taxes.

Net Operating Losses (“NOLs”) – Section 382 Limitation

- Section 382 proposes a limitation on NOLs utilization in the case of a change in ownership of more than 50.
- Limitation based on value of company times long-term tax-exempt rate.
 - Limitation computed only once, not annually.
 - Unused limitation can be carried over from year to year.
 - States may impose additional limitations on the use of NOLs.
 - Special rules apply for companies emerging from bankruptcy.

Net Operating Losses – Section 382 Limitation example

- X corporation has \$50 million of NOLs and its stock is acquired for \$100 million.
The long term tax exempt rate is 5% when the stock is acquired.
 - $\$100\text{m} \times 5\% = \$5,000,000$: No more than \$5,000,000 of NOLs can be used annually.
 - If not used, the limitation carries over to the next year increasing the amount of NOLs that can be utilized.
 - Exception for built-in items (e.g., increase in limitation from amortization of Net Unrealized Built-In Gains (“NUBIG”)).

Installment Sale - Overview

- An installment sale is a sale, resulting in a gain, of property where Taxpayer receives at least one payment after the tax year of the sale. May include:
 - Funds held in escrow
 - Earn-outs

- As a general rule -Gain is recognized ratably as total payments are received

Installment Sale – Overview (cont.)

Example -installment sale treatment (no consideration of imputed interest):

FACTS:

Total proceeds	600	
Cost basis	<u>150</u>	
Gross profit - %	450	75%

$$\text{Gain recognized} = \frac{\text{Gross profit}}{\text{Total contract price}} \times \text{Payment received}$$

CALCULATION OF GAIN RECOGNIZED:

Yr 1- initial	= 75% X 200 = 150
Yr 2	= 75% X 200 = 150
Yr 3	= 75% X 200 = <u>150</u>
Total Gain	450

Installment Sale – Contingent Payment Sale

- **What is it?**

A contingent payment sale is one in which the total sales price cannot be determined by the end of the tax year of the sale. This may happen, for example when the sales price includes a percentage of future profits, or milestones.

- **Method available in a contingent payment:**

- **Stated Maximum Sale Price** – when the max sale price can be determined. Cost basis recovered as payment received using gross profit.

- **Fixed Period** – when the max sale price cannot be determined, but the max. period over which payment is received is fixed, then cost basis is allocated equally to the payment years.

Installment Sale – Contingent Payment Sale (cont.)

- Example -installment sale with contingent payment (no consideration of imputed interest):

FACTS:

Non-Contingent Payments	100	
Contingent Payments	<u>900</u>	
Maximum Stated Selling Price	1,000	
Maximum Stated Selling Price	1,000	
Cost basis	<u>300</u>	
Gross profit - %	700	70%

$$\text{Gain recognized} = \frac{\text{Gross profit}}{\text{Total contract price}} \times \text{Payment received}$$

CALCULATION OF GAIN RECOGNIZED IN 1ST YEAR

$$\text{Yr 1- initial} = 70\% \times 100 = 70$$

Installment Sale – Tax Considerations

- Taxpayer may elect out of installment sale and recognize all gain at that time.
- Imputed interest – if the sales contract does not provide for adequate stated interest, IRC 7872 may require some of the capital gain to be re-characterized as interest.
- Reduction of selling price - if sales price is reduced, taxpayer may need to recalculate gross profit.
- Loss transaction – if installment sale becomes loss transaction, loss should not be recognized until all payments are received or becomes worthless.

Part III: Tax-Free Transactions - U.S. Tax Aspects



Overview

IRC Section 351 governs tax-free incorporations.

