Tax Planning and Strategies for Mergers & Acquisitions

July 26, 2007

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71 S. Wacker Drive, Chicago, IL

Internal Revenue Service Circular 230 Notice

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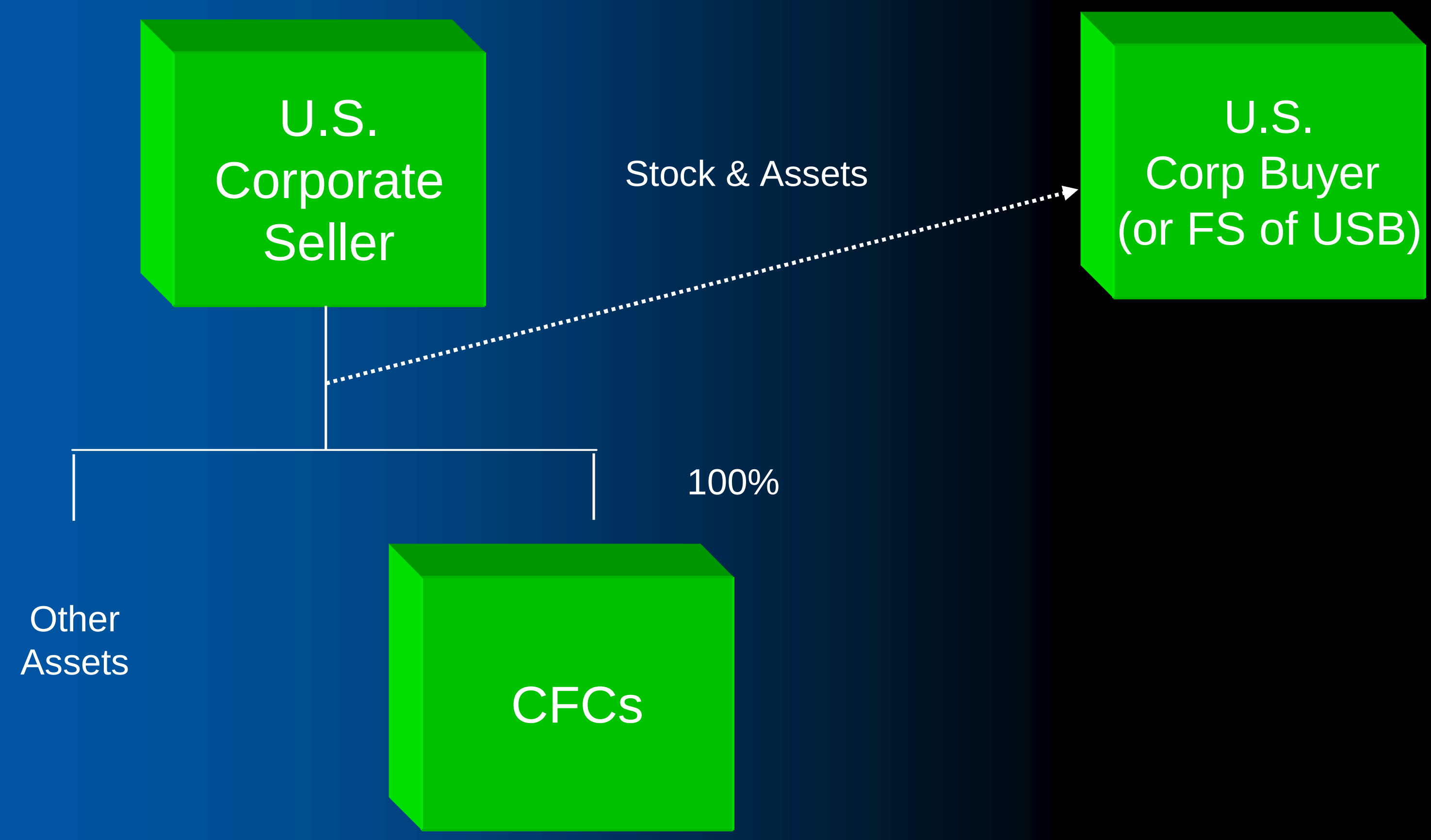
Tax Considerations in Buying and Selling Non-US Subsidiaries

Speaker: Tom Bottomlee

Common Fact Pattern



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Agenda

- Acquisition Structure
  - Seller considerations
  - Buyer considerations
- Mechanics of Section 1248
- Mechanics of Section 338(g)
- Miscellaneous topics

Acquisition Structure

- Seller's objectives/considerations
  - Maximize after tax proceeds
  - Factors impacting tax on sale:
    - Local country tax
    - Character & Source of Gain
    - Availability of tax attributes to reduce tax on sale
      - Basis, FTCs, NOLs etc.
    - Purchase price allocation

Acquisition Structure

- Buyer's considerations/objectives
  - Minimize purchase price
  - Adopt structure that minimizes taxes going forward (taking into account non-tax considerations)
    - Basis step-up (without paying too much for it)
    - Allocation of purchase price
    - Debt push down

MECHANICS OF SECTION 1248

First: What If No §1248:

- Character - Generally, capital gain/loss
- Source of Gain
  - US Source (residence of seller rule)
  - Unless passive foreign source (Section 865(f))

Section 865(f) Source Rule

General Rule: Gain on sale of stock in foreign corporation is FSI if:

1. The stock is sold by a US resident,
2. The foreign corporation is affiliated with the US resident seller (applying section 1504(a) without regard to section 1504(b)),
3. The foreign corporation is engaged in the active conduct of a trade or business in the country in which the sale occurs,
4. More than 50% of the gross income of the foreign corporation over the preceding 3-year period is from sources within the country in which the sale occurs, and
5. Affiliation Election - TP may elect to treat foreign corporation and all other corporations which are wholly owned (directly or indirectly) by the foreign corporation as one corporation for purposes of the above test.

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Section 1248

- Converts gain into deemed dividend to the “extent of E&P attributable to such stock”
- Section 902/904 FTC rules apply
- Typically, dividend is general limitation foreign source
- So taxpayer favorable provision?

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Purpose of §1248

- Adopted in 1962 when capital gains were subject to a 28% rate, and ordinary income was subject to a 48% tax rate.
- Without 1248, taxpayers could effectively convert ordinary income into capital gains by conducting operations through foreign corp subsidiary.

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1962 Illustration

	Capital Gain	Ordinary Income
Sales Price	1000	1000
Basis	(500)	(500)
Gain	500	500
Tax Rate	28%	48%
U.S. Taxes	140	240

Note 1: This assumes all gain is recharacterized as dividend.

Note 2: U.S. tax on the ordinary income amount may be reduced by foreign tax credits.

2007 Illustration

	Capital Gain	Ordinary Income
Sales Price	1000	1000
Basis	(500)	(500)
Gain	500	500
Tax Rate*	35%	35%
U.S. Taxes	175	175

* For corporations.

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Section 1248 Generally Beneficial to Corporate Sellers

- US source capital gains / Passive basket FSI === > GL FSI
- May bring up deemed paid FTCs
- Since ordinary and capital gains rates are the same for corporations, §1248 generally is not detrimental
- May be detrimental, if seller has capital losses.
- Different considerations for individuals (i.e., non-qualified dividends subject to higher rate; individuals are not eligible for section 902 credits).

