MERGERS AND ACQUISITIONS IN A POST-TAX REFORM WORLD

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Significant tax legislation often seems designed to provide full employment to tax lawyers. The 2017 federal tax reform legislation, often referred to as the Tax Cut and Jobs Act (TCJA), is no exception.[1] While the TCJA does not totally rewrite the Internal Revenue Code of 1986, it changes the ground rules for individual and business taxpayers in a wide array of areas, the area of mergers and acquisitions being no exception. Indeed, potential buyers and sellers of businesses are well advised to consider the new opportunities and obstacles presented by the TCJA before signing on the dotted line for any new deals.

Enter the lawyers and accountants who advise these buyers and sellers, who have (hopefully) kept abreast of all the changes ushered in by the TCJA, and on the regulations being promulgated by the Treasury Department under the act (Treasury Regulations). Many more regulations—plus administrative rulings and ultimately judicial interpretations—are still to come. Some of these changes, such as the creation of opportunity zones and qualified opportunity funds, present new possibilities for sellers, who can use these funds to defer their taxable gain from merger and acquisition (M&A) deals. Other changes, such as the new limitations on the deductibility of interest payments, raise the cost of doing deals.

Even the first question often asked of a tax lawyer at the start of a deal—should we buy (or sell) the stock or membership interests of the target company or the assets owned by the company instead?—must be reexamined in light of the TCJA.[2] The adage sellers prefer to sell the stock, but buyers prefer to buy the assets not only remains true, but is perhaps truer than ever before.

This article examines why that is the case, and what can be done if a stock deal is unavoidable. First, the article considers a key reason why asset deals have never been better for buyers—namely, the TCJA's expansion of code Section 168(k)'s bonus depreciation rules. Second, the article looks at several new considerations buyers must take into account when approaching stock deals, particularly when the target company has historically operated abroad or is structured as a partnership for income tax purposes (as most multi-member limited liability corporations (LLCs) are). Third, the article examines the new tax and withholding tax regime applicable to sales of partnership interests by nonresidents when the partnership is engaged in a U.S. trade or business. Finally, the article discusses the indemnification provisions and tax elections buyers should consider if a stock deal is the only deal on the table.

Assets—Buy Now, Deduct Sooner

One of the key advantages for buyers of an asset deal, as opposed to a stock deal, has long been that asset deals provide a greater opportunity for recovering the purchase price through tax deductions over time. Corporate stock cannot be depreciated—the buyer's cost in acquiring the stock sits in stock basis, often not benefiting the buyer at all until the stock is ultimately sold. While the situation is often more buyer-friendly when the target company is an LLC,[3] asset deals tend to benefit buyers regardless of the target company's entity type. This is because asset buyers get a 'stepped-up' basis in the assets they buy. The portion of the purchase price allocated to many assets, including goodwill and going concern value, can then often be deducted over varying periods of time via depreciation or amortization deductions permitted by the code. Pre-TCJA, a common practice was to allocate the seller's book value to most assets, with the remainder of the purchase price (often a substantial amount) being allocated to goodwill, which could be deducted straight-line (*i.e.*, in equal increments) over 15 years.[4] But the TCJA opened the door to allowing M&A buyers to use 'bonus depreciation' to completely write off a significant portion of the purchase price in the year of the deal itself.

Before the TCJA, taxpayers were allowed to deduct 50 percent of the cost of new 'qualified property' in the year the property was placed in service. Qualified property included most new tangible property and certain new computer software. Now, taxpayers may deduct 100 percent of the cost of qualified property placed in service after Sept. 27, 2017, and before Jan. 1, 2023, as long as several factors apply, including that the taxpayer did not use the property before acquiring it and the property was not acquired from a related party.[5] In addition, the definition of qualified property has been expanded to include used qualified property. As a result of the new rules, a buyer in an asset deal can now often deduct 100 percent of the portion of the purchase price allocated to many types of tangible assets and certain other assets acquired from the seller in the year the deal closes, allowing the buyer to recover a significant portion of the purchase price in year one.

Due Diligence Gets More Difficult for Stock Deals

Not only do stock deals not allow for stepped-up basis and enhanced depreciation and amortization deductions, but they require a buyer to investigate the historic tax compliance of the target company and make provisions for the satisfaction of tax liabilities in respect of pre-closing income and activities. The TCJA further complicates both of these requirements.

The TCJA includes a deemed repatriation tax, which is a one-time tax on the past earnings of foreign corporations owned by U.S. shareholders, regardless of whether the earnings are actually brought back to the United States. The repatriation tax requires a U.S. shareholder owning at least 10 percent of a foreign corporation to generally include in income the shareholder's *pro rata* share of the foreign corporation's accumulated post-1986 earnings and profits (to the extent the earnings and profits were not already subject to tax).[6] The shareholder's *pro rata* share is based on the foreign corporation's last tax year beginning before 2018, and is measured as of either Nov. 2, 2017, or Dec. 31, 2017, whichever date produces a greater result. A U.S. shareholder can either pay the tax in a lump sum or elect to pay it over a period of up to eight years.