Additionally, IRC Section 368 contains the following tax free reorganizations:

- A** - Merger or consolidation
- B** - Stock acquisition
- C** - Asset acquisition
- D** - Transfer to controlled corporation
- E** - Recapitalization
- F** - Mere change of name, form or place of organization

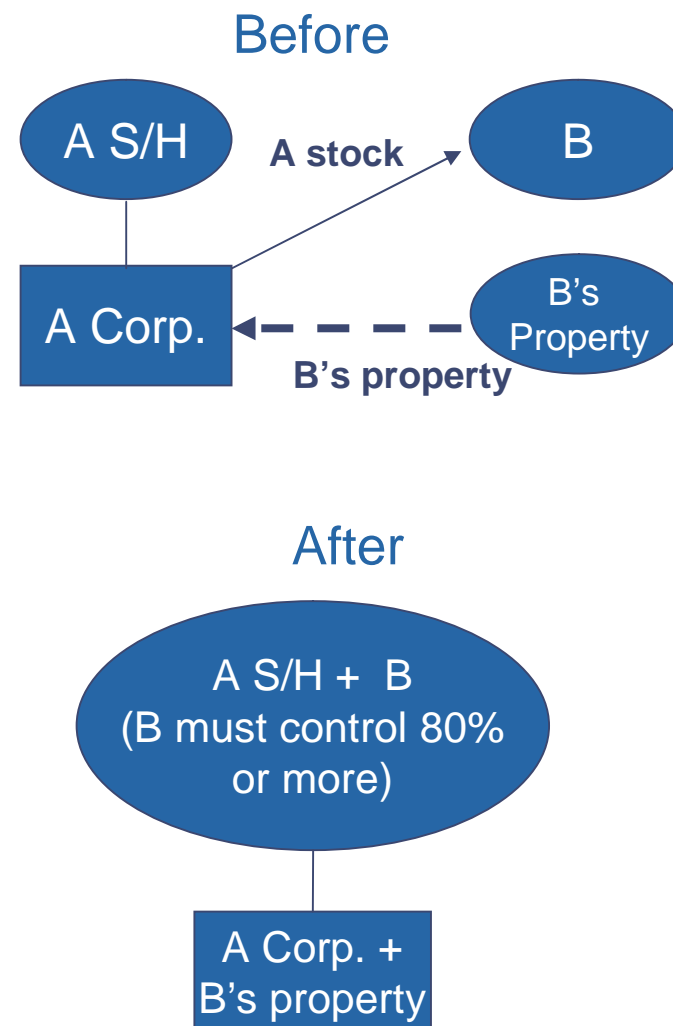
Tax-Free Incorporation - §351

Description:

- B contributes its property to A Corp in exchange for A's stock

Main Requirements :

- Transfers **property** to a corporation solely for **stock**, and
- The transferor(s) is(are) in **control** of the transferee corporation **immediately after** the transfer



General rules applicable to all reorganization

- **Business Purpose**

Valid business purpose - some reasons for the reorganization other than tax savings is required for the transaction to be respected by the IRS and the courts.

- **Continuity of business**

After the reorganization, the acquirer either uses a significant portion of target's assets or continues a significant line of the target's business.

- **Continuity of shareholder interest**

Material part of the consideration received by target shareholder consists of stock of the acquirer.

- **Step transaction doctrine**

The reorganization cannot be part of a larger plan that if taken in its entirety would be a taxable transaction.

Tax Consequences

If a transaction is qualified for a tax-free treatment, the associated tax consequences will generally be as follow:

- Target Corporation
 - No gain or loss is recognized by Target (“T”)
 - The assumption of T’s liabilities does not trigger the recognition of gain

Tax Consequences – (cont.)

▪ Purchaser Corporation

- The acquiring corporation does not recognize gain or loss when it receives property in exchange for its stock
- P takes a carried over basis in the T's assets and generally acquires T's tax basis attributes
- Carryover holding period

Tax Consequences – (cont.)

- Target shareholders
 - No gain or loss on the exchange of their stock for stock in the acquiring corporation
 - If a T shareholder receives non-stock property (“boot”), the T shareholder generally recognizes gain to the extent of the boot received, not in excess of the gain realized on the transaction.
 - T shareholder’s substituted basis in P stock received is equal to the basis in the T stock surrendered, plus any gain recognized, and decreased by the amount of any boot received.