§1248 Overview

- Applies to the sale or exchange of stock by certain US persons (“US Shareholder”)
- in a foreign corporation that was a “controlled foreign corporation” (“CFC”) at any time during previous 5 years.
- Does not apply to sale of stock in a domestic corporation that owns CFCs (unless deemed sale via section 338(h)(10) election)

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Shareholders Subject to §1248

- Same As “U.S. Shareholder” Under Subpart F
  - U.S. Persons
  - 10% or More Ownership
- Voting Stock Only (not value)
- Constructive Ownership
- U.S. Shareholder Status at Any Time During Prior 5-Years when FC was CFC

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Only applies w/r/t certain FCs

- FCs that were CFCs at Any Time During Prior 5-Years
- Same As "CFC" Under Subpart F
  - A Foreign Corporation
  - Where "U.S. Shareholders"
  - own more than 50% of Stock
    - Votes or Value
    - Constructive Ownership

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Applies to "Sales or Exchanges"

- Sales of CFC Stock
- Taxable Redemption of CFC Stock (§302)
- Taxable Liquidation of CFC (§331)

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Deemed Taxable Transfers Subject to §1248

Distribution by U.S. Shareholder of CFC Stock to Shareholders that Trigger Gain

- These include transfers as:
  - Dividends (§311)
  - Redemptions (§311)
  - Taxable Liquidations (§336)
- Deferral Under Consolidated Returns (Regs. §1.1502-13(c)(7)(ii), Ex. 15)

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Does not apply to:

- Tax-Free Organizations (§351)
- Tax-Free Reorganizations of CFC or Shareholder (§368)
- Tax-Free Liquidations of CFC or Shareholder (§332)
- But, §1248 Applies to Gain Recognized Under §367

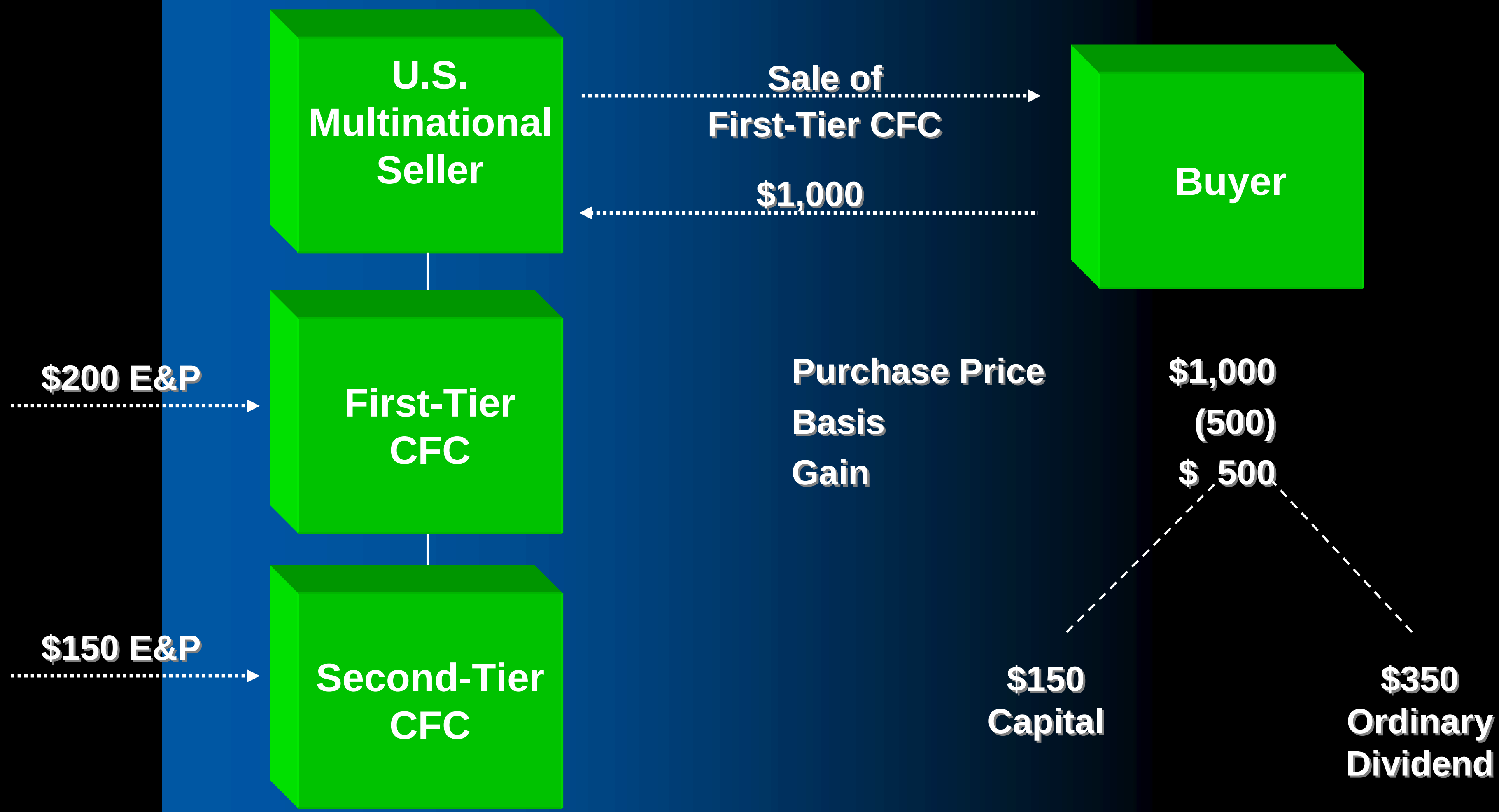
Gain is recharacterized as dividend to “the extent E&P of attributable to such stock”

- Only certain E&P is taken into account:
  - Post-1962
  - While a CFC
  - While such stock was held by such US person
  - Excludes PTI
- Lower-tier E&P (and deficits) §1248(c)
- Calculated at end of year (after all distributions)

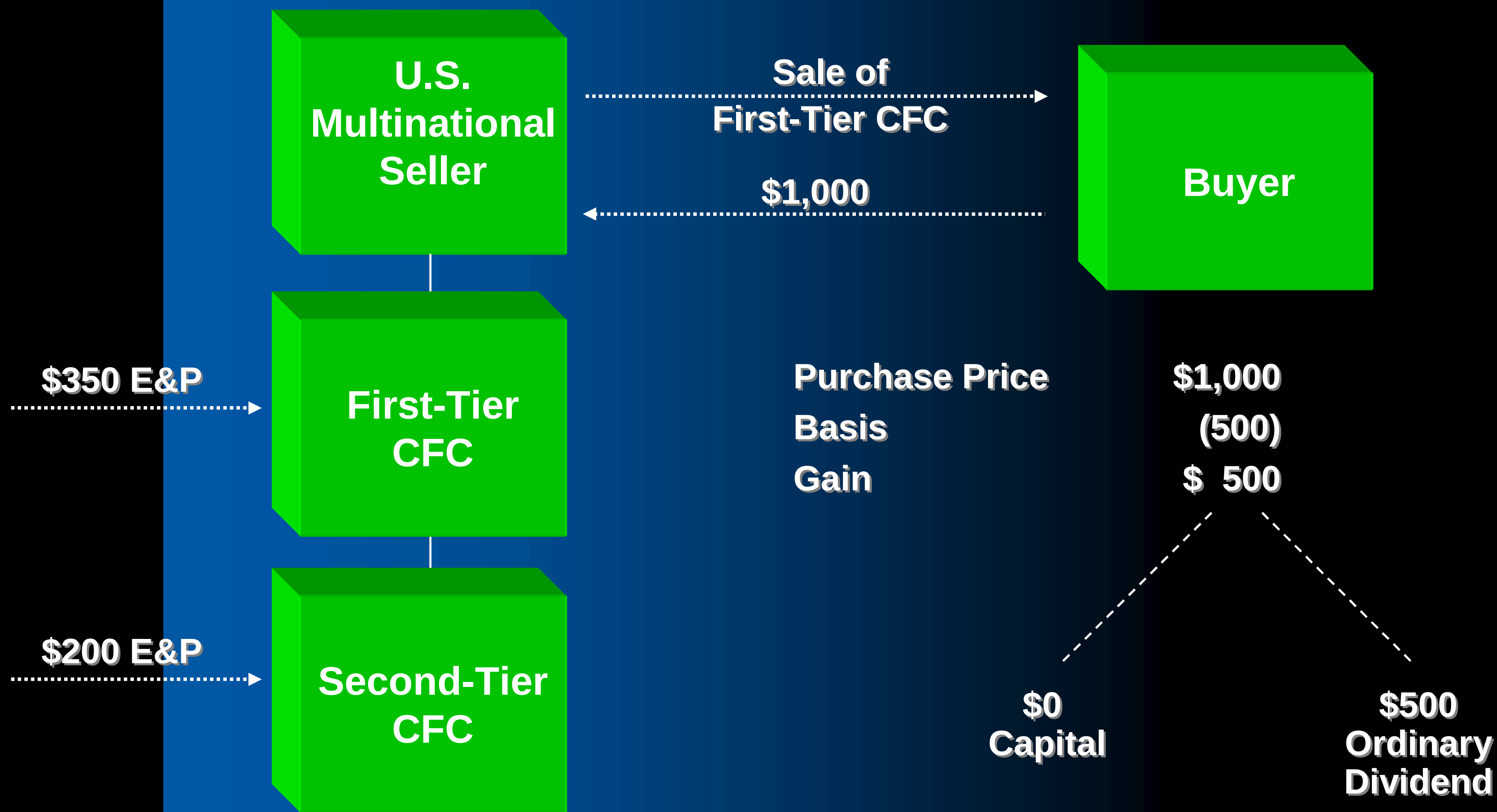
Attributable E&P

- E&P Attributable to particular shares §1248(a)
  - Generally, prorata
  - Simple method
    - During each day of US shareholder's holding period, FC was a CFC
    - Only one class of stock
  - Complex method

