M&A Deals – What's New?

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Agenda

I. Recent Trends in M&A Transactions
   A. Buyer leverage
   B. Monetizing tax assets
   C. Impact of Section 174
   D. Accounting method changes
   E. Success-based fees
II. Abandoned Deal Developments
III. Consolidated Group M&A Developments and Reminders
IV. Partnership M&A Developments and Reminders
V. Other Ongoing M&A Considerations

Buyer leverage

- More asset deals
- Attempts to bridge valuation gaps
  - Earnouts
  - Founder holdbacks
  - Tax-free reorganizations with adjustments based on buyer stock price
  - CVRs (buy side and sell side)
- Impact of purchase price adjustments (debt-like items, working capital)
- Reverse mergers
- Control over post-closing tax matters that impact tax indemnity
- Stock as consideration

Monetizing tax assets

- R&D Payroll Tax Credits
  - Certain qualified small businesses can apply research tax credit against employer portion of FICA tax (and after 2022, Medicare tax)
  - For taxable years ending on or before 12/31/2022, $250k per year
  - For taxable years beginning after 12/31/2022, $500k per year
  - Eligibility:
    - No more than 5 years past period for which it had no gross receipts
    - Gross receipts in year of election of less than $5mil

Example: Transaction Deductions and NOLS

Section 174 R&E Expenditures

- TCJA disallowed full expensing of research and experimental (R&E) expenditures as of 1/1/2022
- Costs must now be capitalized and amortized
  - Domestic costs = 5 years
  - Foreign costs = 15 years
  - Midyear convention
- Broad definition of R&E under Section 174: generally includes all such costs incident to the development or improvement of a product.
  - salaries, wages
  - G&A
  - travel
  - patent costs
- Latest guidance from IRS released on Sep. 8, 2023

Tax Consequences of Accounting Method Changes

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Tax Consequence of Accounting Method Changes cont'd

Tax Consequence of Accounting Method Changes cont'd

Tax Consequence of Accounting Method Changes cont'd

EXAMPLE:

- X Corporation enters into an agreement to sell the stock of its wholly owned subsidiary T Corporation to Z Corporation. T is a calendar year taxpayer. Z discovers during due diligence that T improperly defers advance payments for services. Z requires that, prior to its acquisition of T's stock, T changes its method of accounting for advance payments for services to a proper method for 2023. In February 2024, Z acquires the stock of T.
- In March 2024, T files for an extension of the time within which to file its 2023 federal income tax return. In September 2024, T files the return and Form 3115 in accordance with the automatic change procedures of Rev. Proc. 2015-13, which results in a positive §481 adjustment.
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Tax Consequence of Accounting Method Changes cont'd

CONTRACT PROVISION

- Parent shall prepare Parent Prepared Returns for any taxable period that ends on or before the Closing Date in a manner consistent with the past practice of the Company, except as otherwise require by applicable Law; provided that, (x) if permitted by applicable Law, Parent shall be entitled to cause the Company to change its method of accounting for income Tax purposes, effective immediately prior to the Closing, from the cash method of accounting to the accrual method of accounting and, with respect to any positive adjustment under Section 481 of the Code (or any corresponding or similar provision of state, local, or non-U.S. Law) resulting from such change in method of accounting, cause the Company to elect pursuant to the "eligible acquisition transaction" election procedures set forth in Section 7.03(3)(d) of IRS Revenue Procedure 2015-13 (or any comparable election under state, local, or non-U.S. Law) to include such adjustment in its taxable income for the Pre-Closing Tax Period (collectively, the "Elective Accounting Method Change"), and (y) if the Elective Accounting Method Change is not permitted by applicable Law, Parent shall be entitled to take all actions permitted by applicable Law to result in the same consequences, and in any event all Pre-Closing Taxes will be computed for purposes of this Agreement, as if the Elective Accounting Method Change had been made.

