



Dbriefs U presents:

# The Role of Tax in Mergers and Acquisitions

## Why Tax Structure Matters

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# Agenda

What is M&A?

What role do accountants play in M&A?

What is due diligence?

What is transaction structuring, and why does it matter?

Common acquisition structures

Cases studies

# What is M&A?

- Merger

- Two companies legally combine to operate as one company going forward

- Example: Delta and Northwest combined to form the world's largest airline

- Acquisition

- One company buys another company's stock or assets for cash, stock, or other forms of consideration

- Example: Kraft Foods acquired Cadbury in a stock purchase valued at approximately \$19 billion; created the world's second largest food company

- Joint venture

- Contractual agreement between two or more parties to execute a specific business plan, often for a limited period of time

- Example: Verizon Wireless is a joint venture between Verizon Communications (U.S.) and Vodafone Group (UK); provided Vodafone with access to the U.S. wireless market

# What is M&A? (cont.)

## The players in an M&A transaction

### Strategic buyers

- Companies with an existing operating business, often looking to expand their market share or enter a new market

### Financial buyers

- Generally, private equity funds or hedge funds who seek to acquire and operate a business for a period of time before re-selling or taking a company public

### Buyer and seller management

- The principal decision makers and business experts in the transaction

### Investment bankers

- Assist sellers by helping them “shop” the company
- Assist buyers with valuation and negotiation strategy

# What is M&A? (cont.)

## The players in an M&A transaction

### Attorneys

- Assist with negotiation of transaction terms
- Perform legal due diligence
- Draft legal documents to effectuate the transaction

### Accountants

- Perform accounting, tax, and other forms of financial due diligence
- Consult on tax structure of the transaction

# What role do accountants play in M&A?

- Due diligence
- Transaction structuring and tax planning
- Analysis of and comment on investment models
- Comment on transaction agreements
- Preparation of funds flow statements
- Closing date balance sheet or working capital analysis
- Assistance in identifying purchase price adjustment
- Assist with post-merger integration of the businesses

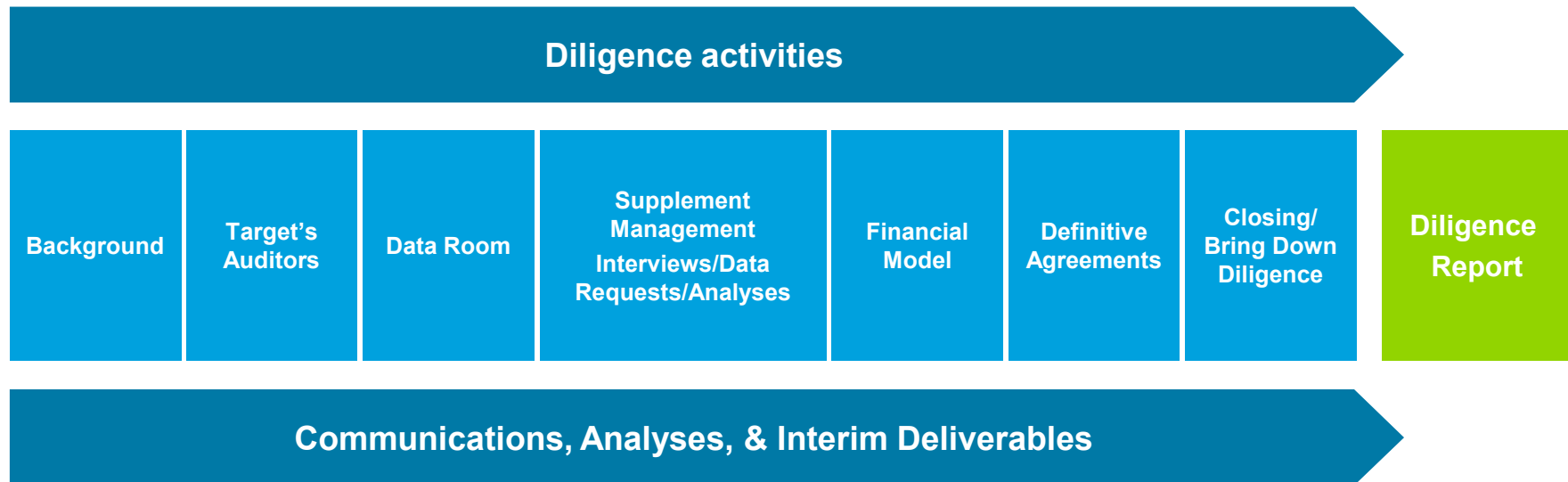
# What is due diligence?