Example – Sale of CFC Stock (E&P Less Than Gain)



Example – Sale of CFC Stock (E&P Exceeds Gain)



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Foreign Tax Credit Rules

- Section 902 deemed paid credit rules apply to §1248 dividend
- Qualifying shareholders –
  - Domestic C corporations
  - at least 10% voting (first tier)
- Deemed paid credit = (Dividend/E&P Pool) x Tax pool
- Section 78 gross up for deemed paid credit
- Section 904 Limitation –
  - Basically, 35% x FSI
  - applied by basket (e.g., passive & general limitation)

Foreign Tax Credit Rules

- 904(d)(3) Look Through For Divs from CFC
- 904(d)(4) Look Through for Divs from 10/50 Corps
- Pre-acquisition earnings – In general, qualified shareholder gets look-through for E&P accumulated even while FC was not a look-through corp and regardless of when taxpayer acquired the stock.
  - So, broader concept than 1248 E&P.

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Direct Sale of CFC Stock

GL E&P Pool = $2,000
GL FTC Pool = 600
(23% EFT)

FMV =	$1,000
Stock basis =	0
Gain	1,000
1248 Div	1,000

1. Computation of Deemed Paid Credit:

Div/E&P x FTC Pool = DPC

$1000/$2000 x $600 = $300

2. Computation of US tax

Div	$1,000
78	300
Total	1,300
Tentative US tax	455
FTC	300
Residual US Tax	155

Comparison of No §1248 with §1248

	No §1248	§1248
Gain	$1,000	$1,000
Gross-up	0	300
Taxable Income	$1,000	$1,300
U.S. Taxes	$350	$455
FTC	(0)	(300)
Net U.S. Tax	$350	$155

Seller Issue: Post-Sale Dividends

- Current year E &P is prorated after taking into account all dividends.
- Thus, if
  - CFC is sold during year,
  - And CFC's tax year does not end on date of sale,
  - And buyer causes CFC to make a post-acquisition dividend
- Then, Seller's 1248 amount could be reduced (even though distribution is PTI to Buyer; see Rev. Rul. 71-388 and TAM 199906035)
- Consider adding provision to agreement that prohibits dividends to buyer until year closes

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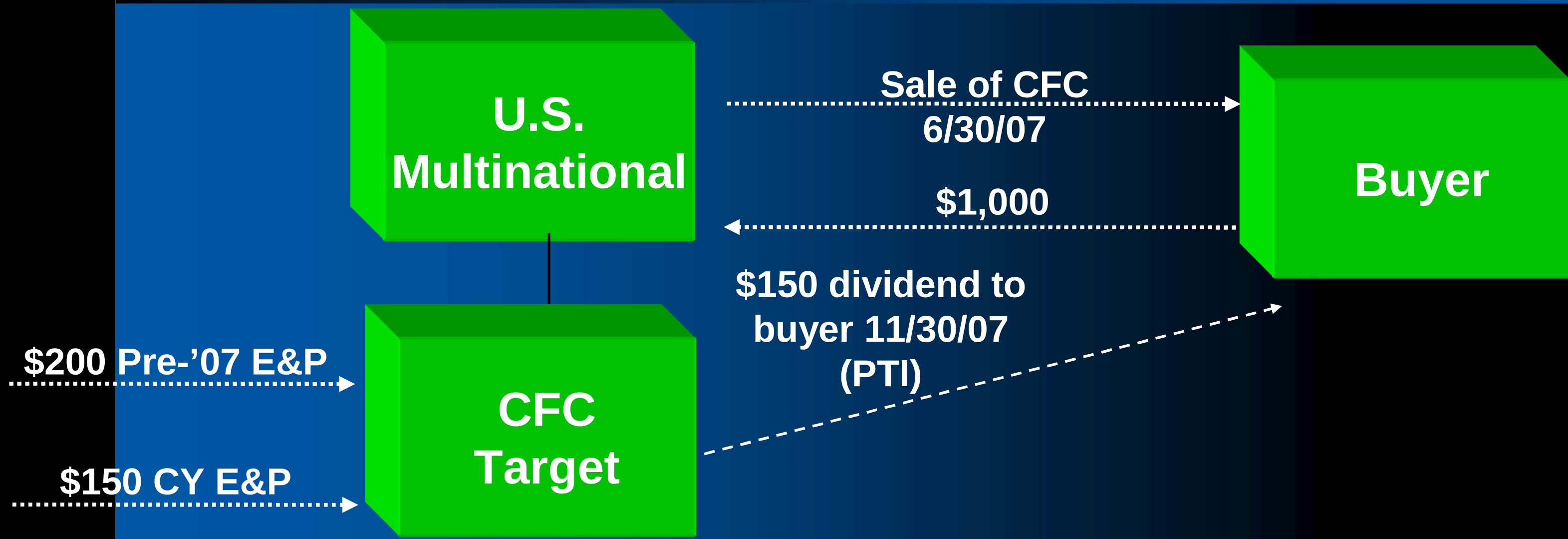
Post-Sale Dividend to Buyer



	Without Dividend	With Dividend
Accum E&P	$200	$200
CY	150	150
Less CY Div	0	(150)
Total CY E&P	150	0
Prorata portion	75	0
Total E&P	275	200
1248 Div	275	200
Cap Gain	225	300

Purchase Price	**$1,000**
Basis	**500**
Gain	**$500**

* assumes no section 338(g) election

MECHANICS OF SECTION 338(g)

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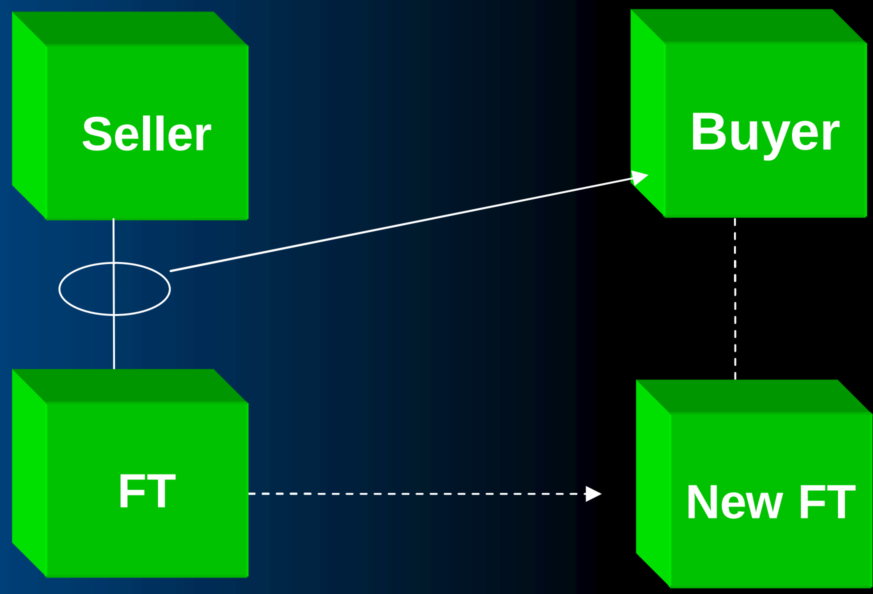
Mechanics of Section 338(g)

- Qualified stock purchase - 80% vote and value, 12 months
- Election is made unilaterally by buyer
- May be made for a foreign corporation (Foreign CFC)
- Old T is treated as selling its assets to New T as of end of acquisition date. New T is treated as buying the next day.
- Seller is treated as selling its Target CFC stock to Buyer
- Three Step Analysis:
  - Deemed sale of Target CFC Assets
  - Application of Subpart F
  - Application of section 1248 (E&P and stock basis)

Section 338(g) Applied to CFC

Given:

PP= $500
Initial stock basis = 200
Initial stock gain = $300
Asset basis = 300
Inside gain = $200
   Sub F = $50
   Non-Sub F = $150
Historical GL E&P = $50
Tax Pool (GL) = $40



