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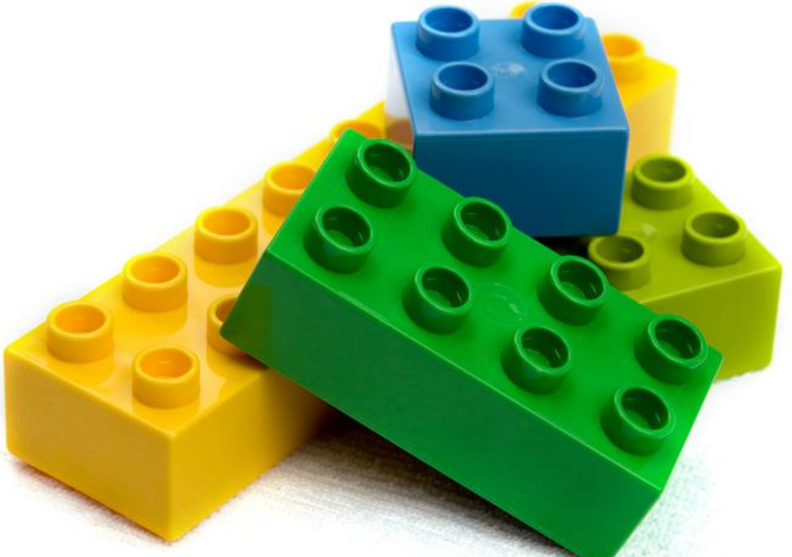
Mergers & Acquisitions: The Expanding Role of State Taxes



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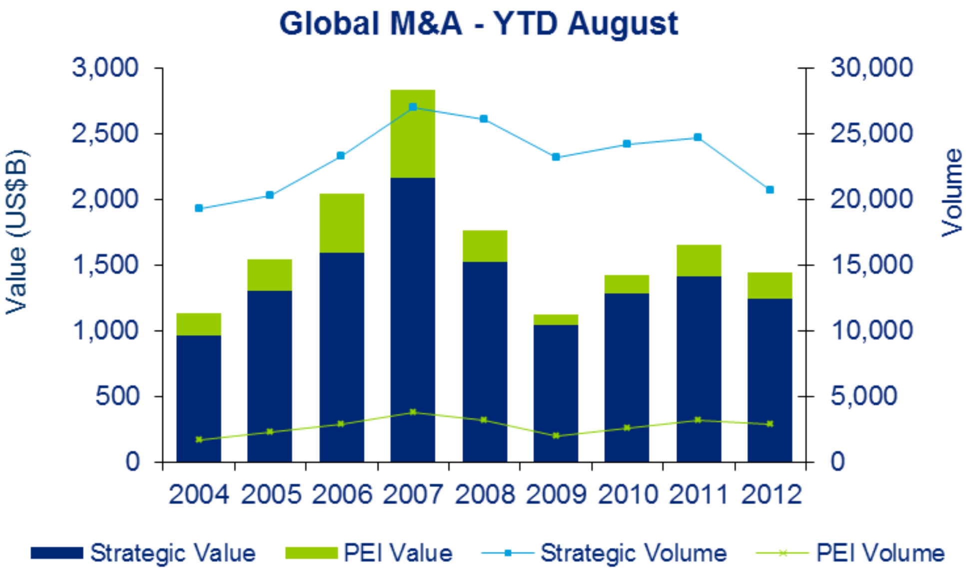
Agenda

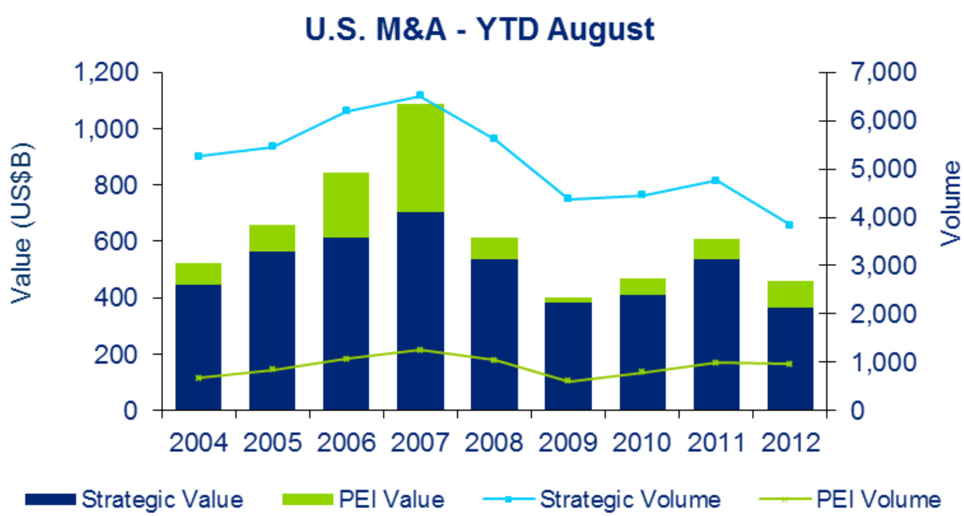
- Overview
- Buyer's due diligence
- Escrows and voluntary disclosure agreements
- Welcoming a new member of the family
- Elections and return positions
- Seller's due diligence and preparation
- Transaction structuring
- Key take aways

Overview

Global M&A activity continues to improve

- While still well below the peak in 2007, M&A activity continues to improve.
  - M&A activity in 2012 has declined from 2011, however, due to slowing domestic economic growth and concerns about the Eurozone.
- Strategic deals drive the marketplace; private equity deal flow remains subdued.
- US deal volume continues to be lower as a percentage of total deal flow than the 2007 M&A peak.





