



Recent Developments in M&A Transactions: Tax Implications

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Agenda

- Acquisition of US company/assets by an Israeli company
- SPACS – Tax aspects
- Acquisition of Israeli company by a US company

Acquisition of US company/assets by Israeli company

Tax Aspects relating to Planning an Acquisition Transaction

Type of transaction:

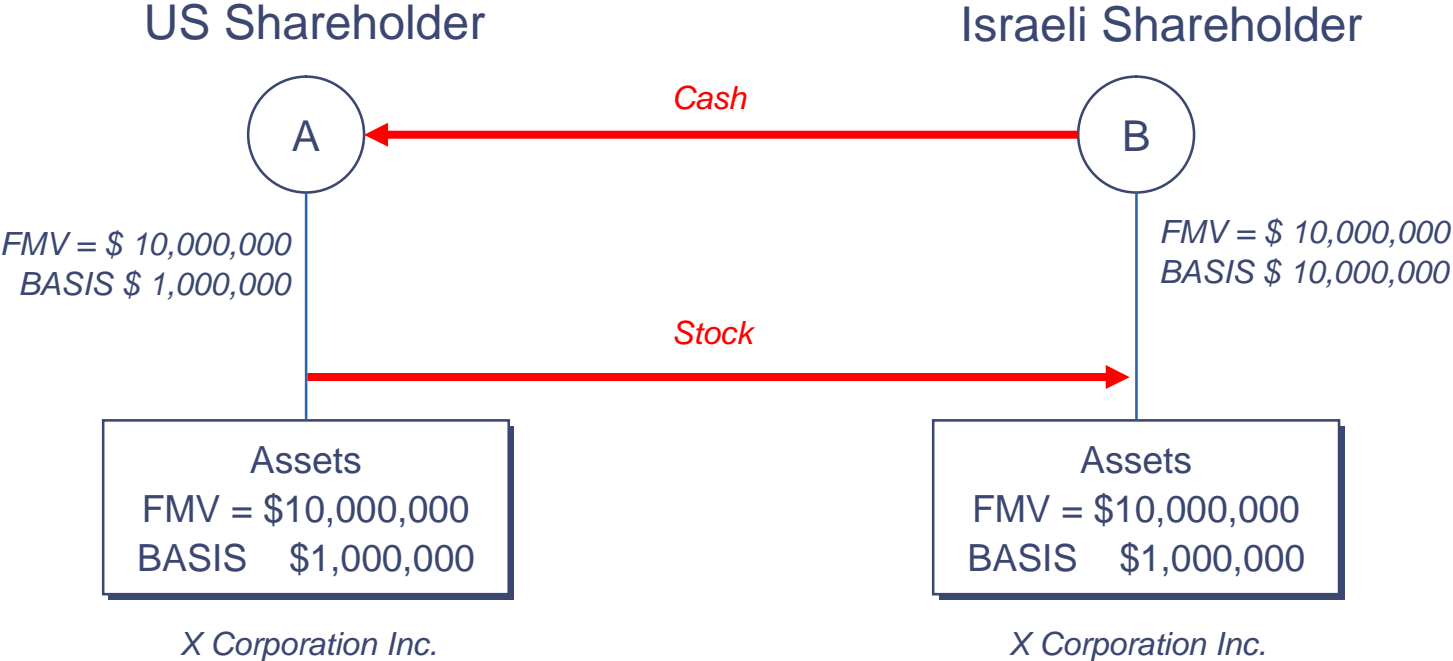
- Stock transaction – Acquisition of stock (or other rights) of the target entity
- Asset transaction – Acquisition of all (or part) of the target entity's assets
- A combined transaction (combining both types of transactions) can be performed (e.g., by splitting off a business segment into a new company immediately prior to the transaction)
- In certain countries, stock transactions can provide entitlement to the advantages embodied in an asset transaction (e.g., Section 338)

Tax Aspects relating to Planning an Acquisition Transaction

Asset transaction compared to a stock transaction

ADVANTAGES	DISADVANTAGES
Acquisition of a company free of claims	New entity – Transfer of legal obligations
Depreciation and amortization of acquisition costs (fixed assets, know-how, other intangible assets)	Possible difficulties for the sellers to obtain a tax exemption on the transaction
Flexibility in creating an optimal capital structure for the acquired entity	Possible harm to the sellers (individuals, venture capital funds, investors with accumulated losses)
	Employees