Buyers contemplating stock deals should investigate whether the seller is or was subject to the repatriation tax, and whether the seller elected to pay the tax in installments. If the seller failed to pay the tax or elected installment payments, the target corporation will be liable for the outstanding tax after closing. Thus, a buyer will want to ensure that the seller indemnifies the buyer for outstanding taxes or otherwise compensates the buyer for assuming the tax liability.

Even if the target company did not operate abroad, or have income from abroad, before the transaction, if it is a partnership for tax purposes and the buyer is buying less than 100 percent of the outstanding equity interests, diligence is required regarding historic tax elections and possible tax underpayments. Before the TCJA, this was not the case. Under old code Section 708(b)(1)(B), a partnership was deemed terminated, with a new one immediately taking its place, if there was a sale or exchange of 50 percent or more of the partnership's equity interests within any 12-month period. While this rule often operated as a trap for the unwary

because 'creeping' acquisitions of interests in a partnership could, in the aggregate, inadvertently trigger the rule, it had the upside of allowing a buyer of less than 100 percent of a partnership's equity interests to start with a clean slate as of the closing date. A technical termination meant that some tax attributes of the old partnership disappeared, the partnership's taxable year closed, partnership depreciation recovery periods restarted, and partnership-level elections generally ceased to apply.

Unfortunately for buyers, the TCJA repealed code Section 708(b)(1)(B). As a result, buyers now generally inherit the tax attributes and elections of the pre-closing partnership and no longer have the opportunity to start over as of the closing date. This includes the inheritance of any imputed underpayments for which the partnership may be liable. Under the Bipartisan Budget Act of 2015, a partnership may be audited at the partnership level and, absent certain elections, any adjustments resulting from such an audit (called imputed underpayments) are assessed at the partnership level. The partnership will remain liable for any imputed underpayments following the sale of interests in the partnership, thus, the buyer should be sure to obtain an indemnity from the seller.

Note that the concerns above do not apply if a buyer buys 100 percent of the outstanding equity interests of a partnership. Such an acquisition would still result in a termination under code Section 708(b)(1), which provides that the partnership will terminate if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners. Following the acquisition of 100 percent of the partnership's equity interests, the entity will be disregarded for tax purposes, thereby terminating the partnership (and consequently all tax attributes, elections, and liability for imputed underpayments).[7]

Goodbye, *Grecian Magnesite*; Hello, Code Sections 864(c)(8) and 1446(f)

A nonresident alien or foreign corporation engaged in a U.S. trade or business is subject to U.S. federal income taxes on income that is effectively connected with the trade or business, commonly referred to as ECI.[8] If a nonresident alien or foreign corporation is a partner in a partnership engaged in a U.S. trade or business, the nonresident alien or foreign corporation is deemed to itself be engaged in such trade or business. The result is that its share of the partnership's income from the trade or business—including income from the sale of the relevant assets—is taxable as ECI.[9] But it has long been an open question whether a nonresident alien's or foreign corporation's sale of a partnership interest results in ECI for the seller where the partnership is engaged in a U.S. trade or business.

Revenue Ruling 91-32 provided that such a sale of partnership interests did, in fact, result in ECI for the seller. But many taxpayers disregarded this revenue ruling as being incorrect, and the tax court similarly disagreed with the Internal Revenue Service in its *Grecian Magnesite* decision. In that decision, the court held a seller does not have ECI on the sale of partnership interests.[10] After *Grecian Magnesite,* many practitioners believed the matter was settled.

Then along came the TCJA with its new code Section 864(c)(8), which rejects the *Grecian Magnesite* holding and codifies Revenue Ruling 91-32. Code Section 864(c)(8) provides that if a foreign transferor owns (directly or indirectly) an interest in a partnership that is engaged in the conduct of a trade or business within the United States, the gain recognized by the foreign transferor on the transfer of the partnership interest will be treated as ECI. The amount of gain required to be recognized is limited to the amount that would be recognized on a deemed sale of the partnership's assets for fair market value.

The TCJA also added code Section 1446(f), which provides that if any gain on the transfer of a partnership interest will be ECI under Section 864(c)(8), the transferee of the partnership interests must withhold an amount equal to 10 percent of the amount realized on the transfer. Section 1446(f) generally only applies to the transfer of partnership interests. In the case of asset sales by partnerships, withholding is generally only required if any of the assets are U.S. real estate or certain indirect interests in U.S. real estate, in which case the Foreign Investment in Real Property Tax Act of 1980's (FIRPTA) code Section 897 and its corresponding withholding regime under code Section 1445 continue to apply.