No 1248/No 338(g)	1248/No 338(g)	1248/338(g)
Capital gain/ FSP = $300	Gain = $300 - $50 Dividend - $250 Capital gain/FSP	Sub F Income = $50 Stock gain = $250 - 1248 Dividend (*) $200 - Capital gain/FSP $ 50 * $50 Historic + 150 enhanced $50 GL/ $150 Cap gain/FSP

Buyer Benefit – Section 338(g) Hypes Effective Tax Rate

Foreign Target

Asset Basis	$ 0
FMV	$ 500
Step-UP	$ 500 (Avg 10 year life)
Annual Taxable Income	$ 100
Local Tax Rate	30%

No Section 338(g)

Taxable Income	$100
Depreciation	0
Pre tax U.S. E & P	$100
Local Tax	$ 30
Effective Rate	30%

Section 338(g)

Taxable Income	$100
Depreciation	50
E & P	50
Local Tax	$ 30
Effective Rate	60%

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Seller Detriment – Dilutes FTCs Impact of 338(g) per CCA 200103031

- Impact on the AMOUNT of the 1248 Dividend:
  - Deemed asset sale increases CFC's E&P
  - the amount of the increased E&P is referred to as "Enhanced E&P"
  - Pre-existing E&P is referred to as "Historic E&P"
  - Enhanced E&P is taken into account in computing AMOUNT of 1248 Div.
  - Thus, if gain is more than Historic E&P, Section 338 election should increase the 1248 dividend.

Seller Detriment – Dilutes FTCs Impact of 338(g) per CCA 200103031

- Impact on SOURCE and CHARACTER of income - Section 338(h)(16) states there is no impact on source (i.e. US vs. foreign source) or CHARACTER (i.e. 904 limitation basket of income).
- Impacts AMOUNT of tax pool deemed distributed.
  - 1248 DIV/Total E&P (incl. Enhanced E&P) x GL Tax Pool.
  - So, dilutive to the extent Enhanced E&P causes total E&P to exceed stock gain.

Seller Detriment – Dilution of FTCs

DS — Stock Basis = $0; FMV = $80

DB

CFC

	Basis	FMV		
			GL E & P	$40
Active assets	$0	$80	Foreign Taxes	$20

No 338(g) Election

1. **Section 1248 Div**:

Div	$40
78	20
Total	60
US Tax (35%)	21
GL FTC	20
Residual US tax	1

2. **Remaining Gain** (USI/FSI Passive)

Gain	$40
US Tax	$14

3. **Total US Tax** $15

338(g) Election

1. **Section 1248 Dividend = $80**

Total E & P

GL E & P	$ 40
Enhanced E & P	$ 80
Total	$120

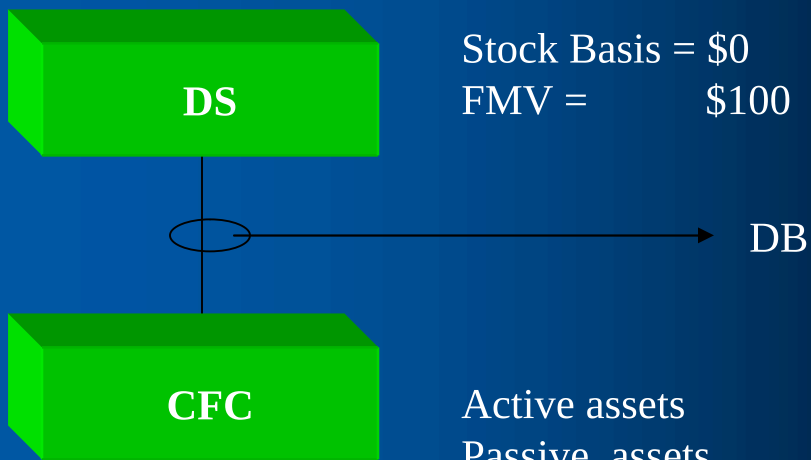
Dividend limited to gain
$40 GL
$40 USI/Passive

2. **Available FTC = $13**
= Div/E & P x Tax Pool
= $13 [80/120 x $20; all GL; $7 lost]

3. **Computation of US Tax:**

	GL	Passive	Total
Div	40	$40	$80
Sec. 78	13	-	13
Total	53	40	93
Tax	18.6	14	32.6
FTC	13	-	13
Residual US Tax	5.6	14	$19.6

Seller Consequences – Sub F Basket Shift Detriment



Stock Basis = $0
FMV = $100

	Basis	FMV
Active assets	$0	$80
Passive assets	$0	$20

GL E & P	$100
Foreign Taxes	$ 0

No 338(g) Election

Sales Price	$100
Basis	0
Gain	$100
GL 1248 Div	$100

Section 338(g) Election

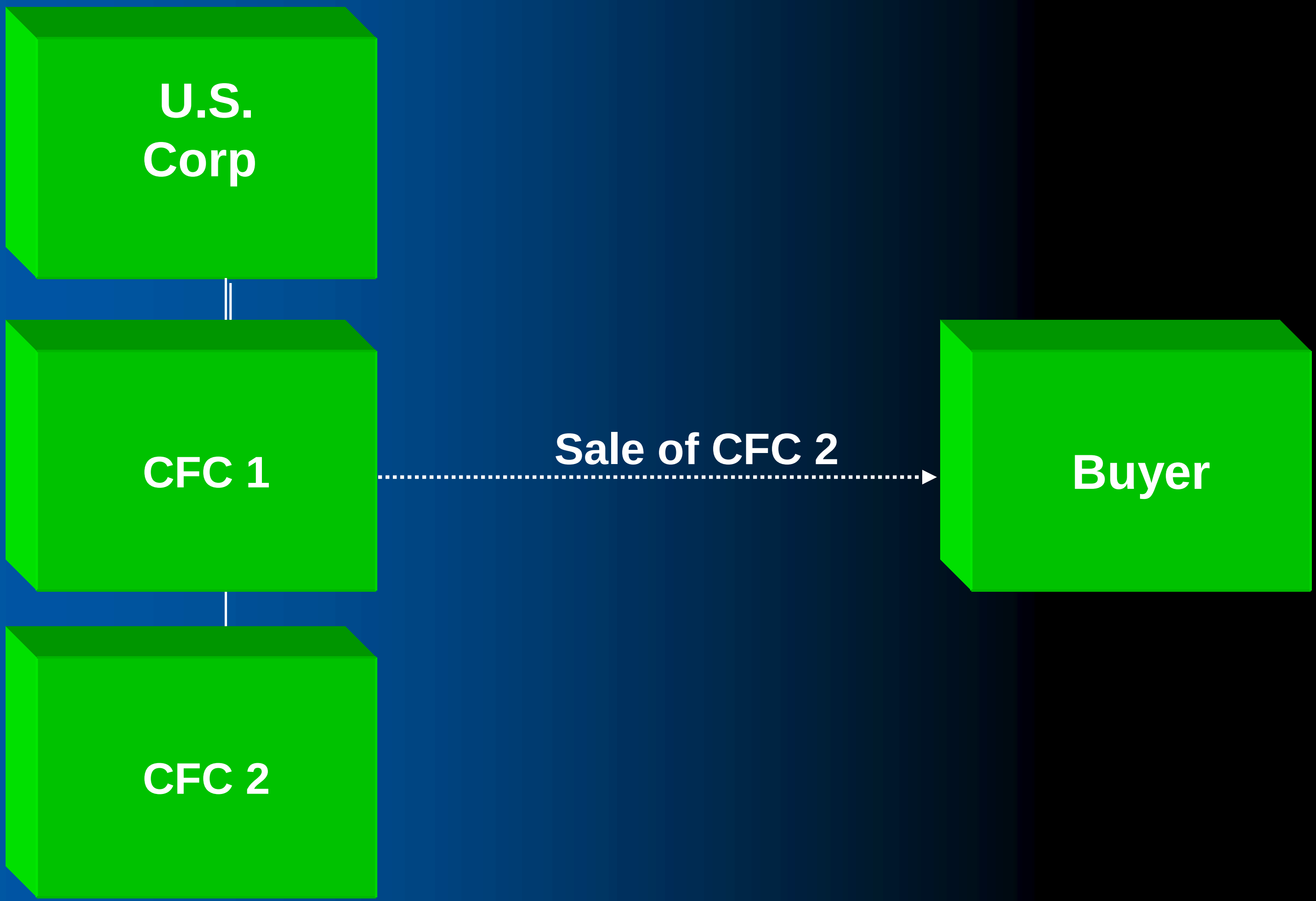
Sub F (passive) inclusion	$20
Sales Price	$100
Basis (after 961)	20
Gain	80
GL 1248 Amount	$80