Typical Stock Purchase (with No Section 338 Election)



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 inherits all of Target tax attributes (may be subject to limitation).
- 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

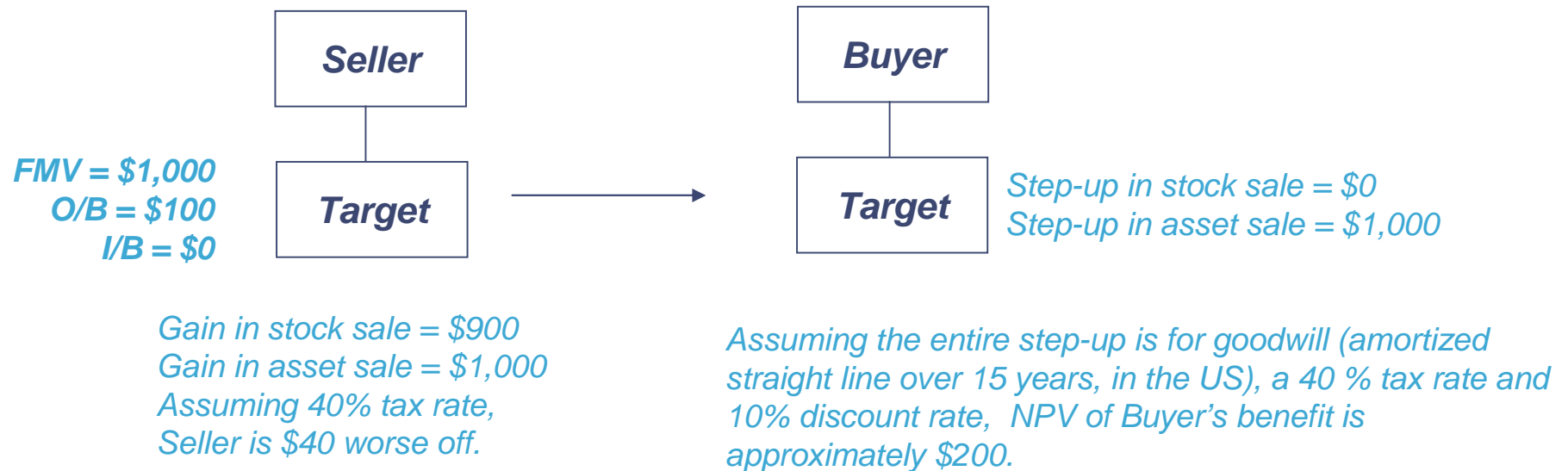
Section 338 election is an election to treat the acquisition of stock, for US tax purposes, as an acquisition of a target's assets.

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.
- When is it available?
 - Must be a Qualified Stock Purchase – at least 80% of Target’s stock must be purchased by another corporation during a 12-month period in a taxable transaction.
 - Target may be an S or C corporation.
 - C corporation must be a subsidiary with at least 80% of its stock owned by another domestic corporation.

Section 338(h) (10) Election – Example

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.



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 in the case of a change in ownership of more than 50 percent in ownership of a corporation.
- Limitation based on value of company times long-term tax-exempt rate.
 - Limitation computed only once, not annually.
 - Unused limitation can carry over from year to year.
 - States may impose additional limitations on use of NOLs.
 - Special rules for companies emerging from bankruptcy.
- Other limitations can impact NOL utilization (e.g., SRLY).

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”)).
 - Reduction of equity value for additional debt.