- Investigation of financial, accounting, tax, cash flow and operational matters (such as legal, human resources, information technology, environmental)
- Usually requested by a Buyer to understand where value in the Seller exists and identify issues that should be considered before or after the acquisition

## What is due diligence? (cont.)

- Objective of financial due diligence is to gain better understanding of:
  - Quality and composition of historical and projected EBITDA or GAAP earnings
  - Level, stability, timing and certainty of future cash flows
  - Quality of assets and working capital
    - Example: Is inventory slow-moving or obsolete?
  - Existence of unrecorded liabilities
  - Identification of tax deficiencies or opportunities to save taxes
  - Identification of operational matters

# Accounting and tax due diligence process



# What is transaction structuring?

	Strategic buyers	Financial buyers
<b>Goal</b>	<ul style="list-style-type: none"><li>• Integrate the acquired business into the existing business in an efficient manner</li></ul>	<ul style="list-style-type: none"><li>• Generally, to structure the transaction in a manner that provides for an efficient exit (e.g., in an IPO or future sale)</li></ul>
<b>Considerations</b>	<ul style="list-style-type: none"><li>• Domicile of entities<ul style="list-style-type: none"><li>– Would the transaction result in duplicate entities or overlap of operations in certain locations?</li></ul></li><li>• Tax attributes<ul style="list-style-type: none"><li>– What is the optimal utilization of attributes (e.g., NOLs generated by the separate companies?)</li></ul></li><li>• Effective tax rate<ul style="list-style-type: none"><li>– Will the acquired company result in a significant increase to the tax rate, and, thus a reduction to earnings per share?</li></ul></li></ul>	<ul style="list-style-type: none"><li>• Cost recovery and interest deductions<ul style="list-style-type: none"><li>– How can these reduce cash taxes and affect future cash flows for purposes of determining purchase price?</li></ul></li><li>• Subsequent diligence upon exit<ul style="list-style-type: none"><li>– Is it too convoluted or confusing for a potential buyer?</li></ul></li></ul>

# Tax structure — Why it matters

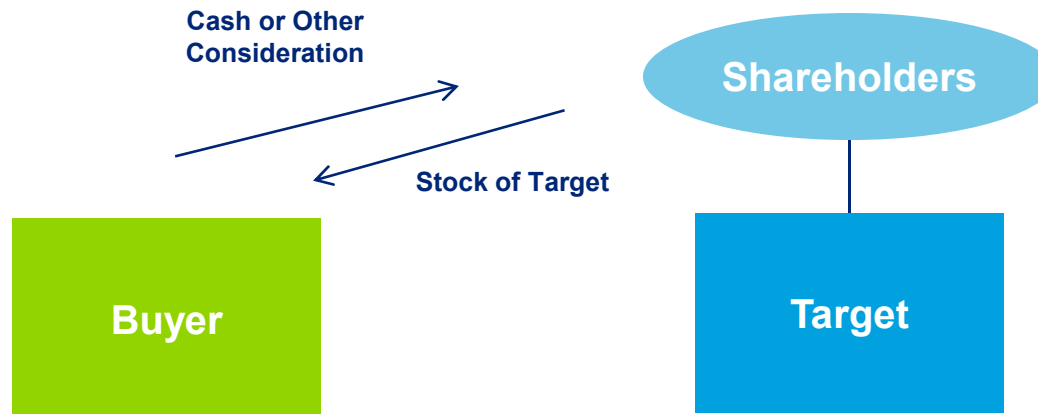
- Determine the preferred domicile and type of legal/tax entity
- Obtain desired tax treatment of transaction (taxable or tax-free, where available)
- Obtain step-up in asset basis to fair market value in taxable asset transactions
- Place debt in the acquisition structure where it will yield the greatest tax benefit (interest deductions)
- Minimize “tax leakage” (such as withholding taxes) relating to cross-border movements of cash
- Optimize use of tax attributes, such as net operating losses
- Avoid adverse consequences, such as limitations on deductibility of interest or tax-related change of control costs