Section 338 may be harmful to Seller

- May Dilute FTCs
- May cause unfavorable shift in section 904 limitation baskets
- Since buyer can unilaterally make the election, need to address in the agreement

Sale of Foreign Subsidiary Stock

- Treat similar to section 1248



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§964(e) – Special FTC Rule on Sale of Lower-Tier Stock

- Treat gain as dividend to FS to extent of FT's E&P (like §1248)
- Typically, general basket
- Carries deemed-paid taxes
- Subpart F income?
  - No same country exception, but high tax exception
  - Look through rule for dividends till 2009 (Section 954(c)(6))

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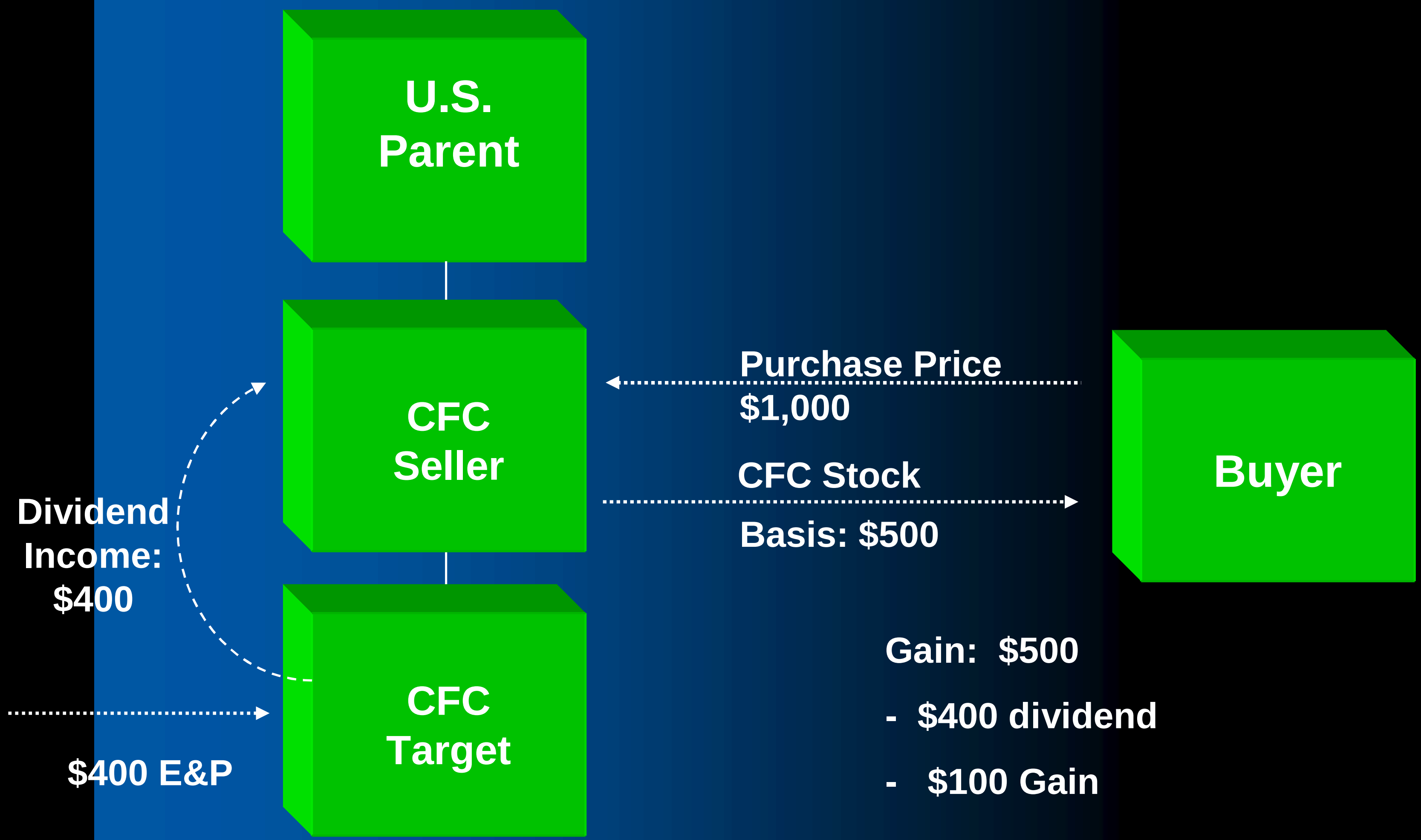
Sale of Lower-Tier CFC Stock



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Sale of Business by CFC (U.S. Tax Consequences)

- To the extent gain on sale of stock is treated as dividend, not Subpart F income till 2009
- To the extent gain on sale of stock is not treated as a dividend, may be subpart F income
- Note that gain on the sale of assets used in a trade or business (including goodwill) is not Subpart F income and no direct U.S. tax

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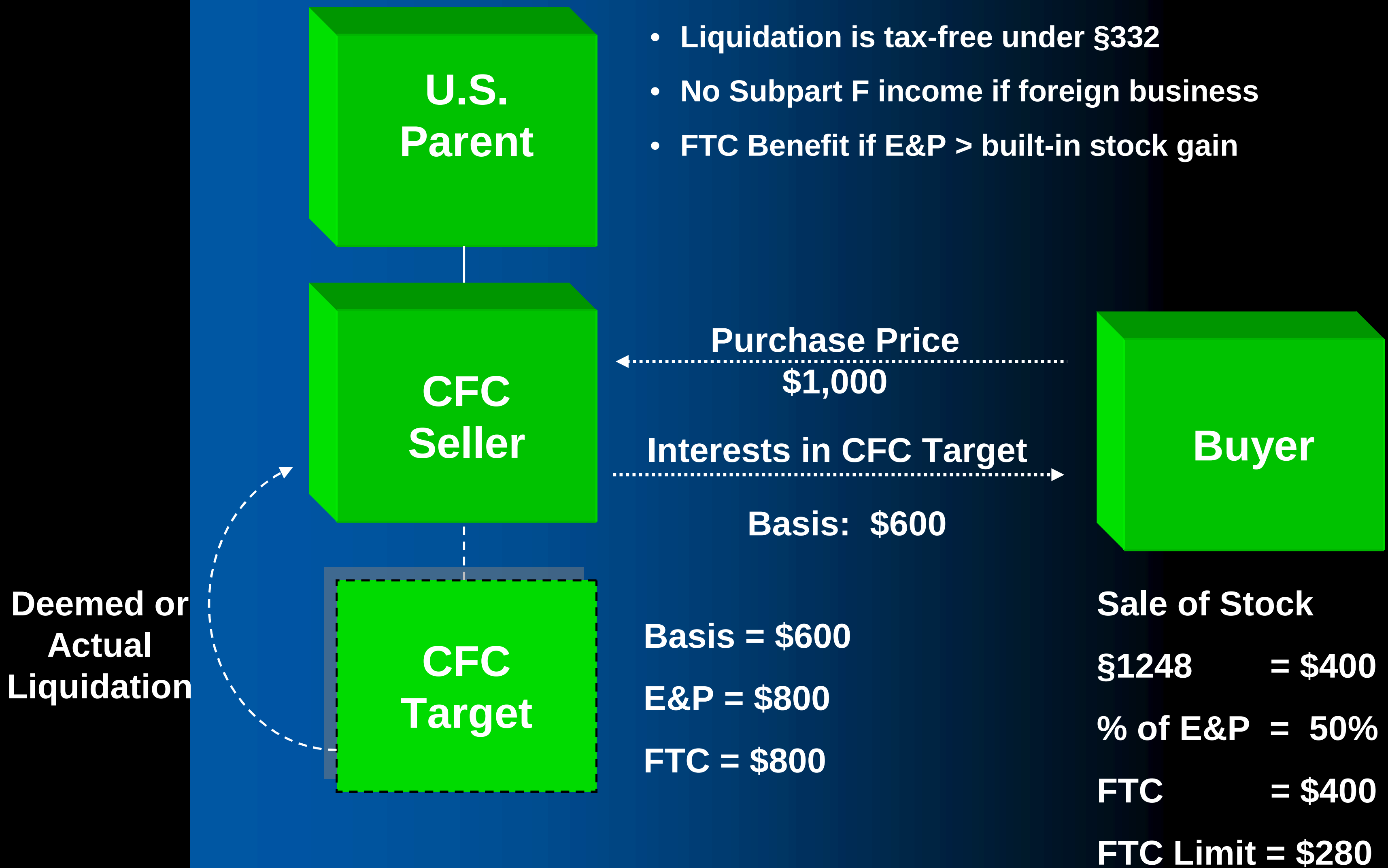
Sell Assets instead of stock (“Check-and-Sell” Technique)