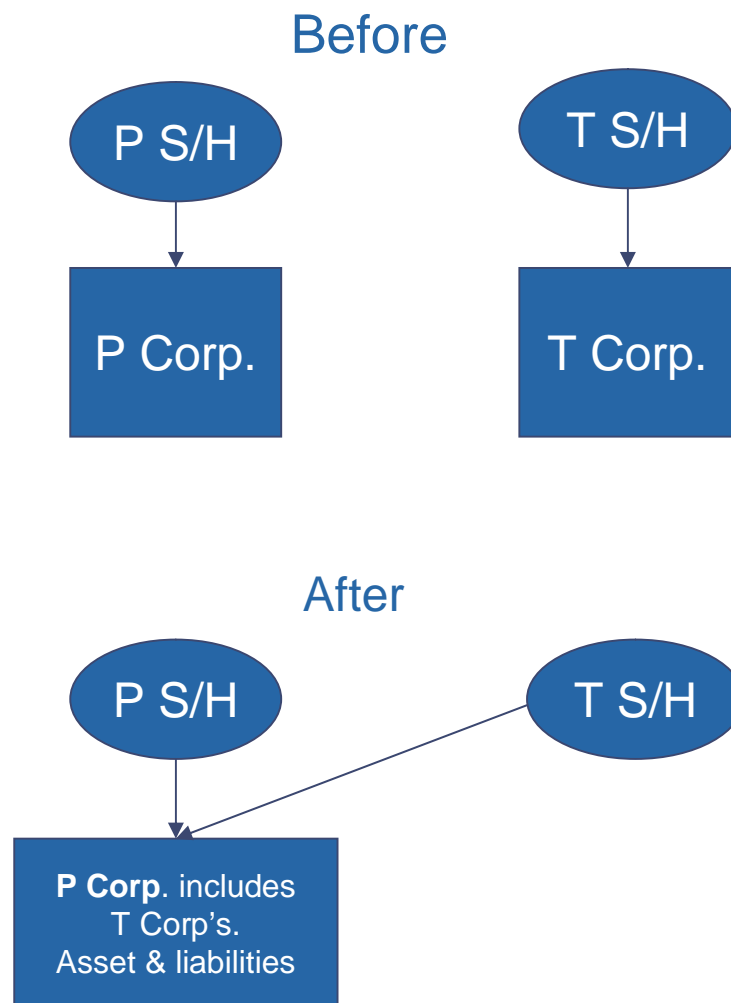
“A” reorganization §368(a)(1)(A)

Description:

- T merges with and into P under federal, state law, or foreign law. P is the surviving entity.
- T’s shareholders receive P stock and/or boot in the exchange.

Main Requirements:

- Statutory mergers or consolidations in accordance with federal, state or foreign mergers laws
- Assets and liabilities of Target are transferred to the acquiring corporation
- No “solely for voting stock”, boot can be used – e.g., cash.
- No requirement for “substantially all” assets.



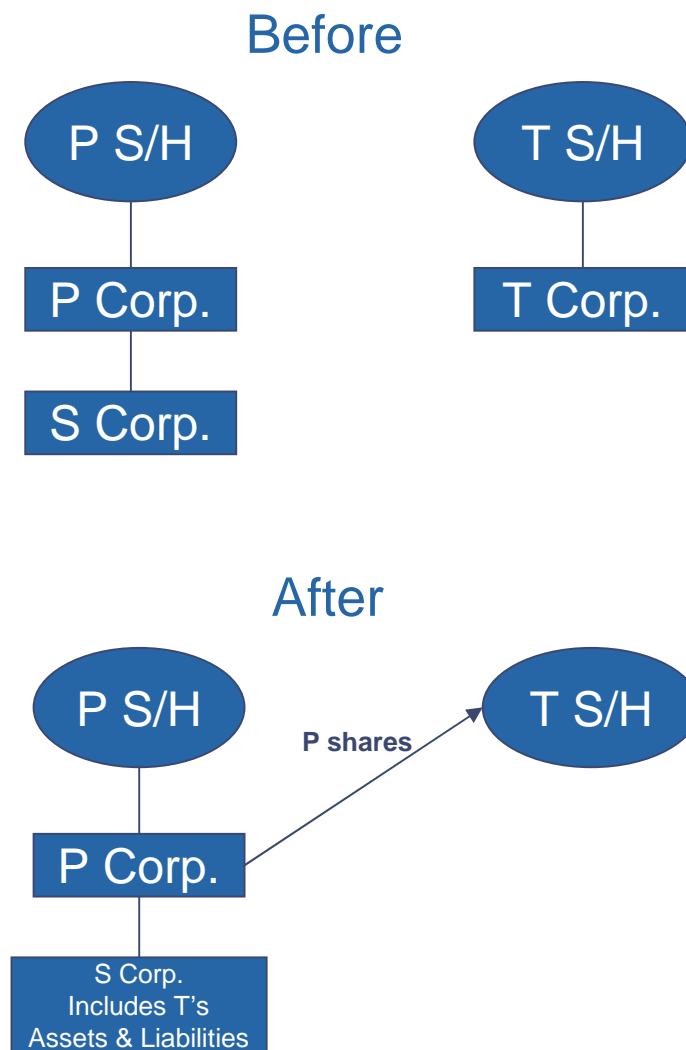
Forward triangular merger §368(a)(2)(D)