# Common acquisition structures

- Stock purchase
- Asset purchase
- Merger
- Others
  - Stock purchase with Section 338(h)(10) election
  - Joint venture

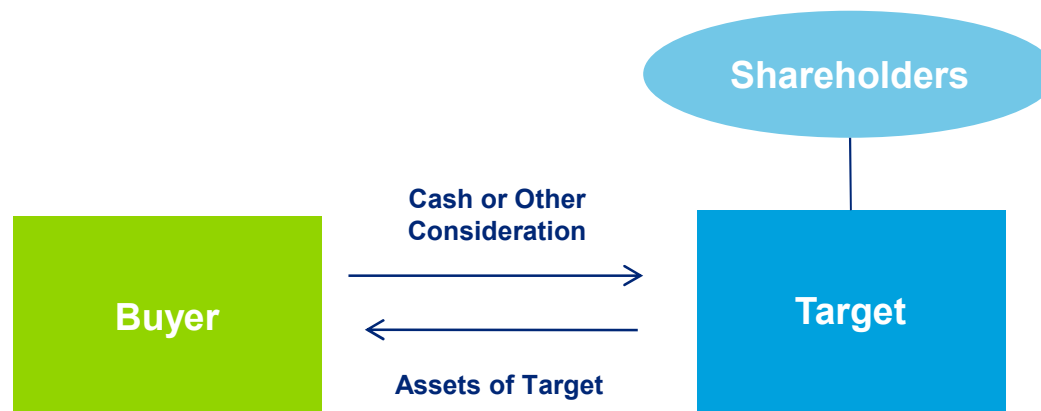
# Common acquisition structure — Stock purchase

- Stock purchase
  - Buyer inherits all tax attributes and liabilities
    - Specifically includes known and unknown tax contingency items
    - Due diligence and contractual protection becomes crucial



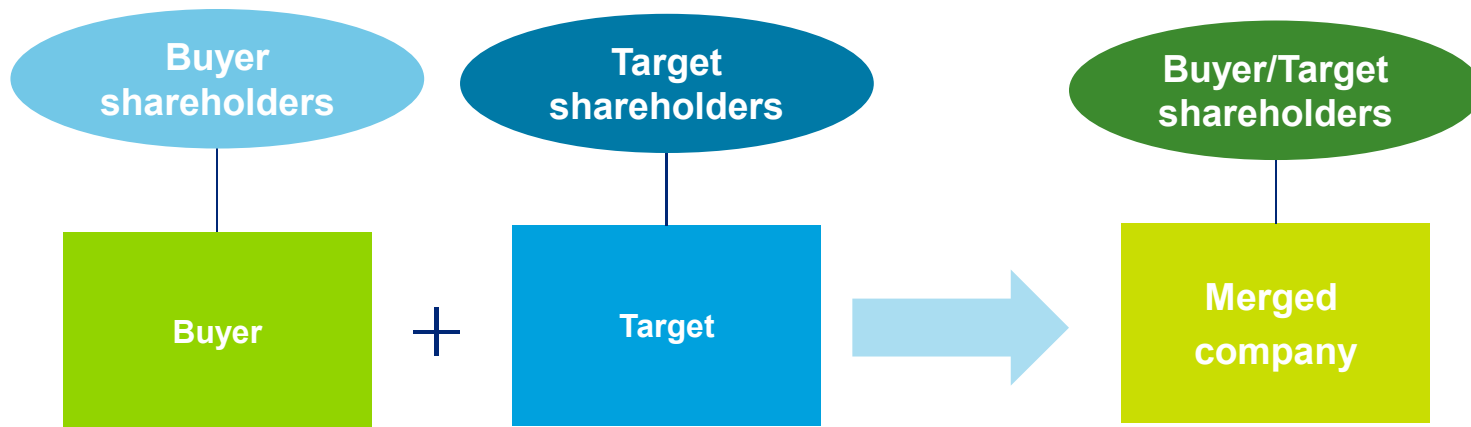
# Common acquisition structure — Asset purchase