- Liquidation is tax-free under §332
- No Subpart F income if foreign business
- FTC Benefit if E&P > built-in stock gain



Miscellaneous Topics

- Purchase Price Allocation
- Debt Push Down

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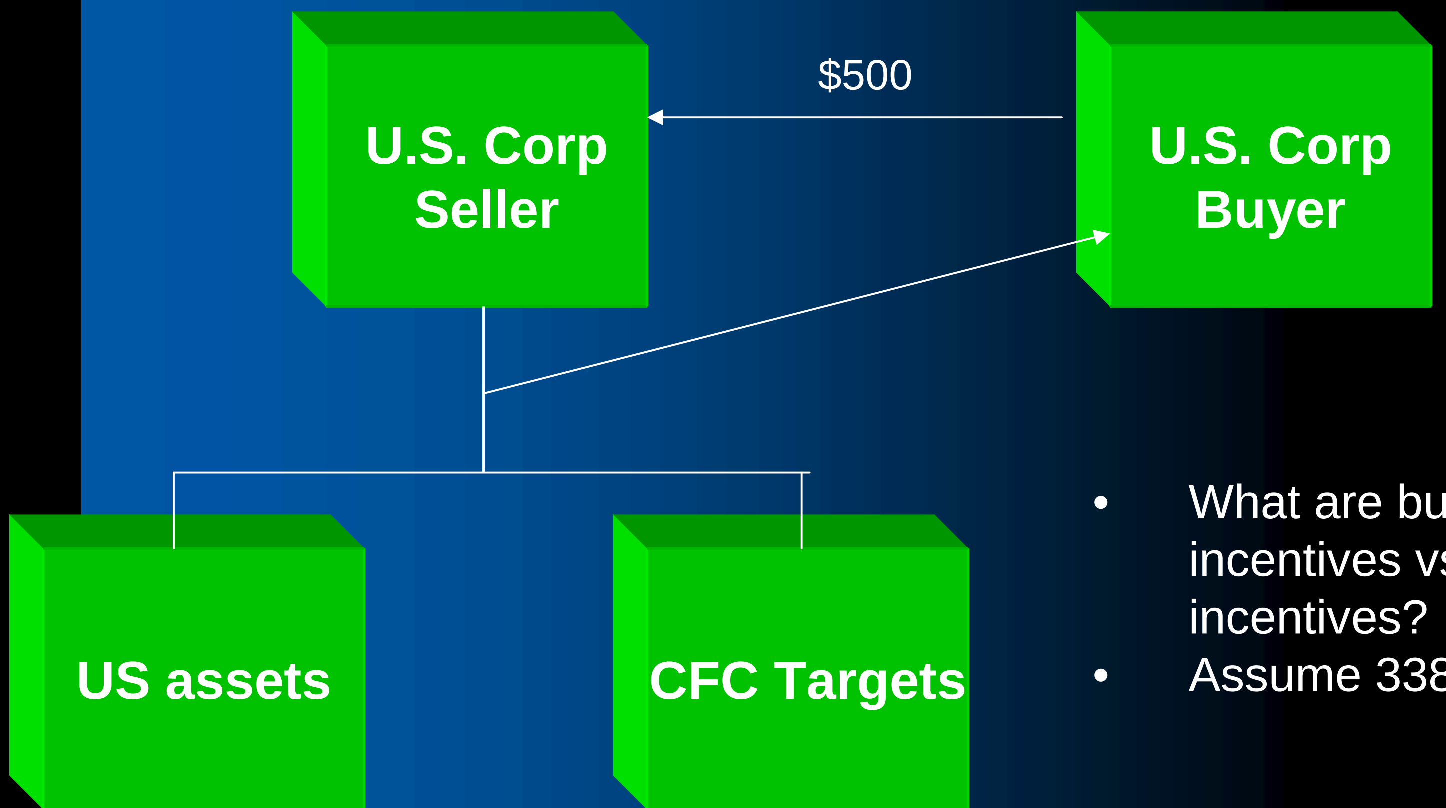
Example – Purchase Price Allocation



- What are buyer's incentives vs. seller's incentives?
- Assume 338(g)

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Example – Purchase Price Allocation

- What if more of PP is allocated to US corp's assets (and less to CFC Assets)
  - Buyer:
    - More US amortization deductions
    - CFC has lower effective tax rate for US purposes
    - With lower CFC valuation, may not be able to push down as much debt.
  - Seller:
    - More US source gain on US assets
    - And less 1248 amount.

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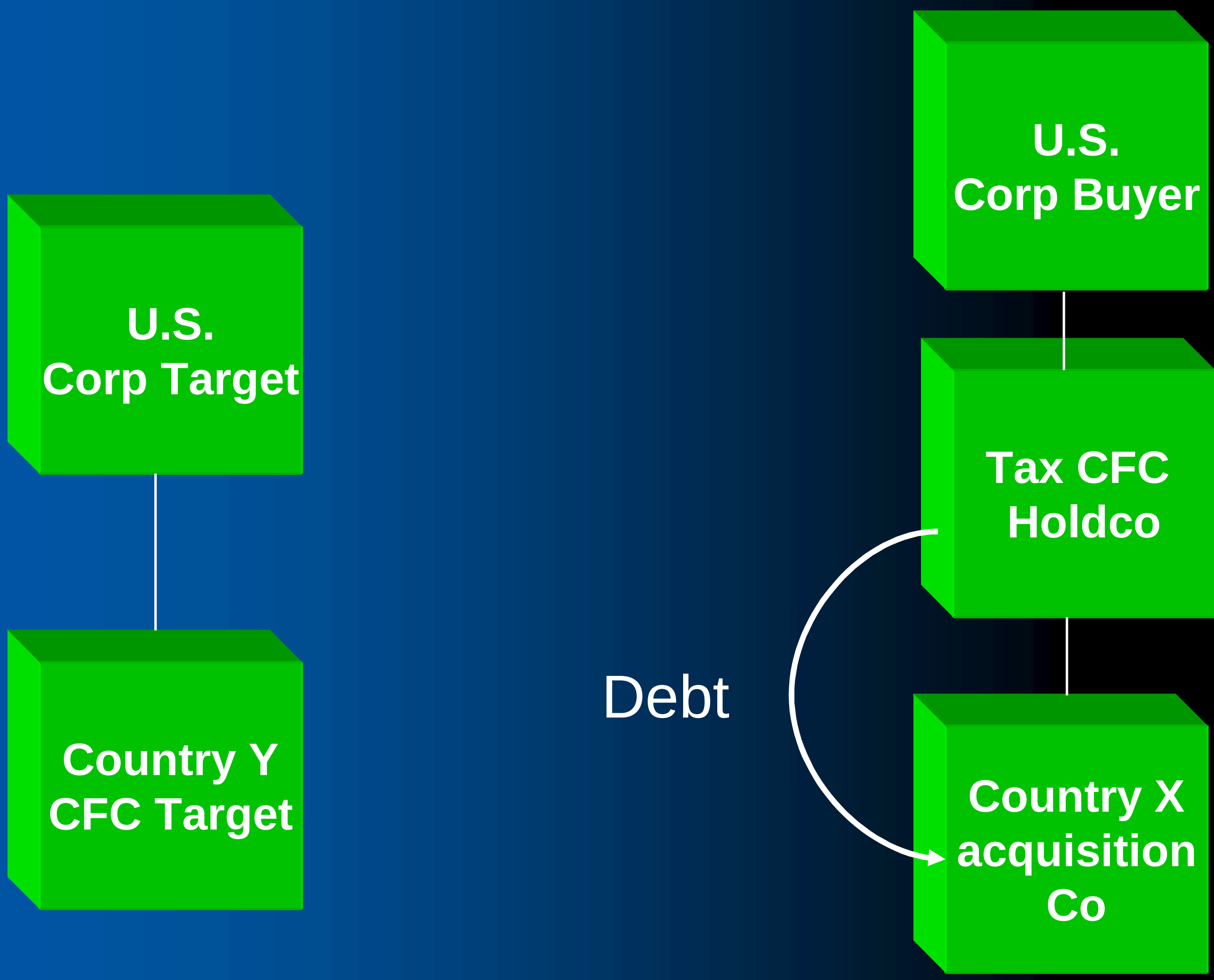
Buyer Structure/Debt Push Down



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Recent High Profile M&A Transactions
Topics: CBOT, Tribune, Killer B's

Speaker: George Craven

M&A TAX ISSUES (HIDDEN) IN TRANSACTIONS IN THE NEWS

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CONTENTS

1. Continuity of Interest in the Battle for the CBOT
2. Tribune Corp.
3. Killer B's

CONTINUITY OF INTEREST

- Required in all tax-free reorganizations.
- "Continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. . . All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved." Treas. Reg. § 1.368-1(e)(1)(i)

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Recent changes to the 368 regulations have allowed more precision.