Recent Developments in Success-Based Fees

- Amounts paid to facilitate certain business acquisitions or reorganizations, including amounts paid in the process of investigating or otherwise pursuing the transaction, generally must be capitalized. Treas. Reg. §1.263(a)-5(a).
- Amounts that are contingent on the successful closing of the transaction are presumed to facilitate the transaction. A taxpayer my rebut the presumption by maintaining sufficient documentation that a portion of the fee is allocable to activities that do not facilitate the transaction. Treas. Reg. §1.263(a)-5(f).
- Numerous disagreements have arisen between taxpayers and the IRS about the type and extent of the documentation required to establish the portion of a success-based fee allocable to activities that do not facilitate a business acquisition or reorganization.
- Rev. Proc. 2011-29, 2011-18 IRB 746, provides for an election to treat 70% of a success-based fee as an amount that does not facilitate the transaction in lieu of maintaining documentation.

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PLR 202308010

- Parent sought 9100 relief for an extension of time on behalf of its wholly owned subsidiary (“Taxpayer”) to file a safe harbor election under Rev. Proc. 2011-29 for a success-based fee paid to an investment bank (“IB”) in connection with the

PLR 202308010, cont'd

TAXPAYER'S POSITION

- Taxpayer "incurred" the IB fee because it, not Seller, entered into the contract with IB that obligated Taxpayer to pay the fee. Seller or Buyer paid the fee on its behalf. Treas. Reg. §1.263(a)-5(k).
- IB fee is properly regarded to be paid on Taxpayer's behalf because it primarily benefited from IB's engagement in that it was actively involved with the negotiation of its sale, which enabled it to obtain funding for its expansion efforts, and engagement of IB provided only incidental benefits to Seller.
- A press release issued by Seller and IB states that IB provided strategic and financial advisory services to both Taxpayer and Seller with respect to the sale of Parent to Buyer.
- Double tax benefit is justified because (a) Seller should be deemed to have made a capital contribution to Taxpayer equal to the IB fee (thereby increasing Seller's basis in Parent and reducing Seller with

PLR 202324001

- After its deduction for an IB success-based fee was disallowed on audit, Taxpayer sought 9100 relief for an extension of time to file a safe harbor election under Rev. Proc. 2011-29.
- Taxpayer had entered into an agreement with IB for services in connection with the sale of Taxpayer (whether in the form of a merger, asset sale, or equity sale) under which IB would receive a percentage of the sale consideration, plus expenses.
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PLR 202324001, cont'd

RULING

- Denied late election relief because Taxpayer was informed of the election and its consequences in all material respects and chose not to make it.
- In addition, taxpayer had the benefit of hindsight, and the policies behind Rev. Proc. 2011-29 (to eliminate controversy) exacerbate the hindsight issue.
- Finally, in the interest of sound tax administration, IRS has discretion to deny relief to make a late election for which the taxpayer fails to qualify.
- Fee "likely was not Taxpayer's expense, and Taxpayer likely was not 'otherwise eligible to make' the safe-harbor election. The costs "originated from and directly and proximately related" to the former shareholders' generation of sales proceeds from the disposition of Taxpayer, a portfolio company invested in by the interrelated private equity funds. Therefore, the fee would likely have been taken into account by Former Shareholders, not Taxpayer, as an offset to amount realized.

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PLR 202335013

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PLR 202335013, cont'd

RULING

- Late election relief granted. Taxpayer acted reasonably and in good faith and granting relief will not prejudice the interests of the government.
- To be deductible as an ordinary and necessary expense, the cost must be "directly connected with" or have "proximately resulted from" a taxpayer's business activity. *Kornhauser v. United States*, 276 U.S. 145, 153 (1928).
- The Service generally has not asserted that costs directly paid by a non-majority controlled public target company must be treated as the costs of selling shareholders so as to preclude a Section 162 deduction by the target. *INDOPCO*.
- No opinion is expressed in the PLR as to whether Taxpayer is otherwise eligible or otherwise qualifies to make the safe harbor election, the fee was paid on the taxpayer's behalf, properly treated as a cost of Taxpayer, was a success-based fee or subject to any other Code section that would preclude deduction or capitalization.

Deal Termination Fees

Does Section 1234A Apply?