- Asset purchase
  - Generally requires less income tax due diligence
    - Buyer can purchase specific assets without contingent liabilities
  - More focus on structuring and tax planning
    - Enhanced flexibility to implement optimal transaction structure
    - Evaluate Target asset tax basis to estimate potential step-up
    - Cash requirements of potential transaction taxes must be considered



# Common acquisition structure — Merger

- Merger
  - May be structured in a manner that results in either a stock or asset purchase for tax purposes.
  - The Target will generally want to perform due diligence on the Buyer to validate the value of the equity its shareholders will receive in the combined company (reverse due diligence).



# Case study #1 — Tax structuring opportunity

- Large non-U.S. manufacturer (“Buyer”) bid on division of U.S. manufacturing company (“Target”)
- Target had world-wide operations
- Buyer had opportunity to purchase Target’s U.S. operations using a Section 338(h)(10) election to obtain a step-up in the basis of Target’s U.S. assets

# Case study #1 — Tax structuring opportunity (cont.)

- Buyer had the following goals when structuring the purchase of Target's non-U.S. operations:
  - Minimize world-wide tax rate
  - Minimize withholding taxes on repatriation of future earnings from operating subsidiaries to parent company
  - Create holding company for Target's intellectual property that will allow subsidiaries in high-tax jurisdictions to pay royalties to subsidiaries in low-tax jurisdictions
  - Maximize tax benefits from interest deductions

## Case study #2 — Value of tax due diligence

- Public company (the “Buyer”) with a significant U.S. presence desires to purchase a non-U.S. based privately held company (the “Target”) to expand its presence internationally.
- Target owns a U.S. operating subsidiary that is not significant, relative to Target’s worldwide operations.
- In an attempt to reduce overall deal costs, Buyer’s management chooses not to perform tax due diligence on Target’s U.S. operating subsidiary.
- Following the acquisition, Buyer learns that Target has not filed U.S. federal or state income tax returns since formation.

## Case study #2 — Value of tax due diligence (cont.)

- Although not a significant component of Target's worldwide business, Target's U.S. operating subsidiary has a significant, unrecorded tax liability.
- Target, now a subsidiary of Buyer, is responsible for such tax liability. The tax liability results in a significant cash cost to Buyer.
- Had Buyer performed tax due diligence, Buyer might have negotiated a purchase price adjustment.

# Poll question #1

Accountants can assist participants in M&A transactions in which of the following ways:

- Draft the stock and asset purchase agreements
- Perform tax and financial due diligence and provide tax structuring advice
- Provide the financing for the transaction
- Act as the principal decision maker on whether or not to purchase a business

## Poll question #2

Buyers generally perform due diligence in order to:

- Assess the quality of the Target's assets
- Gain a better understanding of Target's historical earnings
- Identify unrecorded liabilities
- All of the above

## Poll question #3

\_\_\_\_\_ generally requires more due diligence because Buyer inherits all of Target's liabilities.

- Asset purchases
- Stock purchases
- Mergers
- Both stock purchases and mergers

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