A buyer of partnership interests can avoid its withholding obligations under Section 1446(f) if it obtains a certification from the transferor (or, in certain cases, the partnership) certifying as to one of the following: 1) the transferor is not a foreign person, 2) the transaction did not result in any realized gain, 3) the amount of ECI from the deemed asset sale would be less than 25 percent of the total gain on the deemed asset sale, or 4) the transferor's allocable share of the partnership's ECI for each of the prior three taxable years was less than 25 percent of the transferor's total distributive share of income from the partnership for that year.[11]

The Treasury Department has issued proposed regulations that add two additional exceptions to withholding (*i.e.*, that the transaction is a non-recognition transaction or qualifies for a treaty exception), and also lower the 25 percent *de minimis* income thresholds to 10 percent.[12] If at all possible, a buyer of partnership interests should obtain a certification from the seller or the target partnership regarding one of the foregoing exceptions in order to avoid withholding obligations.

What to Do When the Deal Must Include Stock

If, despite all the warnings above, a stock deal is the only deal to be had, the buyer's lawyer should not just throw their hands up in the air and proceed to the nearest exit. Yes, additional diligence will be required. Yes, 1446(f) withholding may be required, and at minimum a closing certificate will be needed if partnership interests are being sold. But there are measures that can be taken to improve the situation for the buyer.

To start, the buyer should insist on a broad tax indemnity from the seller for pre-closing tax liabilities. The indemnity should cover both taxes that became due before the closing, as well as taxes on pre-closing income regardless of when they become due. It should also cover any liabilities for another person's taxes that the target company may have or that the buyer may inherit, such as under Treasury Regulations Section 1.1502-6 (which makes consolidated group members jointly and severally liable for the group's tax liability) or as a result of an unfiled or improperly filed bulk sale notice or noncompliance with escrow and payment demands resulting from the filing of a bulk sale notice.[13] The buyer should also insist on control over, or at least an approval right with respect to, tax returns filed after the closing but with respect to pre-closing tax liabilities.

Still more can be done if the target company is a corporation and the transaction qualifies as a 'qualified stock purchase,' (*i.e.*, any transaction or series of transactions in which 80 percent of the target corporation's stock is acquired by the purchasing corporation during a 12-month acquisition period).[14] If the target corporation is an S corporation or is a member of a consolidated group, the buyer and seller may jointly make an election under code Section 338(h)(10), which is an election to treat the transaction as a taxable acquisition of 100 percent of the target corporation's assets for tax purposes, followed by the liquidation of the target corporation (*i.e.*, as though a new corporation formed by the buyer acquired the assets).[15] The buyer may require the seller to join in the election in the purchase agreement. Such an election provides significant tax benefits to the buyer, in that the buyer's basis in the assets will be 'stepped up' to fair market value, resulting in additional depreciation or amortization deductions. The purchase price allocated to goodwill can also generally be amortized ratably over 15 years and, as noted above, bonus depreciation may be available.

A 338(h)(10) election often results in higher tax costs for the seller, particularly if some of the seller's income is accelerated in what would otherwise be an installment sale (*e.g.*, with respect to gain on the sale of inventory and the recapture of previously taken depreciation deductions, which cannot be deferred under the installment method),[16] or if income that would otherwise be capital gain is converted to ordinary income (*e.g.*, gain on assets such as inventory or accounts receivable).[17] The seller may only agree to the joint election if the buyer pays a 'gross-up' payment as a result of this increased tax liability, which is based on the increased tax liability of the seller as a result of the election. It is intended to put the seller in the same position it would have been had the election not been made. The term 'gross-up' payment stems from the fact that every dollar paid in this regard adds to the purchase price, which in turn adds to the seller's taxable gain—thus the payment must be grossed-up to account for additional tax. Nevertheless, a buyer will often agree to make a gross-up payment because the cost of the payment is often outweighed by the tax benefits to the buyer.

If the target company is a foreign corporation or has significant net operating losses (NOLs), a corporate buyer may instead wish to consider an election under code Section 338(g). A 338(g) election similarly results in a basis step-up for the buyer but, unlike the 338(h)(10) election, this election only requires the buyer's consent, and is not limited to certain categories of target corporation. The reason a 338(g) election is easier for the buyer to make is because, in the case of a 338(g) election, it is the buyer that recognizes the taxable gain resulting from the deemed asset sale. In most cases, the current tax cost of the deemed asset sale would outweigh the buyer's future tax savings from having stepped-up basis. But if the target is a foreign corporation, most if not all of the gain resulting from the deemed asset sale is likely not to be subject to U.S. taxation.[18] Likewise, if the target has significant NOLs, those NOLs may be able to offset, perhaps completely, the taxable gain resulting from the deemed asset sale. In either case, the buyer can get a stepped-up basis in the target's assets without paying for the step-up (other than perhaps giving up NOLs, the use of which may have been limited for the buyer post-closing anyway).[19] This step-up can then be used to reduce the taxable income generated by the target company after the closing.