Description:

- T merges with and into S, a new /pre-existing first tier subsidiary of P, under federal, state or foreign law. S is the surviving entity.
- T's shareholders receive P stock and/or boot in the exchange.

Main Requirements :

- The merger would have to qualify as an "A" reorganization.
- S must acquire "substantially all" of T's assets. The IRS has defined "substantially all" for purposes of issuing private rulings as 90% of the FMV of T's net assets and 70% of the FMV of T's gross assets.
- Boot can be used – e.g., cash



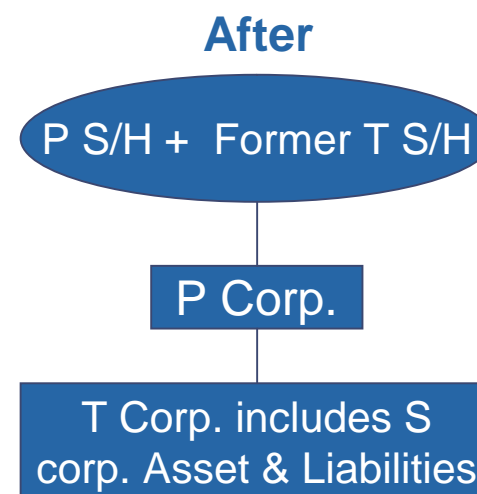
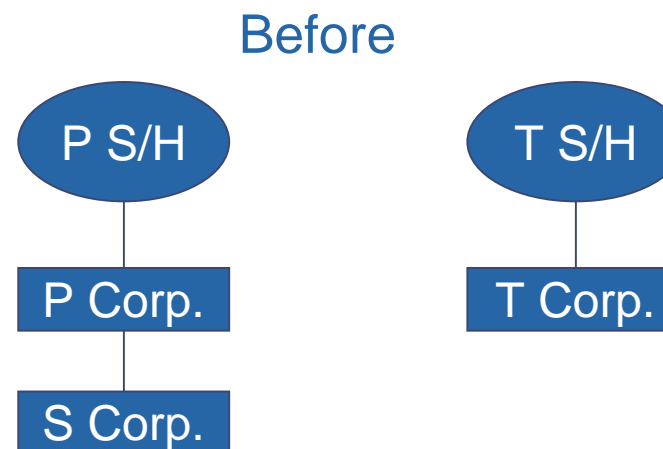
Reverse triangular merger §368(a)(2)(E)

Description:

- T merges with S, a new /pre-existing first tier subsidiary of P, under federal, state or foreign law. T is the surviving entity.
- T's shareholders receive P stock and/or boot in the exchange.

Main Requirements :

- The merger would have to qualify as an "A" reorganization.
- P must acquire "control" of T in the transaction (at least 80% of the vote and 80% of each class of non-voting stock) in the exchange for P voting stock. Therefore, only up to 20% boot is allowed.
- T must end up with substantially all of its assets and substantially all of S's assets
- Boot can be used – e.g., cash