SPACS - Tax Aspects

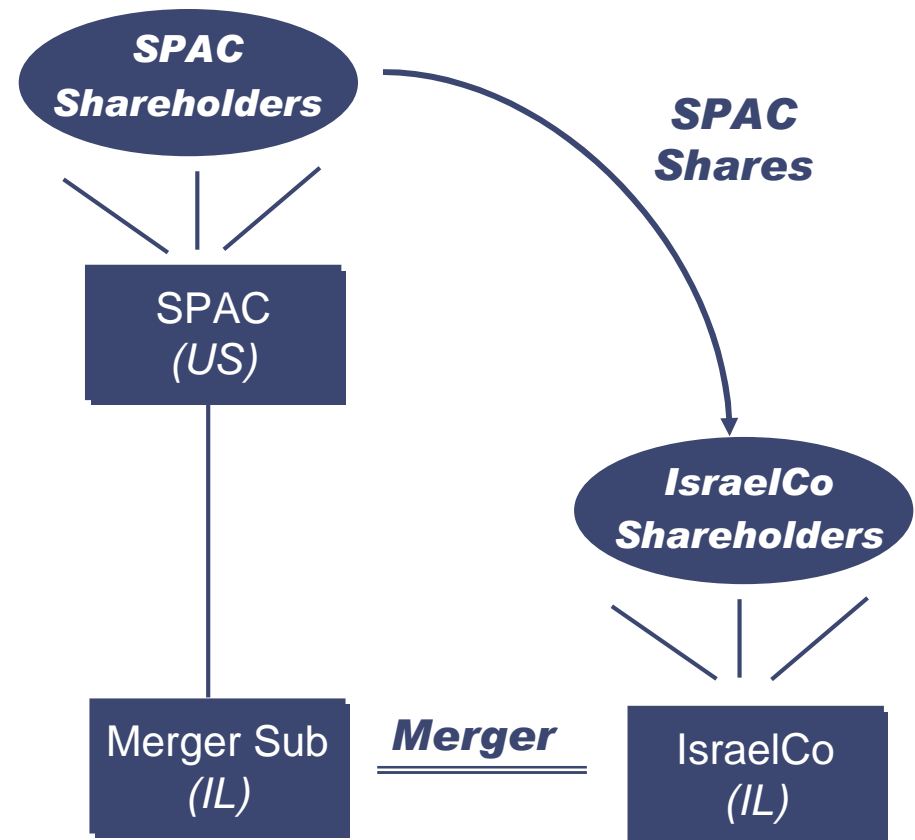
SPACs – General Features

- A Special Purpose Acquisition Company ("SPAC") is a publicly-traded vehicle that has been formed to facilitate a business combination, typically a merger, acquisition or asset sale, usually within a specified industry. The capital is raised through an initial public offering of securities.
- SPAC offerings are typically sold via an initial public offering (IPO) in units each of which consist of a certain number of shares and warrants.
- SPACs trade as units and/or as separate common shares and warrants on the OTC Bulletin Board and/or the American Stock Exchange (both the Nasdaq and the New York Stock Exchange have announced plans to list SPACs in 2008) once the public offering has been declared effective by the SEC.
- We have come across SPACs established in the US (Delaware) as well as the Cayman Islands.

Conventional SPAC Acquisition of Israeli Target

Transaction Steps – Outline

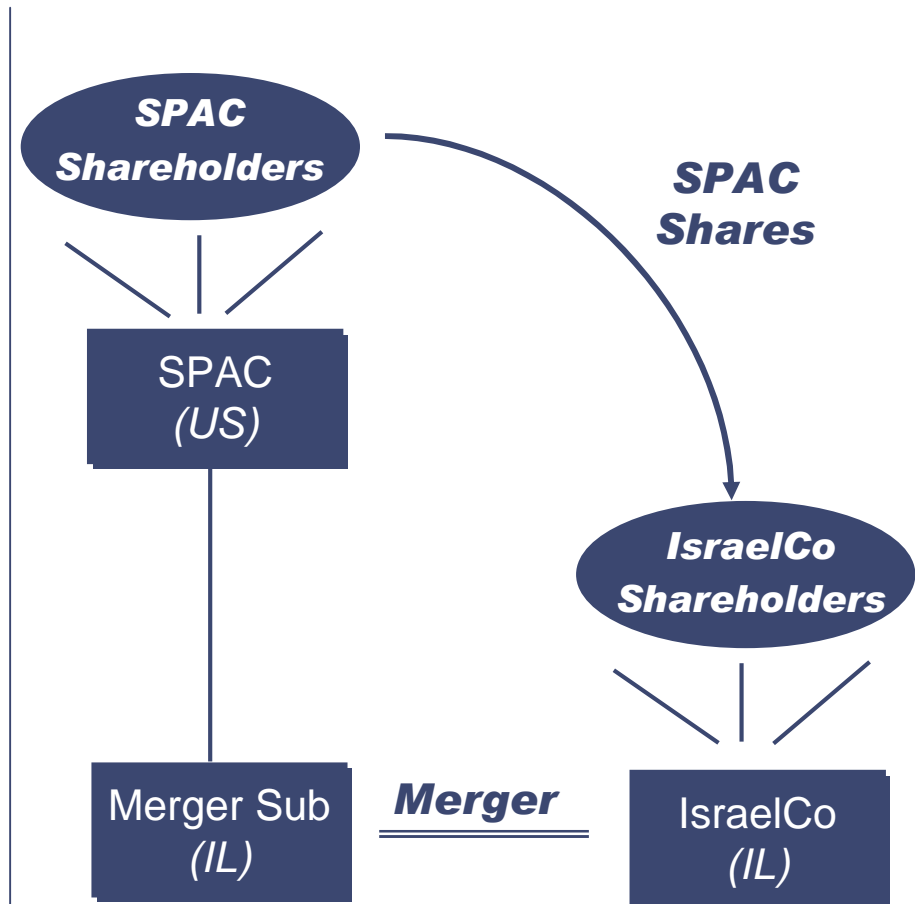
- SPAC forms an Israeli SPV (“Merger Sub”).
- IsraelCo merges with Merger Sub, with IsraelCo surviving as the wholly-owned subsidiary of SPAC.
- In consideration for the merger, IsraelCo shareholders receive stock/warrants of SPAC in exchange for the stock/warrants of IsraelCo.