- “Mere dispositions” of target company stock to unrelated persons before the acquisitions, and of issuing company stock to unrelated persons after the acquisitions are disregarded.

  McDonald’s Restaurants of Ill., Inc. v. Commissioner, 688 F.2d 520 (7thCir. 1982) (which denied continuity treatment under step transaction principles when the target shareholders intended to sell acquiring company stock) is overruled.

How much continuity of interest is required?

- The Service’s traditional ruling standard was 50%. Rev. Proc. 77-37, 1977-2CB. 568.
- Some counsel reportedly gave opinions in the 40% range, probably based on Groman v. Commissioner, 302 U.S. 82 (1937) (41.4 percent treated as sufficient) or John A. Nelson v. Helvering (38%), 296 U.S. 374 (1935).
- In 2005, examples in Treasury's new regulations indicate that 40% is sufficient (Treas. Reg. § 1.368-IT(e)(2)(v) Example 1 and 2(ii)) but 25% is not (Treas. Reg. § 1.368-IT(e)(2)(v) Example 2(ii)).

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When do you measure continuity?

- On the date the deal is struck?

  Even though there may be some contingencies such as a shareholder vote, Hart-Scott approval, and other conditions precedent to the deal?

- Or on the date that regulatory approval is obtained?
- Or shareholder approval?
- Or the date the deal is finally consummated even if there are dissenters' rights?

What happens if the parties agree to exchange 5 shares of acquiring company stock (worth $8 per share, or a total of $40, on the date the deal is struck) and $60 in cash for each share of T stock, and the value of acquiring company stock slides to $6 per share by the time the deal closes?

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- In the merger of CBOT Holdings with CME Holdings, there were many possible dates for measuring continuity.
- On October 17, 2006, CBOT and CME entered into a merger agreement, subject to regulatory and shareholder approval, in which each CBOT shareholder would receive 0.3006 shares of CME common, or cash equal to 0.3006 shares of CMS common, with a cash limitation of $3 billion. 62.47% continuity if October 17, 2006 prices are used.

- On May 11, 2007, CBOT and CME amended the merger agreement so that each CBOT shareholder would receive 0.3500 shares CME common. Also, after the completion merger, CME agreed to make a cash tender offer for 6,250,000 shares at $560/share, for a total of $3.5 billion. The tender offer will be open to all holders of CME stock, including the former CBOT holders who received CME stock in the merger.
  - Even if only CBOT shareholders tender in the tender offer, continuity would be 61.99%, based on May 11 stock prices

On June 14, 2007, CBOT and CME amended the merger agreement to require CBOT to pay a special dividend of $9.14 per share of CBOT stock outstanding, such dividend to be paid to shareholders of record before the merger but conditional on the merger being completed. This dividend forced the parties to allow dissenters' rights for the first time.

- If 49% of the shareholders dissented and received cash equal to the June 14 value of one CBOT share, if the pre-merger CBOT dividend did not count for COI, and if only former CBOT shareholders tendered in the post-merger tender offer, the COI percentage would be 8.92%
- But if the dissenting 49% does not count against COI, the COI percentage would be 60.93%

- On July 6, 2007, CBOT and CME amended their deal, leaving the special dividend, the post-merger tender offer and dissenters' rights in place, but changing the exchange ratio so that each CBOT shareholder received 0.3750 shares of CME common stock.
- On July 9, 2007, when the shareholders of both companies approved the merger agreement.
- On July 12, 2007, when the merger became effective.

The "Signing Date Rule"

- Treas. Reg. § 1.368-IT(e)(2)(i): "In determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for the proprietary interests in the target corporation. . . shall be valued on the last business day before the first date such contract is a binding contract, if such contract provides for fixed consideration. . . . If the contract does not provide for fixed consideration this paragraph (e)(2)(i) is not applicable."
- The presence of a condition outside the control of the parties (such as regulatory agency approval) does not prevent a contract from being binding.
- Consideration is fixed even if the target shareholders have a choice between receiving or acquiring company stock or other property, if the number of shares to be provided is determined using the value of the acquiring company stock on the last business day before the binding contract.
- The possibility that some shareholders may exercise dissenters' rights will not prevent the contract from being treated as providing for fixed consideration.

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Effect of Modifications to Binding Contract

- If the contract as modified is a binding contract, the date of the modification is treated as the first date of the binding contract.
- But a modification that preserves continuity is disregarded if it:
  a. Increases the number of acquiring company shares issued per share of target;
  b. Decreases the amount of cash or other property to be given; or
  c. a. and b.
- A modification of a binding contract that does not preserve continuity will not be treated as a modification if it only reduces the portion of continuity.

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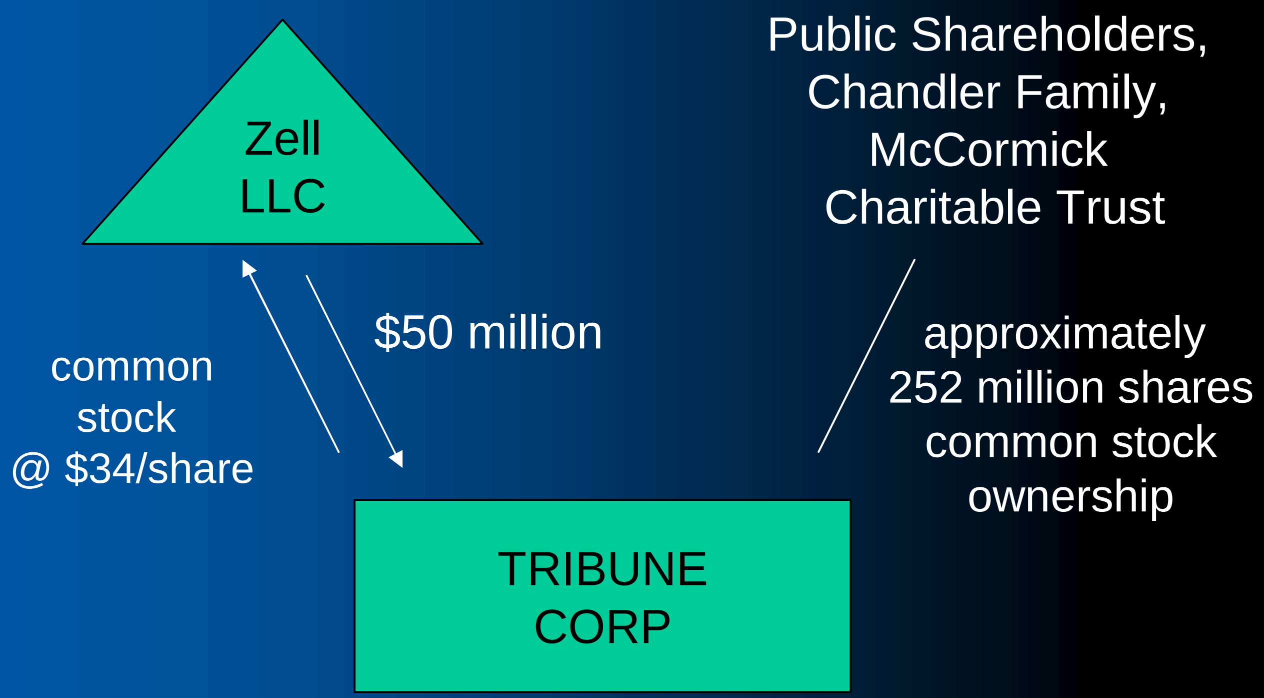
Tribune – the Prologue

- Tribune Co. acquired Times Mirror Corp in June 2000 in a stock-for-stock deal. The Chandler Family, the largest shareholder of Times Mirror, became large shareholders of Tribune, with representation of the Tribune board.
- The Chandlers were notoriously adverse to paying taxes. They had disposed of Times Mirror assets in tax-deferred mixing-bowl transactions and in the highly structured "reorganization" which the Tax Court ruled not a "reorganization" in <u>Tribune Corp v. Commissioner</u>, 125 T.C.110 (2005).
- So many of the assets acquired in the Times Mirror deal came with a low, carryover basis. At least some of the Tribune's other assets, such as the newspaper (in existence for over 100 years) and the Chicago Cubs (purchased in 1980 for $28 million), probably also have a substantial amount of unrealized gain.