- Section 1234A provides:
  - Gain or loss attributable to the cancellation, lapse, expiration, or other termination of:
    - a right or obligation
    - with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer
  -

TAM 200438038

PLR 200823012

- A would-be buyer requested a ruling regarding the fee it was paid when a target backed out of a planned acquisition
- IRS concluded that the fee was ordinary income.
  - Same lost profits analysis as in TAM
  - This time, IRS mentioned Section 1234A but only to say it did not apply (no explanation)

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FAA 20163701F

- Advice describes a would-be inversion
  - Inversion would be structured so that buyer and target would both become subsidiaries of a new foreign parent
- Deal was terminated after Treasury issued a notice adversely affecting the tax aspects of the deal
- Buyer terminated the deal and had to pay the foreign target a termination fee
- IRS conclusion:
  - Shares of new foreign parent would have been capital assets in buyer's hands Section 1234A applied to buyer's payment to terminate its obligations regarding the shares
  - Thus, termination fee gave rise to miniomc pstT-2(in)-2(a)1(t)-8(io)-4(r

CCA 201642035

CCA 202224010

CCA 202224010, continued

- Section 1234A applies to characterize the Section 165 losses as capital losses to the extent those losses were attributable to the termination of rights or obligations with respect to capital assets
- Taxpayer's loss resulting from the termination of the merger agreement is characterized as capital to the extent that loss was

AbbVie Litigation

- AbbVie Inc. filed a petition in Tax Court re: IRS disallowance of a deduction claimed for a $1.6 million termination fee it made to Shire plc after a failed merger
  - FAA 20163701F appears to about this deal
- The deficiency notice, dated 12/6/22, relates to tax year 2014 and asserts that AbbVie owes $572.4 million in additional taxes
  - The $1.64 billion ordinary tax deduction AbbVie claimed on its Form 1120 for the year "is not deductible as an expense under [S]ection 162 or as an ordinary loss under [S]ection 165 because the payment of that amount and termination of an agreement resulted in loss that is treated under [S]ection 1234A as a loss from the sale of a capital asset"
- AbbVie argues that IRS erred in determining the payment was a capital loss under Section 1234A

AbbVie Litigation, continued

- AbbVie cites TAM 200438038 and LTR 200823012 as examples of IRS treatment of termination fees as ordinary income
- Since the AbbVie merger was terminated, IRS released CCA 201642035 and CCA 202224010 (which guidance suggests a change to treat breakup fees as capital in nature)
- AbbVie also filed three FOIA lawsuits against IRS in the U.S. District Court for the District of Columbia March 3, challenging IRS failure to hand over records concerning its handling of AbbVie's breakup fee and post-2014 guidance on the tax consequences of termination fees
- AbbVie filed a lawsuit in September 2023 stating IRS is impermissibly withholding records

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Open Questions

- Is there property which is or would be a capital asset at issue?
- Does character of the fee need to match between payor and payee?
- What if the fee is paid before a contract is executed?
- Many others...

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Consolidated Group M&A Developments and Reminders

- Consolidated Group – Allocation of Income on Joining or Leaving a Group
- Unified Loss Rule
- Member Liability for Group Taxes

Consolidated Group
Allocation of Income on Joining or Leaving a Group

NOL Rules for Departing Members (1.1502-21)

- If a departing member has NOLs (e.g., a portion of the CNOL is allocable to the member), **only that portion NOT absorbed by the old group through the end of the group's year of the departure** is carried forward by the departing member (§1.1502-21(b)(2)(ii)(A))
  - As a result, post-sale income of the group can be offset by the departing member's NOLs. In that event, **use of those NOLs will affect the group's gain/loss on the sale of the stock**.
  - Allocation of CNOLs to a departing member requires apportionment of the CNOLs, applying a separate formula to the CNOL from each year.
  - The allocation of any prior Section 382 limitation is **OPTIONAL** and, if no allocation is elected, the departing member **takes a ZERO Section 382 limitation**.

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Allocation of Income between Departing Member's Two Tax Years

- Suppose P, S and S1 file consolidated returns. Assume P, S, and S1 are calendar year taxpayers.
- During the first half of 2018, S1 has income of $300. During the last half of 2018, S1 has a loss of $100.
- How is this income/loss reported by the parties?