Conventional SPAC Acquisition of Israeli Target (cont.)

General Tax Considerations

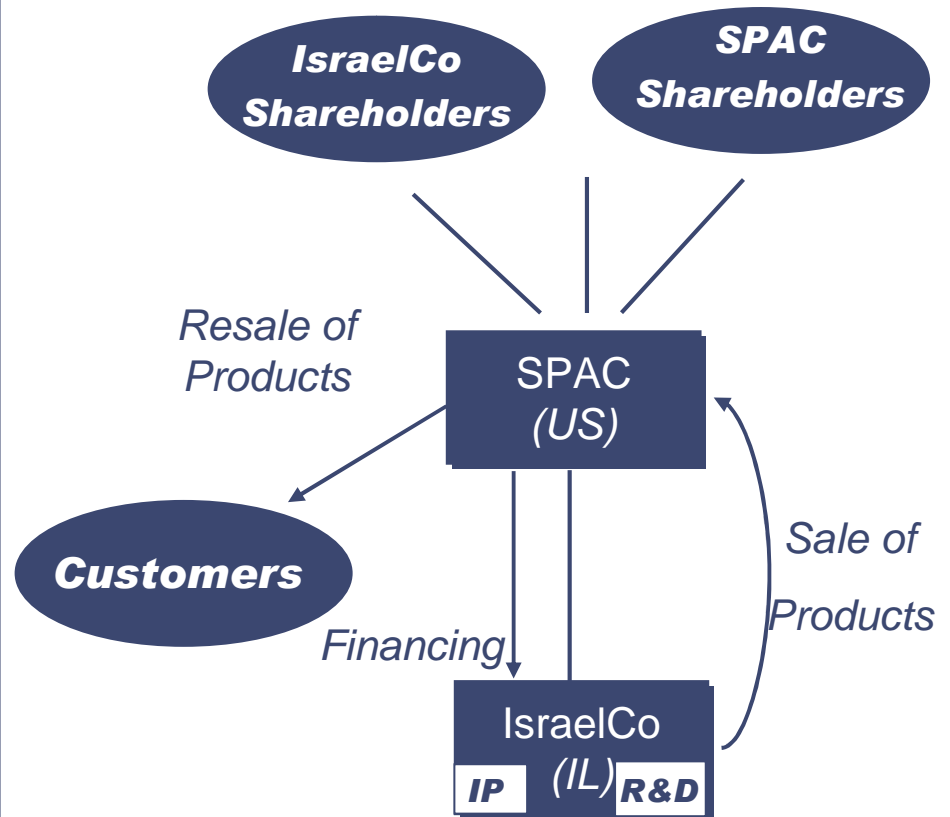
- For Israeli tax purposes, the transaction is generally a taxable disposition of IsraelCo stock, at the capital gains tax rate of [20-25%].
- It may be possible, under appropriate circumstances, to obtain an advanced ruling from the Israel Tax Authorities (“ITA”) whereby the Transaction would be treated as a tax-deferred transaction for Israeli income tax purposes, subject to various conditions and limitations.
- Consideration should be given to the taxation of non-Israeli shareholders in their respective jurisdiction of residence.