Buyer’s Due Diligence

The Multistate Tax M&A Timeline

<u>Past</u>

Evaluate the tax exposure for the periods prior to the transaction to which the buyer may succeed

<u>Present</u>

Evaluate and plan for the tax issues associated with the M&A transaction

<u>Future</u>

Evaluate and plan for the future tax implications of bringing this new business into the buyer's organization

Due Diligence Process

Value Proposition

- Enable a better valuation of the target
- Negotiate an appropriate purchase price that is consistent with the anticipated ROI
- Contractually seek protection for tax exposures associated with periods prior to the transaction
- Identify multistate tax practice/process changes to implement upon acquisition
- Capitalize on tax opportunities such as negotiated credits/incentives

Successor Liability

- Buyer can be held liable for the unpaid taxes of the seller
  - Stock Acquisition:
    - Successor liability for **<u>all</u>** taxes
  - Asset Acquisition:
    - Successor liability for unpaid operating taxes
    - An increasing number of states also have provisions for successor liability for unpaid income/franchise taxes
- Buyer can take steps to protect itself from successor liability

Buyer Protections

- Conduct a due diligence examination
- Adjust the purchase price
- Contractual indemnification/escrow
  - often limited in duration or in value
- Restructure the transaction
- Comply with bulk state notification provisions
  - May generate audit
- Mitigate risk post transaction
  - Voluntary disclosures limit lookback periods
  - Change reporting practices post transaction

Escrows and voluntary disclosure agreements

Escrows and voluntary disclosure agreements

When and how to address issues identified in due diligence

– Be proactive with regard to mitigating issues identified during due diligence

– Escrows

- typically expire at a certain date.
- any funds remaining typically revert to the seller.
- remember to include cost of advisor fees in the escrow amount

– Voluntary Disclosure Agreements (“VDA”)

- can take up to 90 days and in certain circumstances longer – start the process early.
- regardless of whether the issue is sales tax or income tax, most taxing jurisdictions want VDAs to include both – even when no tax is due.

Welcoming a new member of the family

Key compliance matters

– Post Transaction Income Tax Filings

- State filing periods typically mirror federal
- Short period separate return state income tax filings are the general rule
  - Some states require full year filing (e.g., AL, NJ)
  - Some states allow flexibility between full year or partial year (e.g., LA)
- The pre-transaction short period tax return might have a different due date for federal purposes (consistent with the due date of the fed consolidated filing) than for state purposes.

Key compliance matters

- Confirm that nexus determinations reflect the post-transaction world.
- Confirm that transfer tax filings have been made and tax has been remitted
- Many other requirements (e.g., treasury, payroll, regulatory, property tax) are beyond the scope of this presentation

Sales and use tax / excise tax considerations

- Sales & Use Tax Diagnostic of Target's Procedures–
  - Document target's historical sales & use tax processes and procedures to assist with proper transitions
  - Nexus study/voluntary disclosures

- Consider Impact of post transaction structure and operations on both legacy and target businesses-
  - New Procedure Implementation - Create a manual use tax accrual process or fully automate tax decisions by implementing a sales & use tax software approach
  - Letter Rulings - Obtain guidance from the State Departments of Revenue to verify certain tax positions

Sales and use tax considerations

- Resale and Exemption Certificates
  - Resale and exemption certificates may need to be updated based on restructuring and/or acquisition structuring
  - Obtain resale and exemption certificates from seller relied upon for open prior periods
- State Registrations/De-Registrations
  - Sales & use tax permits/licenses may not be transferrable to the new owner or entity
  - Example: Florida requires a new Business Tax Application (Form DR-1) with a change in ownership or legal entity structure
  - Consider titled vehicles

Excise Tax Considerations

- If there is an EIN change with respect to an entity holding a motor fuels tax license, a reregistration would generally be required for both federal and state purposes

- A new registration could also apply to other triggering events too (e.g., officers or director changes, business address change, conversion to new type of legal entity)

Understanding Target's Credits/Incentives

- A best practice in any environment – but particularly true in the context of a life event transaction - is to inventory Target's existing credits and incentives portfolio and to centralize ongoing compliance
- Multiple departments may have been involved in incentives negotiation (e.g., HR, Legal, RE, divisional leaders)
  - Compliance may be a Tax responsibility
  - Noncompliance in form or substance may lead to the taxpayer being in default, thereby triggering "clawback" provisions