Conclusion

There are many tax (and even more non-tax) issues that must be addressed in the context of a well-planned and legally compliant M&A transaction. This article only scratches the surface of some of the tax issues that should be considered. But as should now be clear, when it comes to approaching an M&A deal post-TCJA, what was once true for the American Express card is truer now more than ever with respect to a well-versed tax lawyer: Don't leave home without it. ⚖

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Endnotes

1. Pub. L. 115-97.
2. References to 'stock deals' or the like throughout this article, unless otherwise specified, are intended to apply to acquisitions of corporate stock, limited liability company membership interests, or other types of equity interests in business entities.
3. This is because the acquisition of 100 percent of an LLC's membership interests, where the LLC is not taxed as a corporation, is treated as an asset deal from the buyer's perspective for tax purposes. *See* Rev. Rul. 99-6. Even if the LLC will remain a partnership for tax purposes after the sale (*i.e.*, more than one member, and no election to be taxed as a corporation), stepped-up basis in the LLC's assets is possible if the LLC makes an election under code Section 754.
4. Code § 197.
5. Code § 168(k).
6. Code § 965.
7. *See also* Treas. Reg. § 301.7701-2(c)(2)(i) and Treas. Reg. § 301.7701-3(b)(1)(ii).
8. Code §§ 871(b), 882(a).
9. Code § 875(1).
10. *Grecian Magnesite Mining, Indus. & Shipping Co., SA v. Comm'r*, 149 T.C. 63 (2017).
11. IRS Notice 2018-29.
12. Prop. Treas. Reg. § 1.1446(f)-2(b).
13. *See* N.J.S.A. 54:50-38.
14. Code §338(d)(3).
15. Treas. Reg. § 1.338(h)(10)-1.
16. *See* Code § 453.
17. *See* Code § 1221.
18. *See, e.g.*, Code §§ 862(a)(5), 865(a).
19. *See, e.g.*, Code § 382.

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one additional way to be a 'related organization' in the case of an ATEO that is a voluntary employees' beneficiary association as set forth in code Section 501(c)(9). Code Section 4960(c)(4)(B)(v).

9. Notice 2019-09, Q&A 8. For partnerships control means ownership of more than 50 percent of the capital or profits interest and for trusts ownership of more than 50 percent of the beneficial interests.
10. Code Section 4960(c)(4)(C). The liability for the tax is on the employer. Code Section 4960(b). Notice 2019-09 Q&A 14 clarifies how the tax is imposed if remuneration is paid by an ATEO and other employers that are related entities.
11. Code Section 4960(c)(3)(A).
12. Code Section 4960(c)(3)(B).
13. Code Section 4960(c)(5)(A).
14. Code Section 4960(c)(5)(B).
15. Code Section 4960(c)(5)(D).
16. The other exceptions are listed in code Section 4960(c)(5)(C). Note that the term 'parachute payment' also does not include payments made to an individual who is not a highly compensated employee under code Section 414(q). Code Section 4960(c)(5)(C)(iv).
17. Notice 2019-09, Q&A 15.
18. *Id.*
19. *Id.*
20. *Id.*
21. Notice 2019-09, Q&A 15, Example 3.
22. Notice 2019-09, Q&A 34.

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7. *VNO 1105 State Hwy 36, L.L.C. by Stop & Shop v. Twp. of Hazlet*, 31 N.J. Tax 112, 133 (Tax 2019), *reconsideration denied sub nom.*
8. *Id.*
9. N.J.A.C. 18:12A-1.9(l) states "no assessor shall appear before the board as an expert witness against another assessor or taxing district within the State except to defend the assessment of his or her taxing district."
10. Letter from Philip James Degnan to Hon. Sheila Y. Oliver, April 30, 2019, https://www.nj.gov/comptroller/news/docs/osc_letters_to_dca_taxation.pdf.
11. A-1169/S-3276, 2018 Leg., 218th Sess. (N.J. June 21, 2019).
12. *Handbook for New Jersey Assessors*, § 106.01, revised Oct. 2018.
13. *VNO,* 31 N.J. Tax at 124, fn 10.
14. N.J.S.A. 40A:9-22.1 to 22.25.
15. N.J.S.A. 40A:9-146 to 146.3.
16. N.J.S.A. 40A:9-22.5.
17. A-2004 3R/S-2673 2R, 2018 Leg., 218th Sess. (N.J. passed both Houses on June 20, 2019) amending N.J.S.A. 54:3-27.2.
18. N.J.S.A. 54:3-27.2.
19. S3631, 2018 Leg., 218th Sess. (N.J. May 13, 2019).