KEY TAX INSIGHTS

MERGERS AND ACQUISITIONS NEWSLETTER

DOES THE COMPLICATED ACQUISITION STRUCTURE ALWAYS WORK OR IS IT MORE HASSLE FOR NO BENEFIT?

The tax implications of mergers and acquisitions are complicated and to get the right result requires tax professionals who understand the nuances of the tax classifications of the companies involved. Even if big law firms are involved, sometimes the transactions get more complicated than required even though the tax implications are no different then if the transaction occurred as originally planned under the simplified structure.

We encountered such a situation when we represented the target in an acquisition. The attorneys for the acquiror were not straightforward about their structure and unfortunately by the time we got the relevant information and showed the acquiror's tax attorneys conclusively the special tax treatment they claimed would occur did not work, the attorneys for the acquisition company refused to change course as they needed to save face in front of their large private equity fund client.

The attorneys for the acquiror had touted this great tax planning feat as a reason for their large legal bill to the client, so the attorneys for the acquiror could not let the client know they were wrong. They are after all attorneys!

We were brought into the acquisition after it was well on its way. The target was a c-corporation for tax purposes. The acquiror first attempted to get the target to change its tax classification but for several reasons including negative tax implications the target would not change its tax classification. The acquiror then decided that it would liquidate the c-corporation post-acquisition. As part of the acquisition there was an earnout component to the purchase price that would create tax implications on the post-acquisition liquidation of the target even though it was not certain the earnout would be received.

Tax counsel for the acquiror's solution was through a Zenz transaction to have the

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target redeem stock from the shareholders pre-acquisition in exchange for the earnout. To the acquiror, this removed the earnout as an asset of the target. This can be viewed in two ways, first, the target can be viewed as distributing an appreciated asset at the time of the redemption which would be a taxable transaction to the target. Second, and the approach acquiror's counsel adopted when pressed, the distribution of the earnout to the shareholders can be viewed as an obligation and would not be taxed to the target at the time of redemption or liquidation. This latter point was incorrect.

What acquiror failed to realize was that if the distribution of the earnout was an obligation of the target, then at the time of the post-acquisition liquidation, the distribution of the earnout would be taxable to the acquired corporation. When a corporation distributes an obligation at liquidation, the relief from that obligation is taxable to the corporation. In the end, the acquiror's counsel created an unnecessarily complicated structure that saved no taxes.

We attempted to work through the tax treatment with the acquiror's counsel on several occasions. Until the end of the transaction, acquiror's counsel would provide very little information on the full details of the tax treatment. For the most part, acquiror's counsel would state that the liquidation would not impact our client since it occurs post-acquisition, which for the most part was true, with the exception that at least one of the owners of the target would receive equity in the acquiror.

It unfortunately became clear that the acquiror's attorneys would not change back to the original straightforward stock purchase structure and would only move forward with their more complicated structure, that had no actual tax benefit and would only support their legal bill, and instruct the acquiror to erroneously file the tax return for the liquidation without reporting as income the obligation of the earnout transferred to the post-acquisition shareholders. It was clear that acquiror's attorneys had to stick to the story that their complicated transaction had actual tax benefit, even though it did not.

On our side, we ensured our client had no part in the tax reporting and had the acquiror indemnify the target shareholders from any tax implications of the pre-acquisition redemption and post-acquisition liquidation. While we informed acquiror's counsel about the actual tax treatment and how to report the tax, we have no control over how they will report the post-acquisition liquidation.