Conventional Structure – Post-Merger Considerations

Disadvantages

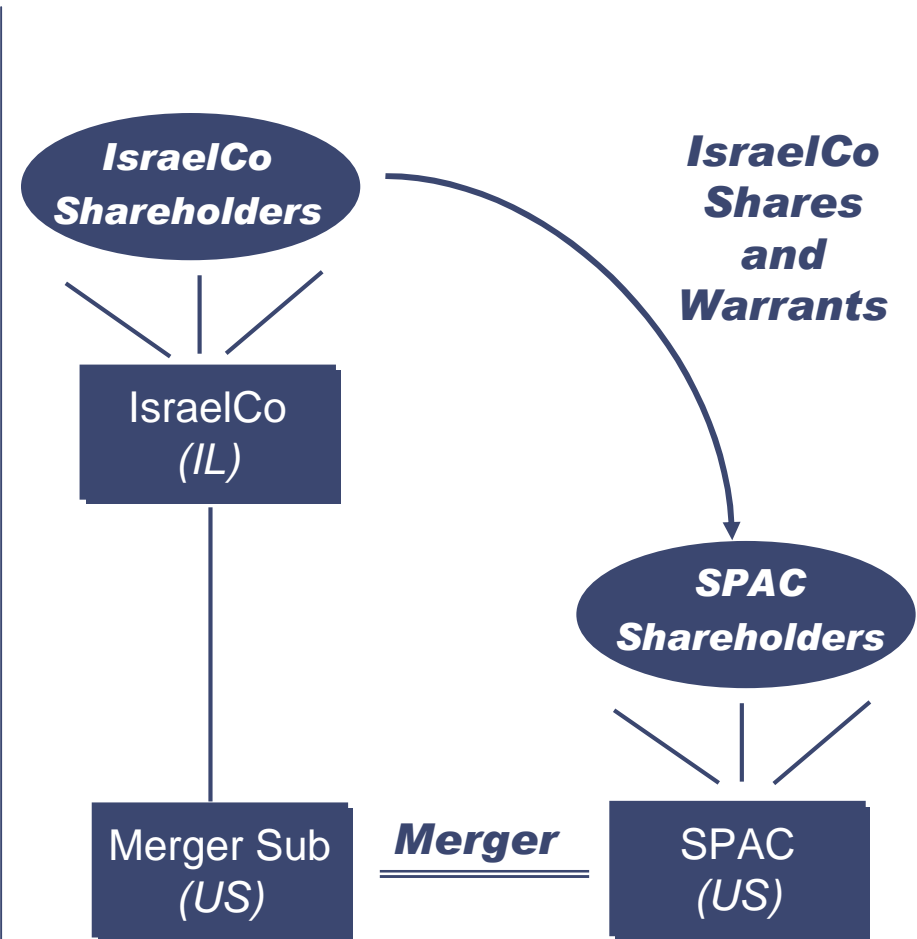
- Overall corporate tax rate of 40% at level of SPAC
- Repatriation of profits from SPAC
- Potential US CFC exposure (Subpart F)
- Compliance issues – IRS reporting requirements
- Financing issues – Debt v. Equity
- Transfer Pricing