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Allocation of Income between Tax Years (Cont'd)

- There are **two methods for the allocation of income** between separate return and consolidated return periods
  - Close the books (§1.1502-76(b)(2)(i))
  - Pro rata allocation (§1.1502-76(b)(2)(ii))
  - Consolidated group is permitted to "**ratably allocate**" (as opposed to "closing the books") the income of a departing/joining subsidiary, provided the subsidiary is not required to change its year end **AND**

Allocation of Income between Tax Years (Cont'd)

- Certain **extraordinary items may not be ratably allocated** and are allocated to the day on which they occur (§1.1502-76(b)(2)(ii)(C)):
  - Section 1231 gains & losses
  - Capital gains & losses
  - Income from discharge of indebtedness
  - Subpart F income
  - PFIC income
  - NOL carryovers
  - Section 481(a) adjustments
  - Credits from activity or items that are not ratably allocated (e.g., the purchase of property)
  - Tort settlements
  - **Compensation related deductions**
  - Dividends from section 304 controlled but unaffiliated corporations

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Taxable Year of Members of Group - §1.1502-76(b)(1)

- Timing
  - Departing/Joining Member is **deemed to leave or enter group at close of the day** of the event (§1.1502-76(b)(1)(ii)(A)(1))
  - Next day rule: Certain items incurred on day of change in status **deemed to occur on next day** (§1.1502-76(b)(1)(ii)(B))

- Special rules for S Corporations (§1.1502-76(b)(1)(ii)(A)(2))
  - Joining S corporation becomes a member **at the beginning of the day** of the acquisition

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Next Day Rule -- Reg. § 1.1502-76(b)(1)(ii)(B)

"If on the day of S's change in status as a member, a transaction occurs that is properly allocable to the portion of S's day after the event resulting in the change, S and all persons related to S under section 267(b) immediately after the event must treat the transaction for all Federal income tax purposes as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of S's day after the event will be respected if it is reasonable and consistently applied by all affected persons." (emphasis added.)

Consider non-qualified stock options and when the right to payment vests (i.e., before closing, after closing, or at closing).

GLAM 2012-010: The IRS concluded that Next Day Rule does not permit certain expenses associated with stock options, SARs, and success-based fees to be allocated to the period after the acquisition.

See also proposed regulations (REG-100400-14) that would amend §1.1502-76(b) and modify how certain items are reported when a corporation joins or leaves a consolidated group.

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Overview of Unified Loss Rules

Key Definitions: "Transfer"

- For this purpose, M and S are members of a consolidated group
- A "transfer" by M of an S share is

Basis Reduction - §1.1502-36(c)

- **Rule (§ 1.1502-36(c)(2)):** If a transferred S share is a loss share

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Basis Reduction (cont'd)

- Under § 1.1502-36(c)(5), **the "net inside attribute amount" equals**:
  - The sum of S's
    - Money
    - Basis in assets other than money
    - Net operating and capital loss carryovers
    - Deferred deductions
  - Minus S's liabilities
- The "net inside attribute amount"
  -

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Basis Reduction Rule Disallows "Noneconomic" Loss Classic of "Son of Mirror" Case

- Facts: M buys the S stock for $100, when S's asset has a $0 basis and $100 FMV. S sells its asset for $100. M sells the S stock for $100.
- Basis Reduction: **M's $100 loss is *disallowed*** because basis in stock of S must be reduced by $100, which is the lesser of:
  - Net Positive Adjustment (NPA) of $100:

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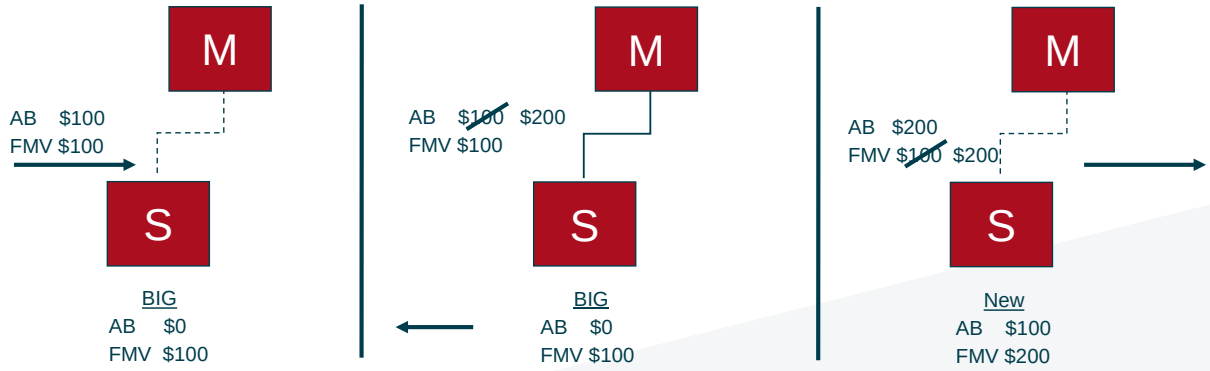
Basis Reduction Rule Allows Sheltering of Economic Gain: "Son of Mirror: Gain + Unrealized Other Gain



- Facts: M buys the S stock for $100, when S's BIG asset has a $0 basis and $100 FMV. S sells the BIG asset for $100. **S reinvests the $100 in a new asset, which appreciates in value to $200**. M sells the S stock for $200.
- Result: M has an economic gain of $100 on the stock due to the appreciation in the new asset. M has no taxable gain because its basis increased from $100 to $200 on S's sale of the BIG asset.
- **Nothing in Treas. Reg. § 1.1502-36 changes this result**. Even though Treas. Reg. § 1.1502-36 does not allow noneconomic basis increases to create or increase a loss, it does allow noneconomic basis increases to shelter post-acquisition gain.

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Treas. Reg. §1.1502-36(c): Buyer Beware

- Suppose Buyer buys a member (T) of a consolidated group. T might or might not be the common parent. T has a subsidiary S.
- Suppose Buyer sells the T stock at a loss. The loss will be disallowed to the extent of the lesser of (1) Buyer's NPA in the T stock, or (2) Buyer's disconformity amount in T, which depends in part on T's prior NPA in the S stock.
- Alternatively, suppose T sells the S stock at a loss. The loss will be disallowed to the extent of the lesser of (1) T's NPA in the S stock, **including adjustments attributable to periods before the Buyer's acquisition**, and (2) T's disconformity amount in S.
- Thus, in either case, for Buyer to apply the rules, Buyer must know not only the stock and asset basis that exists at each level on the purchase date, **but also the history of all NPAs in the stock of all direct and indirect subsidiaries of T**.
  - If Buyer acquired the T stock in a reorganization such as a "B" reorganization, and T was a subsidiary in another group, the history of NPA's in the T stock itself in the prior group would also be relevant to Buyer.

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Treas. Reg. 1.1502-36(d) Attribute Reduction to Address "Duplicated" Economic Loss

The Duplicated Loss Problem

AB $100

Attribute Reduction – §1.1502-36(d)

- Under § 1.1502-36(d)(2), if a transferred share is a loss share after the application of § 1.1502-36(b) and (c), **S's attributes are reduced by S's attribute reduction amount**, which is the lesser of:
  - ***Net stock loss*** – the excess, if any, of members' aggregate bases in transferred S shares over the aggregate value of those shares (§1.1502-36(d)(3)(ii))
  - ***S's aggregate inside loss*** – the excess, if any, of S's net inside attributes (inside asset basis plus losses minus liabilities) over the

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Application of Attribute Reduction Amount: The Basics (§1.1502-36(d)(4))

- Recognized losses must be reduced in full before reducing asset basis. S's attribute reduction amount is applied:
  - **First to reduce recognized losses**:
    - Capital loss carryovers
    - Net operating loss carryovers
    - Deferred deductions, including Section 163(j) carryovers
  - **Then, to reduce asset basis**
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Application of Attribute Reduction Amount (Cont'd)