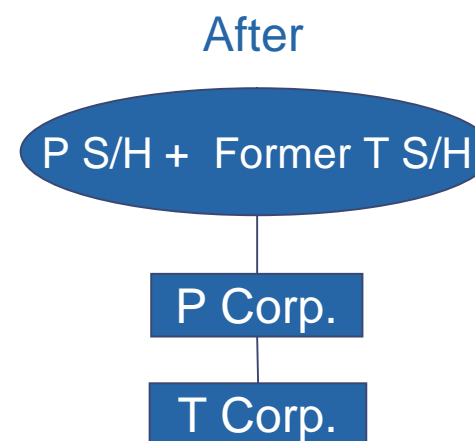
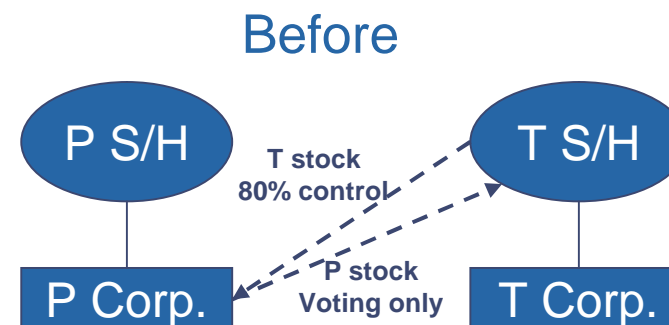
“B” reorganization §368(a)(1)(B)

Description:

- P (or P’s first-tier subsidiary) acquires T stock in exchange for P voting stock, and after the transaction P owns T stock which constitutes control of T.

Main Requirements:

- ‘Solely for voting stock’ –i.e. can’t use nonvoting stock or cash.
- Acquiring corporation must have control immediately after the acquisition.
- The term ‘control’ means the ownership of stock possessing at least 80 percent of the combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.



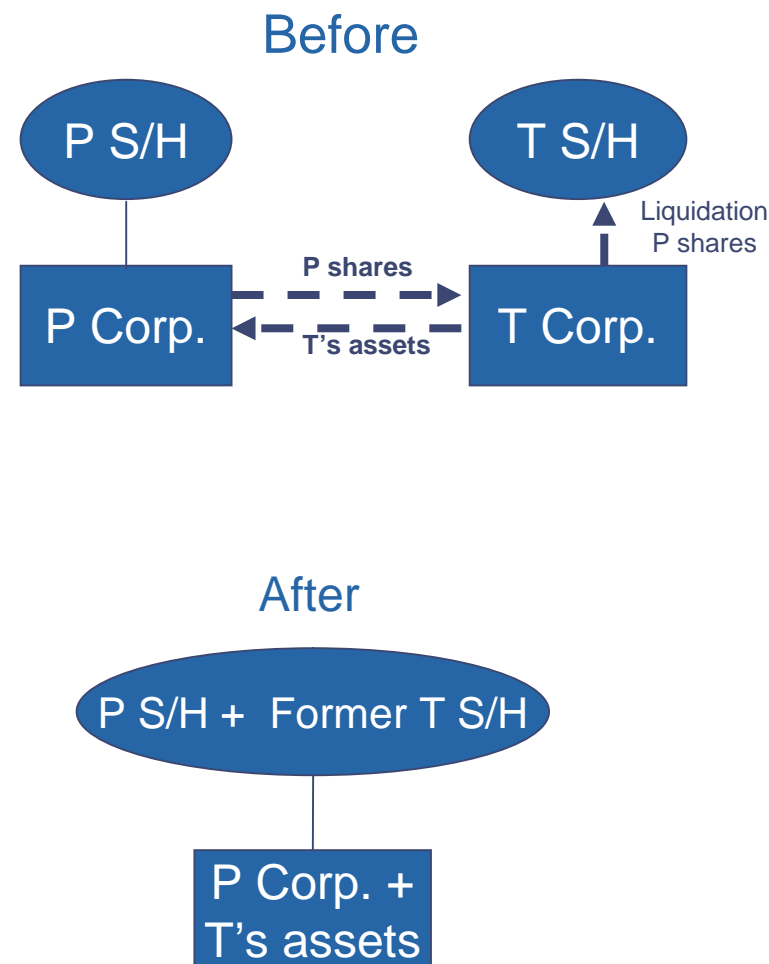
“C” Reorganization §368(a)(1)(C)

Description:

- P (or P’s first-tier subsidiary) acquires T’s assets for P voting stock

Main Requirements:

- P must acquire “substantially all” of T’s assets
- T must liquidate and distribute the P stock received to its shareholders
- A “boot relaxation rule” allows boot in the transaction; however, in general, the amount of the boot plus T’s liabilities transferred to P plus the FMV of any T’s assets not transferred to P may not, in the aggregate, exceed 20% of the FMV of T’s total assets



