Strategic participants in M&A: tax traps for the unwary

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M&A activity had a banner year in 2021, setting new records for deal volume across many industries and sectors. One area of particular interest was increased participation from strategic companies -- those making acquisitions primarily for business expansion and synergies instead of financial gain. While strategic companies may engage in M&A activity from time to time, two key trends have developed among this group in recent years.

Strategic participants are particularly likely to encounter a number of uncommon (although no less impactful) U.S. federal income tax issues uniquely relevant to their circumstances — whether as buyers or sellers.

First, many of these companies have participated in the M&A market by acquiring smaller tech companies to bolster existing product and service offerings — creating internal synergies and expanding their reach. The other involves larger conglomerates engaging in spin-offs or split-ups to focus on core business offerings or taking advantage of higher overall valuations as multiple companies, or both.

While M&A transactions can be inherently complex, strategic participants are particularly likely to encounter a number of uncommon (although no less impactful) U.S. federal income tax issues uniquely relevant to their circumstances — whether as buyers or sellers. This article seeks to highlight certain of these issues observed with strategic companies participating in M&A transactions and which might otherwise fall through the cracks.

Side-stream integration mergers

Post-closing integration of acquired targets is a strategic path companies should undertake with careful tax planning. Typically, having fewer companies is preferred to simplify entity structure and lower maintenance costs. Thus, it often makes business sense to merge an acquired target into an existing affiliate, with an upstream merger into the purchasing company often being the first choice. However, if there is an extended integration timeline, the target could be deemed insolvent for U.S. federal income tax purposes (e.g., an acquired start-up that has significant cash burn post-acquisition), leading to negative tax consequences for the eventual merger.

Upstream mergers of a corporation are generally tested as liquidations. Sections 332(a) and 337(a) of the Internal Revenue Code of 1986, as amended (Code), provide that liquidation of a subsidiary corporation into its parent corporation is tax-free if the parent owns, in the aggregate, at least 80% of vote and value of the subsidiary.

Section 332 does not apply, however, if the subsidiary is insolvent. Under such circumstances, the liquidation becomes taxable to both liquidating subsidiary and its parent. The parent will also lose out on the subsidiary's net operating losses, and other tax attributes that it might otherwise assume in a nontaxable liquidation (although the parent corporation may be able to claim a worthless stock loss deduction under Section 165(g) of the Code).

A possible alternative to avoid the risk of a taxable liquidation (or even administrative costs of establishing solvency, i.e., obtaining third-party appraisals the IRS may nonetheless challenge) is to acquire the target with the parent of the corporation the target would ultimately merge into. In this alternative, the subsequent integration merger would be a "side-stream" merger (instead of upstream) and could qualify as a tax-free reorganization under Section 368(a)(1) of the Code, which has no similar solvency requirement.

Section 409A

Section 409A of the Code is another area where focus during the transaction can mitigate otherwise significant headaches post-closing.

This section applies to "nonqualified deferred compensation plans" provided by an employer to its employees (or other service providers), which generally includes stock option grants. Specific to stock options, Section 409A requires the exercise price to be no less than the value of the underlying stock as of the date of grant. If such a plan does not satisfy Section 409A (including where options have a lower than required exercise price), the employee can suffer a heavy tax cost, including becoming immediately taxed on all compensation already deferred under the plan and paying an excise tax equal to 20% of the total deferred compensation.

The risk is particularly acute when a company might seek to grant new stock options or amend an existing deferred compensation plan before an acquisition. On the eve of the sale, the fair market value of the company's stock typically increases significantly. If new grants or amendments are made relying on old valuations, such actions would most likely violate Section 409A.

This issue can be difficult for a strategic buyer to navigate because the incidence of the tax is borne by the target company's employees — people with whom the buyer wants to build positive relationships and integrate into its organization long-term.

While a buyer cannot remedy a past Section 409A violation after the fact, the impact on the target's employees can be mitigated if discovered prior to closing. For instance, a buyer could require a portion of the purchase price to be redirected to the target company for further distribution to the affected employees to offset their Section 409A tax costs.

Regardless of the remedy selected, it should go without saying that any pre-sale alternative should be more palatable than a surprise conversation with the management team of a newly acquired subsidiary.

Unified loss rules

Sales of existing businesses can also trigger unexpected tax issues for the strategic companies disposing of these businesses. Not being caught unaware is especially important for strategic companies — not only to avoid potential indemnity claims but, perhaps even more importantly, also to maintain good relations and reputation among peers they might repeatedly transact with.