Alternative SPAC Acquisition of Israeli Target

Transaction Steps - Outline

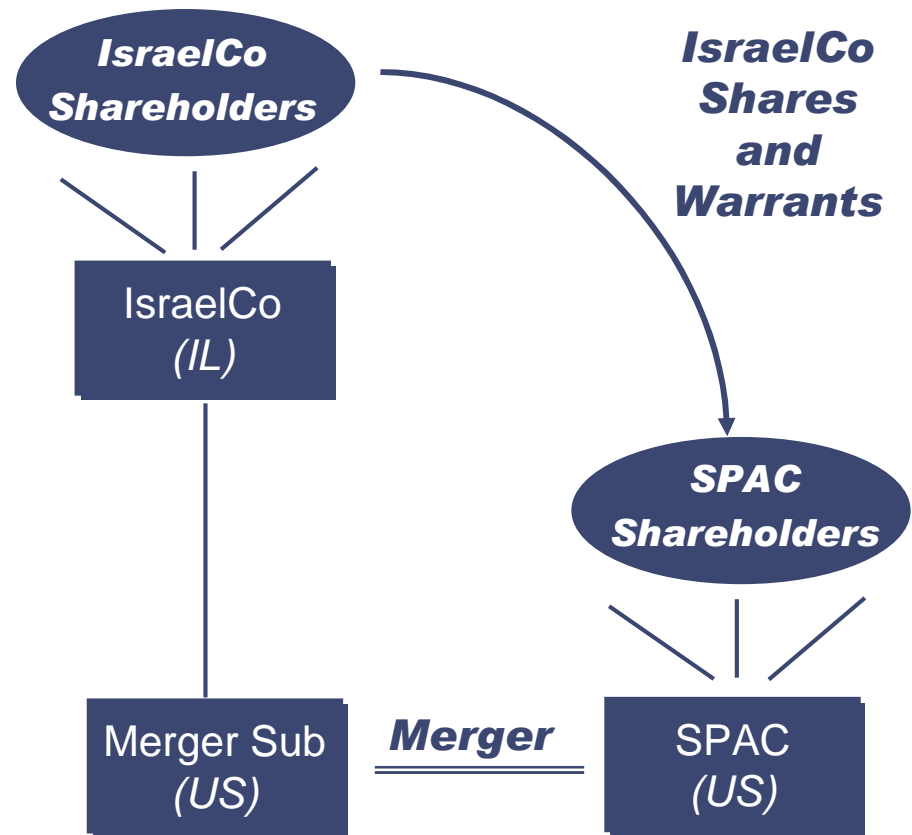
- IsraelCo forms a US SPV (“Merger Sub”).
- SPAC merges with Merger Sub, with SPAC surviving as the wholly-owned subsidiary of IsraelCo.
- In consideration for the merger, SPAC shareholders receive newly issued stock and warrants of IsraelCo in exchange for the stock and warrants of SPAC.
- Cash which resides in SPAC can potentially be extracted to IsraelCo without adverse US tax consequences (e.g., by liquidation of SPAC)



Alternative SPAC Acquisition of Israeli Target (cont.)

General Tax Considerations

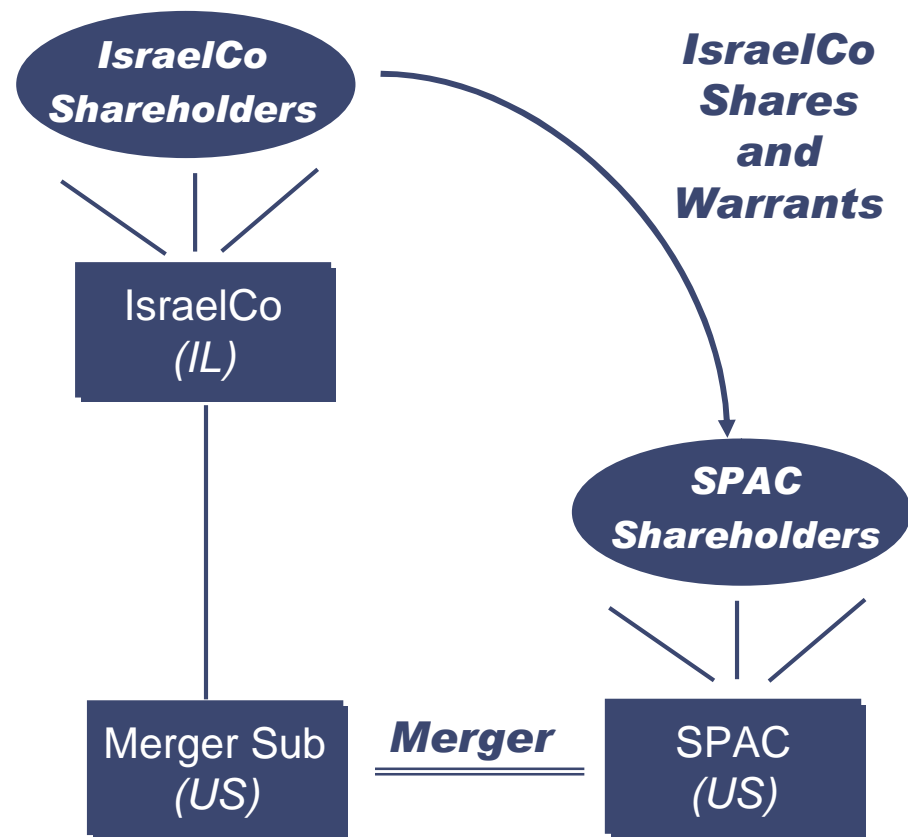
- For US Federal income tax purposes, the merger would generally be treated as a taxable disposition of SPAC stock by the SPAC shareholders upon which the SPAC shareholders would recognize taxable gain (loss) to the extent of the difference between the fair market value (“FMV”) of the IsraelCo shares received in the Transaction and the adjusted basis that the SPAC shareholders have in the disposed SPAC shares.