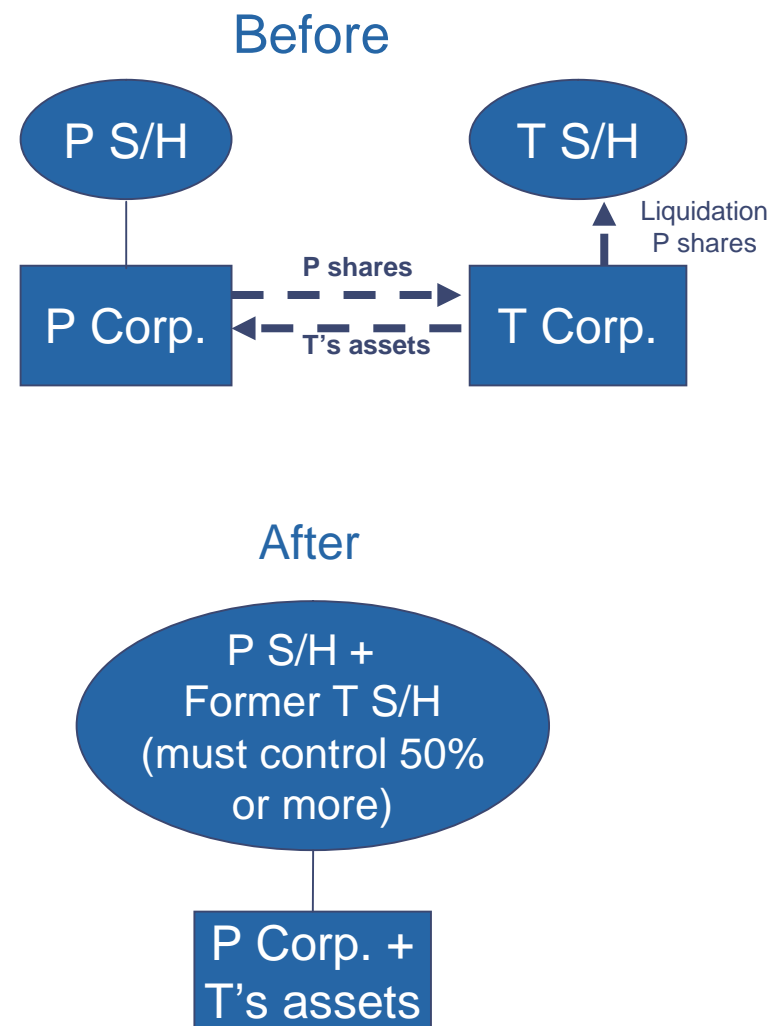
"D" Reorganization §368(a)(1)(D)

Description:

- P (or P's first-tier subsidiary) acquires T's assets for P voting stock

Main Requirements:

- Same as "C" reorganization. However, immediately after the transfer P is controlled (50% or more) by one or more shareholders of T.



“E” Reorganization §368(a)(1)(E)

- If a recapitalization is pursuant to a plan of reorganization, corporation’s shareholders should not recognize gain or loss on the exchange, if stock or securities are exchanged solely for stock or securities in such corporation.

“F” Reorganization §368(a)(1)(F)

A mere change in identity, form, or place of organization.

Reorganizations: Foreign Corporations IRC §367

In a case of an outbound transaction, i.e., a transaction involving a non-US entity, the application of this section may result in a taxable transaction.

Part IV: Taxable / Tax-free transaction - Israeli Tax aspects



Overview

- Under the Israeli Tax Ordinance (“ITO”), in a case where shares constitute the consideration in a merger, the parties to the merger may be eligible for tax deferral treatment provided the following ITO sections are met:
 - Section 104H – If P is a public company
or
 - Section 103T – For Mergers by means of Share Exchange

Section 104H – Tax Free Reorganizations - Main Aspects

- ITO section 104H provides that the exchange of shares by the target company's shareholders in consideration for the issuance of shares listed for trade on a stock exchange will not be regarded as a sale, as of the date of the exchange. The tax event will be **temporarily** deferred subject to:

Section 104H – Tax Free Reorganizations - Main Aspects

- Ratio of - Market value of exchanged shares: FMV of combined group, must be equal to ratio of – FMV of allotted shares: FMV of all rights in the combined group, immediately after the exchange;
- Trustee holds allotted shares in foreign acquiring company until tax payment date;
- Application was submitted to the Israeli Tax Commissioner to certify that the share exchange meets the conditions specified, at least 30 days prior to the date of the exchange;
- If cash is being paid as part of the share exchange, an advance payment of tax is due immediately with respect to the cash component (similar to boot)

Section 103T – Merger by means of a Share Exchange

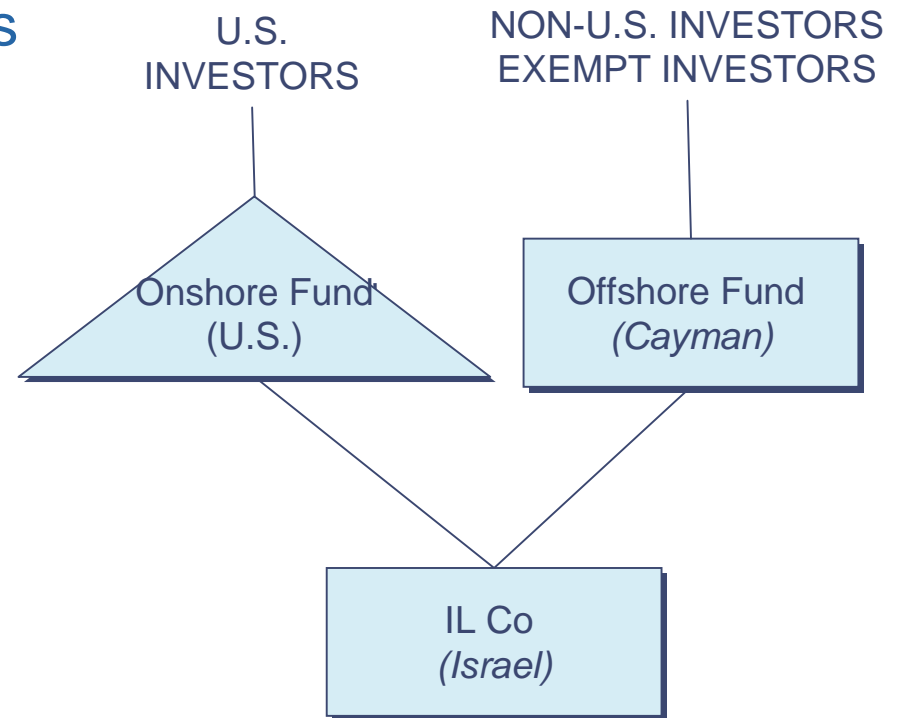
- Section 103T provides that a merger by means of a Share Exchange (where at least 80% of the rights in the transferee corporation are transferred in consideration for shares in the other company) shall be **deferred** from tax, subject to the following main requirements:
 - Immediately after the merger and during the required period (two years after the end of the tax year of the merger), the merged company holds all of the transferee company rights (i.e. those rights held by it on the day of the merger).
 - An application was submitted to the Israeli Tax Commissioner to approve that the merger plan meets the conditions specified above and such application was submitted at least 60 days before the date of the merger, and the Commissioner had issued the approval.

Israeli Domestic Taxation – Certain Exemptions / Relief Available for VC and PE

- Certain exemptions or relief may be available under Israeli domestic law and double taxation treaties, as follows:

- Section 16A ruling;
- Section 97 (b3) – Exemption for Treaty Investors;
- Section 97 (b1) – R&D Company;
- Section 97 (b2) – Exemption for traded securities;
- Tax treaties