C&I – proceed with caution

- Clawbacks: Surviving business may wish to actively address potential clawbacks associated with acquired C&I business by:
  - Not assuming Target's incentive packages
    - Commitments made in the past may be unattainable in new structure
    - Acquirer may have previously negotiated better incentives package or could negotiate a better package going forward
  - Renegotiating incentives packages prior to closing
- Eligibility: Nature of transaction (stock vs. assets) may affect the post transaction entity's eligibility for benefits
- Notification: Don't forget notification requirements with some states prior to or upon change of ownership

Identifying potential new C&I opportunities

- Acquirer may wish to negotiate incentives for potential future business growth and investment plans
  - Bringing an underperforming asset of the target into productive use (e.g., successor to two combined plants)
  - While not always evident as a growth event, rationalizing operations may result in one jurisdiction gaining jobs that are lost from another jurisdiction

- Post merger systems integration implementation may be eligible for additional state R&D or ITCs

Elections and return positions

First year elections

Be mindful that this does affect future years

- Consolidated or combined return elections
  - Understand implications of election in future periods. For example, does an election to file a state consolidated return preclude potential benefits associated with domestic restructuring
- Water's-edge and worldwide elections
  - Elections are typically for multiple years and are generally not revocable
- Apportionment factor elections

First year elections

- "Check-the-box" elections
  - Disregarded vs regarded status can have significant impact in separate return states
- State impact of federal elections (examples)
  - IRC § 59(e) elections – Capitalizing R&D costs
  - Foreign Tax Credit

Return positions

- Lack of instant unity is a presumption in some, but not all, states
  - At what point is the acquired entity unitary
  - Instant unity is rare, but not impossible
  - If beneficial to file unitary (or not), be prepared to defend on audit
    - Gather documentation and build the position
- Acquisition Debt
  - “Debt pushdown” is problematic in states with related party addback provisions~~-~~.
  - Plan ahead prior to close to determine whether debt is in the appropriate entities

Return positions

- Intercompany Transactions – Area of State Challenges
  - Document with Intercompany agreements
  - Transfer pricing
  - Follow payment terms and settle intercompany payables/receivables
- Nexus positions
  - Economic presence
  - Consistency

Financial Statement Implications

- Consider the impact on the state effective tax rate for financial statement purposes.
  - timing might be more accelerated than the actual tax reporting.

- FAS 450 and ASC 740
  - are these liabilities appropriate given what has been discovered on diligence?

Seller side diligence and preparation

Seller side due diligence and preparation

- Prepare for due diligence
    - Gather documents
    - Review all documents anticipate questions and prepare for Q&A
    - Consider obtaining a Seller Due Diligence report
- Consider proactively mitigating risks

Seller side due diligence and preparation

– State issues connected with a sale transaction

- Triggering of deferred intercompany transactions (“DIT”), excess loss accounts (“ELA”) and deferred intercompany stock accounts (“DISA”) (CA only)
- Pre-transaction structuring
- Basis differences
- Sourcing gain and receipts in the sales factor
- Changes in footprint
- Tax provision impact

Transaction structuring

IRC § 338(h)(10) and § 338(g) elections

- Treat stock acquisitions as asset acquisitions for tax purposes. State considerations:
  - State tax basis in the assets may be significantly different than the federal tax basis
  - State NOLs may not be available to offset gain
  - Inclusion of gross proceeds or gain in the sales factor
  - Some states might have special apportionment for the gain.
  - Business vs nonbusiness characterization
  - Does the seller want to be compensated for additional taxes?
- In addition ......
  - California / Wisconsin Only §§ 338 (h)(10) or 338(g) Elections
  - Single sales factor apportionment may mitigate benefit

Basis

- Asset Basis Differences
  - Impact of Bonus Depreciation on Gains/Losses
    - Adjustment for asset sales, including IRC § 311(b) transactions
    - See R.I. Gen. Laws Sec. 44-61-1(b)
    - However, no basis adjustment in North Carolina or Florida
  - Prior Bankruptcy or Attribute Reduction
- Subsidiary Stock Basis Differences
  - State non-conformity to Treas. Reg. § 1.1502-32
  - California DISA
  - Wisconsin combined returns
  - State non-conformity to Treas. Reg. § 1.1502-36

Settling intercompany accounts

– Contributions to capital
  - IRC § 108(e)(6)
  - IRC § 362(e)(2) elections for state purposes

– Distributions in excess of state E&P

– CODI and bad debt deductions
  - State non-conformity to Treas. Reg. § 1.1502-13(g)
  - Unitary states
  - Attribute reduction

Structure (including NOL issues)

– Placement of Acquisition debt
  - Reduce state tax leakage

– Asset distributions and business combinations
  - Basis step-up

– Offset "winners" and "losers"
  - IRC §§ 381 and 382 concerns
  - "Synthetic" combined returns

– Entity rationalization

Take Aways

Key Take Aways

- Whether buyer or seller there are a number of critical multistate tax issues to consider
- Identify and address issues early
- Deal with the past and plan for the future
- Don’t miss out on opportunities to structure well and negotiate incentives

Question and answer

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