- Any ARA not applied to reduce recognized losses is applied to S's assets – assets other than Class I assets in Treas. Reg. § 1.338-6(b)(1) (e.g., cash and cash equivalents). ARA is allocated to S's assets under the "**reverse residual method**," using categories in Treas. Reg. § 1.338-6(b):
  - ARA allocated first to Class VII (reducing basis in that class to zero); then remaining ARA allocated to each next lower class successively (other than Class I)
  - If ARA is less than basis in a class, basis is reduced proportionately within class
- Special rules for lower-tier subsidiaries
- If ARA exceeds attributes, no further effect unless S has contingent liabilities (in which case excess ARA suspended and applied as liabilities are taken into account)
- Reductions **effective immediately before transfer of S shares**
- Attribute reduction is not treated as noncapital, nondeductible expense (so no duplicative stock basis reduction under Treas. Reg. § 1.1502-32)
- Special rules in the case of worthlessness or a taxable liquidation

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Treas. Reg. § 1.1502-36(d)(6) Election

- Group can **avoid or reduce attribute reduction by electing to reduce members' bases in transferred loss shares**, reattribute S's attributes to P (if S leaves the group), or a combination
  - Can ssecc 05(n)-9.1(fs)-7(e9)-5.5.1(me9)2ss(t)-6.9(el1.3(ecc 04.t)60(ctd3.3(rc

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Loss Duplication with NOLs

S

- Facts:

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Loss Duplication Back Stops Basis Reduction

S

BIG			BIL	
AB	$0	$100	AB	$100
FMV	$100		FMV	$0

- Facts: M buys the S stock for $100, when S's BIG asset has a $0 basis and $100 FMV, and BIL asset has a $100 basis and $0 FMV.

Member Liability for a Group's Taxes: Treas. Reg. 1.1502-6

Member Liability for Taxes: Treas. Reg. 1.1502-6

- §1.1502-6(a) – General Rule
  - General rule provides that the common parent corporation and each subsidiary which was a member of the group during any part of the consolidated return year is **severally liable** for the tax for such year.

    The several liability of the member or subsidiary with respect to the consolidated return **is not what the federal income tax would have been for the subsidiary had it filed and been liable on a separate return**, but is for the tax computed in accordance with the consolidated return. It is severally liable for the tax liability of the group.

Member Liability for Taxes: Treas. Reg. 1.1502-6

- §1.1502-

Tax Treatment of Buying a Partnership

- Depends on whether purchase all or a portion.
- Rev. Rul. 99 -6 provides the federal tax consequences of the sale of partnership interests to a single owner, thereby converting the partnership into a disregarded entity.
  - When a third party buys all the interests of an existing multi-

Some Complexities of Buying a Partnership

- Allocation among purchased assets/assumed liabilities.
- Section 1445/1446 withholding.
- BBA audit regime.
  - Under the default rule of the BBA audit regime, IRS has authority to determine, assess, and collect tax on partnership underpayments at the partnership level.
  - A single person — the partnership representative (or a designated individual) — has the exclusive authority to represent, negotiate, and bind the partnership at all stages of a partnership proceeding subject to the BBA audit regime.
  - Partners do not have a statutory right to notice or to participate in the partnership proceeding.
  - Buyers may want to examine whether or when the partnership representative is obligated to make a push-out election and consider requesting that a push-out election be made absent an express obligation to do so in the operative documents.

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Lack of Technical Terminations

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Continuing Partnership Considerations

- Section 708(a) states that "[a]n existing partnership shall be considered as continuing if it is not terminated...A partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership."
- Partnerships therefore can continue through different transaction

Continuing Partnership Considerations, continued

Preserving QSBS in M&A Deals

- **QSBS**: Qualified Small Business Stock
- **Rule**
  - Tax-free reorganization or exchange (368 or 351)
  - Stock of Acquiror does not qualify as QSBS
  - Stock of Acquiror is QSBS in hands of exchanging stockholder, but only up to gain that would have been recognized as of the date of the exchange
- **What does eligible mean?**
  - Eligible corporation
    - Domestic C corporation
    - Not a DISC or former DISC, RIC, REIT, REMIC or co-op
  - $ 50 million gross assets
  - No redemptions
  - Active conduct of a qualified trade or business