Alternative SPAC Acquisition of Israeli Target (cont.)

General Tax Considerations (cont.)

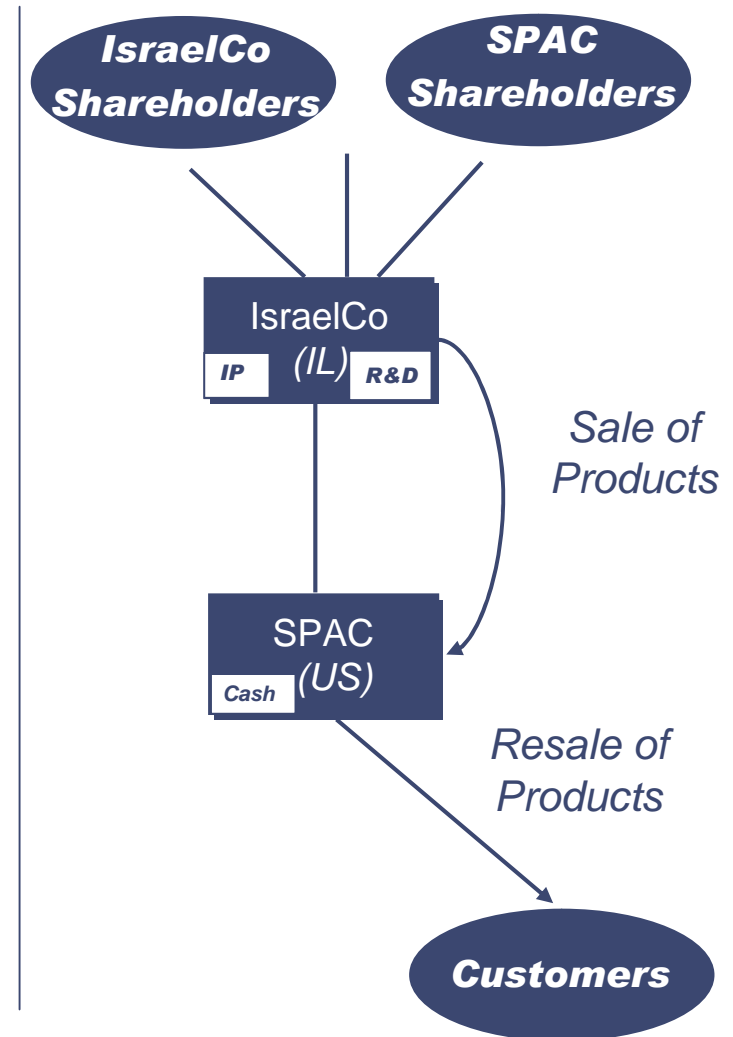
- The merger may qualify as a tax-free (i.e., tax-deferred) transaction, for US Federal income tax purposes. The requirements under sections 368 (tax-free reorganization rules) and 367 (outbound reorganization rules) would need to be considered.
- Consideration should be given to the taxation of non-US shareholders in their respective jurisdiction of residence.



Alternative Structure – Post-Merger Considerations

Advantages

- Corporate tax rate of 27% at level of IsraelCo (to be reduced to 25% in 2010), or lower if IsraelCo enjoys the benefits of an “Approved Enterprise”.
- Mitigation of disadvantages under conventional structure.