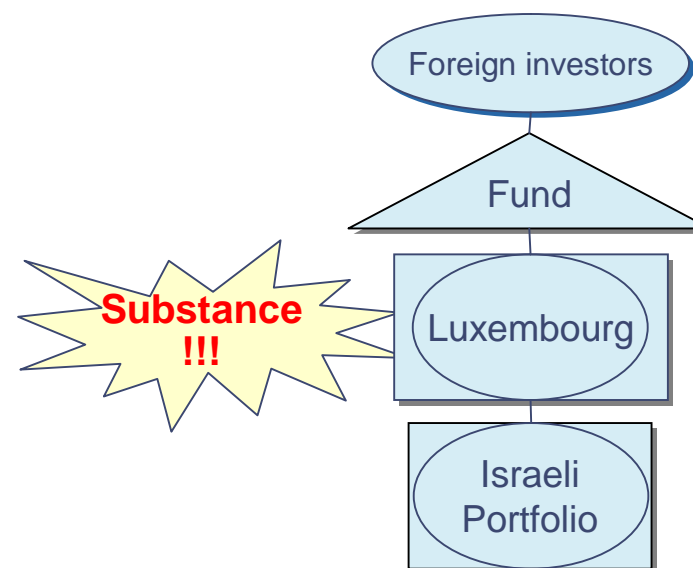
Common Structure



Exemptions / Relief – Treaty Exemption

Luxembourg / Israel tax treaty:

- The use of a suitable offshore intermediate company structure, such as investment through a Luxembourg holding vehicle, for an Israeli investment may:
 - increase flexibility in terms of future exit options; and
 - offer tax treaty protection on future repatriations / capital gains from the investment.
- It is important to note that such intermediary company should generally meet certain substance requirements.
- Under the unique circumstances of a recent case, the Israeli court has determined that the **ITA may rely on domestic law** (specifically, section 86 of the ITO) in determining eligibility for treaty benefits even in a case of a treaty with no Limitation of Benefits clause.



Israel – Luxembourg Treaty Benefits		
	Dividends WHT	Capital Gain
Israel (non-treaty)	20% / 25%	20% / 25%
Treaty rate	5% - 15%	0%

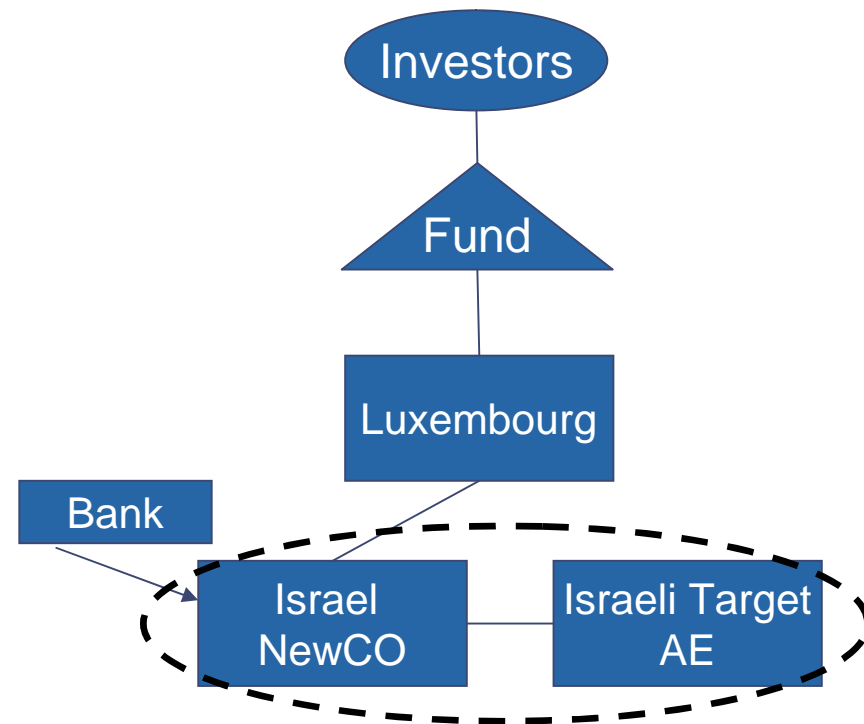
Debt Push Down

Description:

- Fund sets up a company in Luxembourg
- The Luxembourg company sets up subsidiary in Israel (NewCo)
- NewCo borrows money from a bank
- NewCo merges into the Israeli target (AE)
- AE uses the loan's proceeds of NewCo to pay off its debt

Lux Structure – Issues to consider

- AE issues (corporate tax, WHT, buyback)
- Capital gains
- Financing expenses (capital note)
- Repatriation



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