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KEY TAX INSIGHTS

MERGERS AND ACQUISITIONS NEWSLETTER

BE CAREFUL WHEN THE TERMS OF AN ACQUISITION SEEM TOO GOOD TO BE TRUE – THEY USUALLY ARE

When there is a cross-border merger and acquisition there are additional complexities to plan for, typical acquisition planning in one country may be different than in another country, and the resulting tax implications can be significant. We have represented both the acquiror and target in a number of cross-border acquisitions and getting the right result requires a careful analysis of the tax implications involved. **What may seem like a very small detail may have very serious tax implications** that greatly impacts the result of the acquisition for either the acquiror or target.

In one acquisition where we represented the target, a U.S. domestic partnership that was being acquired by a fund located outside the U.S., the purchase price required the primary owner ("**Owner**") of the target to loan $5 million interest free to the acquisition company ("**Newco**") who would then repay the Owner in seven years. The Owner agreed to this as the acquiror agreed to pay ten percent interest while the loan was outstanding, that is the loan was interest free but as long as the loan was outstanding the Owner would receive the equivalent of ten percent interest per year. Based on how repayment of the loan was going to be facilitated, the economics of the loan were not as they seemed.

The Owner sold a portion of their interest in the target to Newco (*new entity formed to acquire the target)* and exchanged a

certain portion of their interest in Target for equity interest in Newco. Newco would initially enter into the loan agreement with the Owner after which Newco would assign the loan to Topco (*new entity formed as blocker corporation*) who owned the remaining equity in Newco. Topco was wholly owned by the real acquiror of Target.

For purposes of this illustration, it is assumed that Owner had forty-five percent of the equity interest in Newco with the balance of the equity in Newco being owned by Topco. Topco would receive an annual fee from Newco to fund the annual interest payment and Topco would have a receivable from Newco to repay the $5 million principal on the loan.

Initially, the acquiror wanted the Owner to both leave $5 million in the Target to fund operations and reduce the purchase price by $5 million with the Acquiror having the indirect obligation to repay $5 million in seven years. There was a math

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problem here as the owner was giving up $10 million today with the right to receive $5 million in seven years, clearly not a good result. We quickly pointed this out to the acquiror's counsel and the issue quickly went away.

Another issue with the proposed loan structure is that the Owner would be repaying themself indirectly forty-five percent of the $5 million and the interest payments as the loan is being funded by Newco. That is, instead of receiving interest at ten percent as the Owner expected, the Owner is really getting interest at five and a half percent. After discounting the note and removing the part of the loan funded by the Owner, the loan would be a detriment to the Owner, that is, the Owner would receive less after seven years than getting $5 million at closing. This was pointed out to the acquiror and the acquiror agreed the loan principal would only be repaid against acquiror's interest in Newco, but insisted the funding of the interest payments not change. Thus, the Owner would not receive the ten percent interest they believed they were receiving in agreeing to the loan in the letter of intent. This is one reason it is good to have tax counsel involved at the start of an acquisition as this issue was completely missed by corporate counsel for the target.

Another issue to review was whether the fee paid from Newco to Topco would be deductible to Newco. Topco is the majority owner of Newco and does not really provide any services for the fee. This is important as if the fee is not deductible, then the Owner will be paying tax on forty-five percent of the fee that goes to Topco to then pay itself interest, the interest of which is also taxable to Owner. The Owner would be double taxed on forty-five percent of the interest payments received, which is not a good result. Obviously if the fee is deductible to Newco, then it would be taxable to Topco, but this is an issue for the acquiror that does not implicate the Owner.

What would be a good loan analysis without original issue discount ("**OID**") implications. The transaction intends for the loan to be interest free, but for the Owner to receive ten percent interest from Topco while the loan is outstanding. The so-called interest free loan starts as an obligation of Newco and the interest payment is an obligation of Topco. On the one hand, the interest is tied to the loan outstanding, on the other hand, the loan agreement states the loan is interest free.

When the interest on a loan is not adequately stated, the OID rules impute interest at the applicable federal rate reducing what is characterized as principal and recharacterizing that portion as interest income. The issue is that the repayment of principal is tax free

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to the Owner, but interest is taxable income. It would be a detriment to the Owner, for example, if the $5 million principal repayment in year seven were recharacterized as $4 million as repayment of principal and $1 million as interest that is taxable to the Owner.

Under the OID rules, where separate entities hold separate instruments, in this situation, Newco holding the loan instrument and Topco holding the interest instrument, the instruments are not aggregated in determining whether OID is applicable even if the entities are related. If the loan instrument and interest instrument were separated in different companies as recommended by the acquiror, then OID would be applicable to the $5 million principal repayment resulting in the OID being taxable to the Owner and the OID being tax deductible to Topco. This was clearly a trap set by the acquiror which the Owner was able to avoid as with our advice the loan was changed to avoid this result.

Was this $5 million loan at ten percent interest too good to be true? In this case it certainly was and could have turned significantly negative if there was not careful review of the cash flows and tax implications of the loan structure. It cannot be said enough, it is important to have tax counsel present from the beginning of an acquisition to understand fully the benefits received to the Sellers.

Too often, transactions look good on paper and the Sellers want to trust the acquiror and their tax counsel, but once the totality of the transactions are fully reviewed, it is not a good deal for the Sellers.

Notice of Firm Name Change

We have long believed that the firm is larger than any one person and it is time for the name of the firm to reflect this value. **In 2024, the name of the firm will transition over time from Klug Counsel PLLC to Basswood Counsel PLLC**. The Basswood Tree is known as a symbol of unity, prosperity, versatility, and justice. The Basswood Tree is found all over the world and in some cultures important meetings and outdoor celebrations occur under the shade of a Basswood Tree. Pulling this all together and in line with our firm ideals, Basswood symbolizes that *"we have you covered."*

In order for the name change to proceed smoothly it will transition over time. There will be notifications when the official name change occurs with our new contact information. Should you contact us through the Klug Counsel contact information after the name change, we will still receive the messages so there will be no disruption to our clients as a result of the name change.

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