Acquisition of Israeli company by a US company

Israeli Domestic Taxation – Overview

- Under Israeli domestic law, a non-Israeli resident is only subject to Israeli tax on income accrued or derived in Israel (i.e., income from an Israeli source).
- Dividend income paid by Israeli corporations is generally considered Israeli source income and subject to a 20% - 25% tax rate*.
- Capital gains from non-traded Israeli securities derived by a non-Israeli resident individual are generally subject to a 20% tax rate unless reduced by a tax treaty.
- Where the person directly or indirectly holds at least 10% of the company's shares during the 12 months preceding the sale, a 25% tax rate would apply.

* The rate is mainly determined by the holding percentage of the interests in the company and may be reduced by an applicable treaty.

Exemptions / Reliefs

Section 16A Alternative Investment Funds Ruling – Main Aspects

- Section 16A rulings offer a measure of certainty for funds with regard to their tax positions, and facilitate the tax structuring of their activities in Israel.
- Generally, the ITA grants pre-rulings, according to which foreign investors in venture capital funds are exempt from tax in Israel and investors in private equity funds may enjoy reduced rates (15% for individuals, 25% for corporations, and exemption for tax exempt entities).
- The existence of a PE in Israel would not create adverse Israeli tax consequences for the fund.
- As such, the fund would be able have a local representative who would not be restricted with respect to the activities that they may perform in Israel.

Exemptions / Reliefs (cont.)

Section 16A – Main Requirements

- There should be at least 10 investors in the Fund (foreign and Israeli) and each investor should hold no more than 20% of the fund's capital; and
- No more than 15% of the Fund's total investment in Israel should be invested in one entity. In other words, the Fund is required to hold at least seven Israeli portfolio companies;
- For VC Funds, at least 75% of the investment in each Israeli portfolio company should be performed by way of a capital contribution (i.e., not by way of a stock purchase).
- The ITA requires submission of certain generic investor information (e.g. entity type, name, residence).

Exemptions / Reliefs (cont.)

Section 97(b3):

- Generally, Section 97(b3) of the Israeli Income Tax Ordinance (“ITO”) provides an exemption for non-residents regardless of their holding percentage in an Israeli company with respect to capital gains from the sale of securities (even where not traded on a stock exchange in Israel) which were purchased between July 1, 2005 through December 31, 2008.
- The list of requirements outlined in Section 97(b3) include the requirement that the gain does not arise from a PE in Israel, and the requirement that the seller be a resident of a **treaty country**.^{*} the receipt of the ruling under this section would generally not be available in case of conducting ongoing activities in Israel.
- Another disadvantage of this ruling is that in practice, the ITA typically requires a full disclosure of the investor information.

* Additionally, the security cannot have been purchased from a related party or by means of a tax-free reorganization, and the taxpayer must comply with certain tax filing requirements.

Exemptions / Reliefs (cont.)

Section 97(b2):

- Generally, Section 97(b2) of the ITO provides an exemption for non-residents regardless of their holding percentage in the Israeli investment with respect to capital gains from the sale of traded securities. If the traded securities were purchased prior to their registration for trade, the portion of the capital gain which would have been generated if the stocks were sold immediately prior to the registration for trade is subject to tax (unless other exemptions apply).
- The requirements outlined in Section 97(b2) include the requirement that the gain did not arise from a PE in Israel.
- Further, the exemption does not apply to stock of a Real-Estate Investment Trust (“REIT”).

Exemptions / Reliefs (cont.)

Section 97(b1):

- An additional exemption from tax is available to foreign investors on gains arising from the disposition of shares in “Research and Development intensive company*.”
- Under this section, an exemption is available, irrespective whether or not the foreign resident is a resident of a treaty country, where such interest was acquired through an allotment of shares.
- One of the main advantages of this provision is that it applies to the investee company, and there are no requirements with respect to the investors in such company.

* Israeli income tax regulations include a complex, detailed definition of an R&D intensive company.

Exemptions / Reliefs (cont.)

Section 104H – Tax Free Reorganizations - Main Aspects

- 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:
 - 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 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 share exchange, an advance payment of tax is due immediately on the cash component.

Thank you

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