If the seller is a U.S. consolidated group, one unique risk is the unified loss rule in Treasury Regulations Section 1.1502-36 ("ULR"). The ULR is intended to prevent two situations. The first is where a consolidated group might recognize a noneconomic loss on the sale of a subsidiary. This can occur when a subsidiary of a consolidated group sells its inside assets and recognizes a taxable gain. Under the Treasury Regulations governing consolidated groups, gain recognized on the subsidiary's asset sale would increase the tax basis of the subsidiary's stock. If the consolidated group then disposes of the subsidiary's stock, it would recognize either less taxable gain on the stock sale or even a loss as a result of the increased stock basis. Such reduced gain (or recognized loss) is considered a noneconomic loss by the ULR.

The other situation the ULR seeks to prevent is when members of a consolidated group (including the former subsidiary) might obtain more than one tax benefit from a single economic loss. A classic example is when a group first disposes of a subsidiary via stock sale and recognizes a loss on that sale. After the stock sale, if the subsidiary has a high tax basis in its assets that exceed the value of the assets, it could subsequently sell those assets and generate a second tax loss.

In such situations, the ULR will make certain adjustments to the tax basis of the transferred shares and attempt to eliminate any such stock loss. If the stock loss remains after these adjustments, the inside tax attributes of the transferred subsidiary will be reduced in the following order until the potential for loss duplication is eliminated: (1) capital loss carryovers; (2) net operating loss carryovers; (3) deferred deductions; and (4) asset tax basis.

This attribute reduction can be avoided if the selling group makes an affirmative election and forgoes its stock loss. On the one hand, purchasers are rarely happy about acquiring a company with reduced tax attributes, but, on the other hand, tax benefits of any forgone stock loss could be meaningful for the seller.

A pre-sale taxable transfer of a historic business to a new holding structure can result in any associated basis step-up being non-amortizable — often a significant loss of potential tax benefits for the buyer.

Savvy purchasers are likely to inquire during diligence whether the ULR might apply and, if so, ask the seller to forgo its stock loss to preserve inside tax attributes. Whether such a trade-off might be worthwhile can be an important business decision, and sellers should be familiar with the potential impact of this rule to make informed decisions.

Section 197 anti-churning

Finally, sellers of any businesses that include pre-1993 intangibles should be aware of the potential for losing significant tax benefits due to pre-sale restructuring. In general, the tax basis of intangible assets, including goodwill, may be amortized under Section 197 of the Code, assuming the intangible was not self-created or otherwise excluded. However, one of the exclusions to amortization is the so-called "anti-churning" rule in Section 197, and it can be unintentionally triggered in the course of a sale.

The anti-churning rule disallows amortization of any intangibles that were acquired after Aug. 10, 1993, and held by the taxpayer or a related party (as specially defined for this purpose) between July 25, 1991, and Aug. 10, 1993. Unfortunately, the anti-churning "taint" is not limited to the value or tax basis of the subject intangible as of Aug. 10, 1993, but will also apply to any subsequent increase in value or tax basis (historic goodwill is particularly susceptible). Thus, a pre-sale taxable transfer of a historic business to a new holding structure can result in any associated basis step-up being non-amortizable — often a significant loss of potential tax benefits for the buyer.

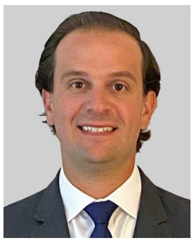
To avoid triggering the anti-churning rule, a buyer could directly acquire the business via asset purchase (without any initial internal transfer by the seller), or acquire the business in stages, e.g., the buyer purchases the new holding structure first, and the holding structure then acquires the business via a subsequent asset purchase.

Helpfully, intangible assets created after Aug. 10, 1993, are not subject to anti-churning regardless of the relationship between buyer and seller. Thus, the application of these rules will continue to narrow as time goes on. Nevertheless, for now, strategic companies should remain wary of this potential trap as they are more likely to have storied, longstanding businesses that may yet be caught.

Conclusion

With deal momentum expected to continue in 2022, it is perhaps more important than ever for strategic companies to be aware and get ahead of potential tax challenges, including the issues discussed herein, if they wish to participate in a thoughtful and successful manner. When it comes to tax planning, and as in so many other aspects of business, fortune favors the prepared.

About the authors



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