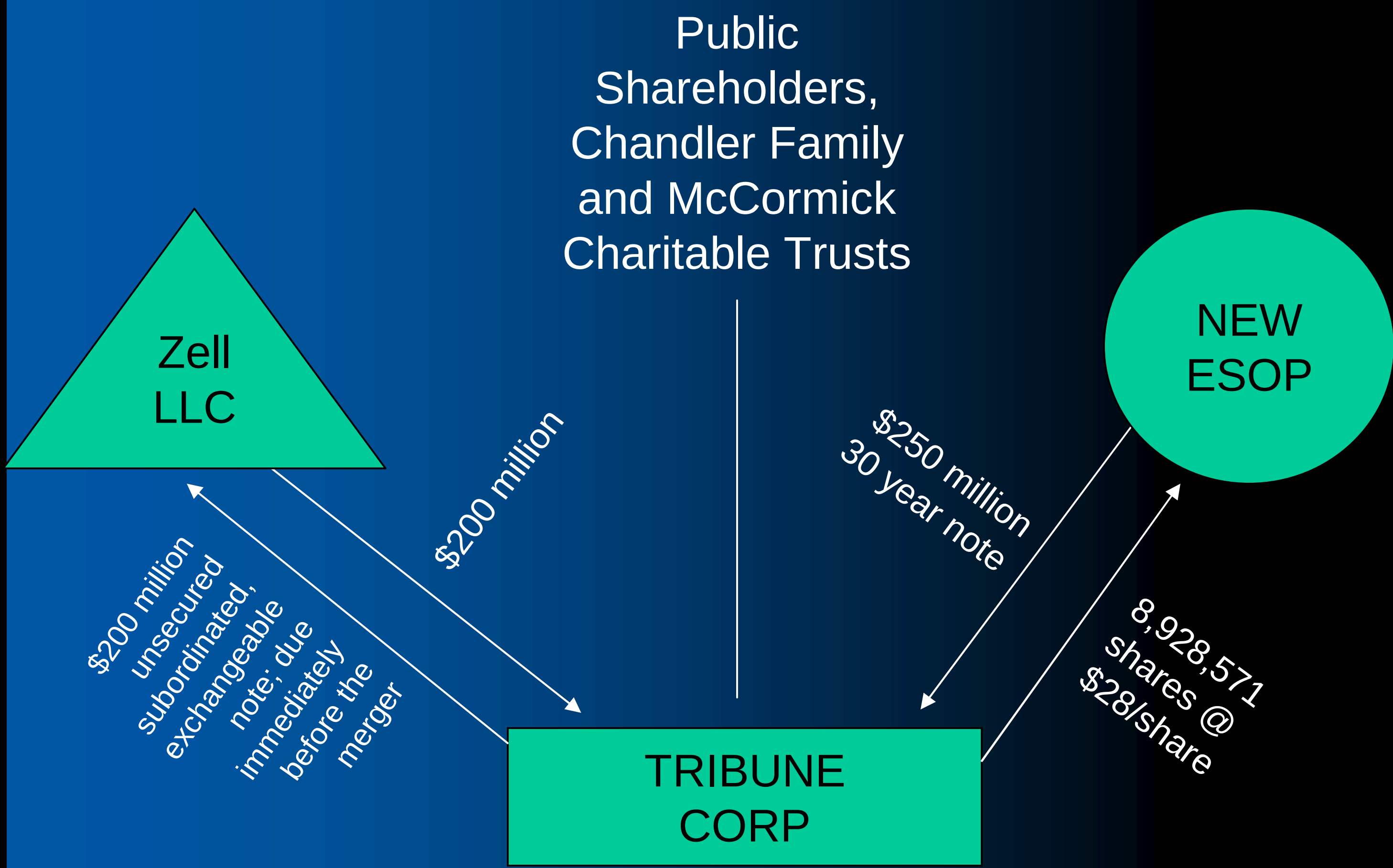
The Deal

All pursuant to binding contracts

On April 1

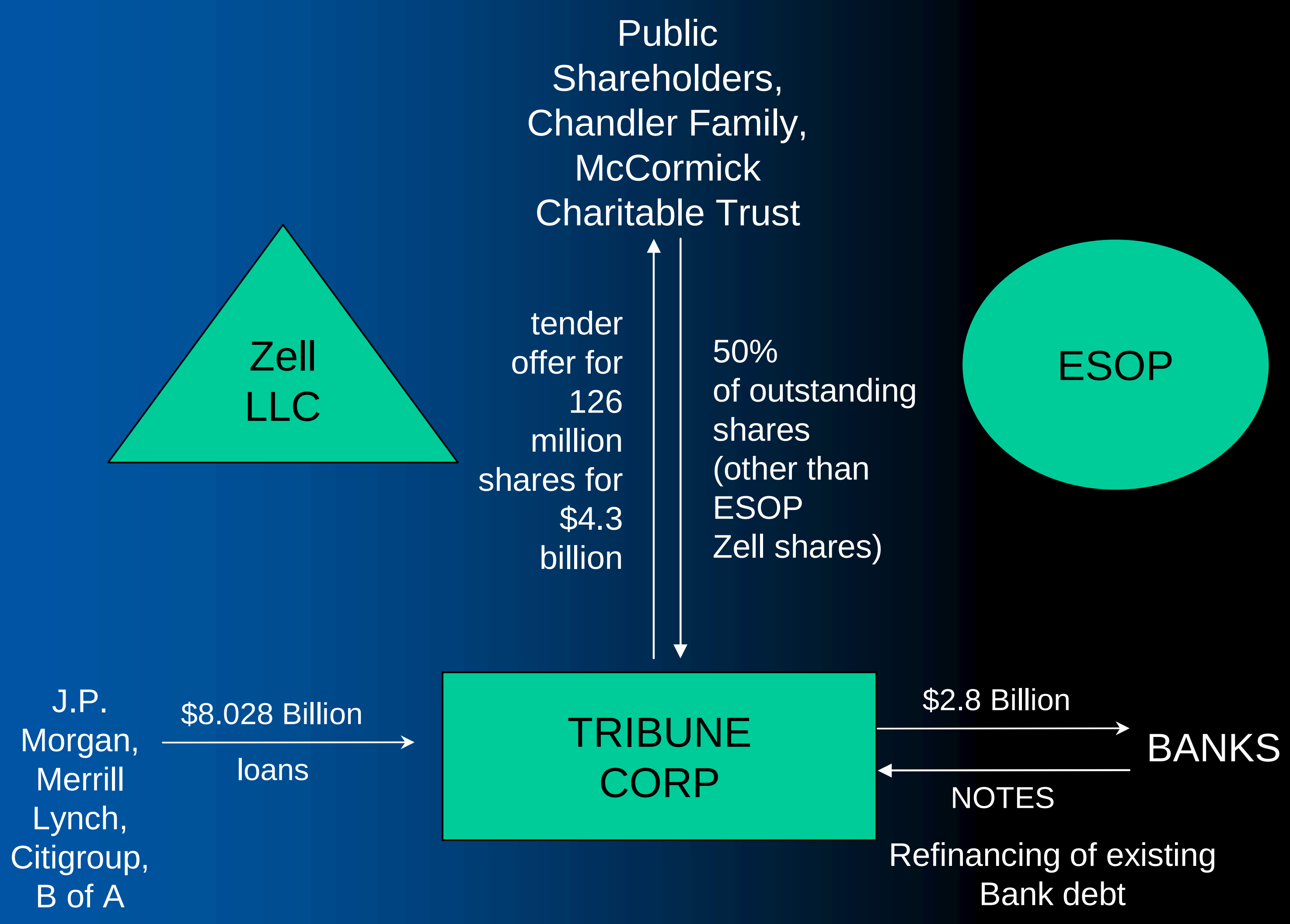


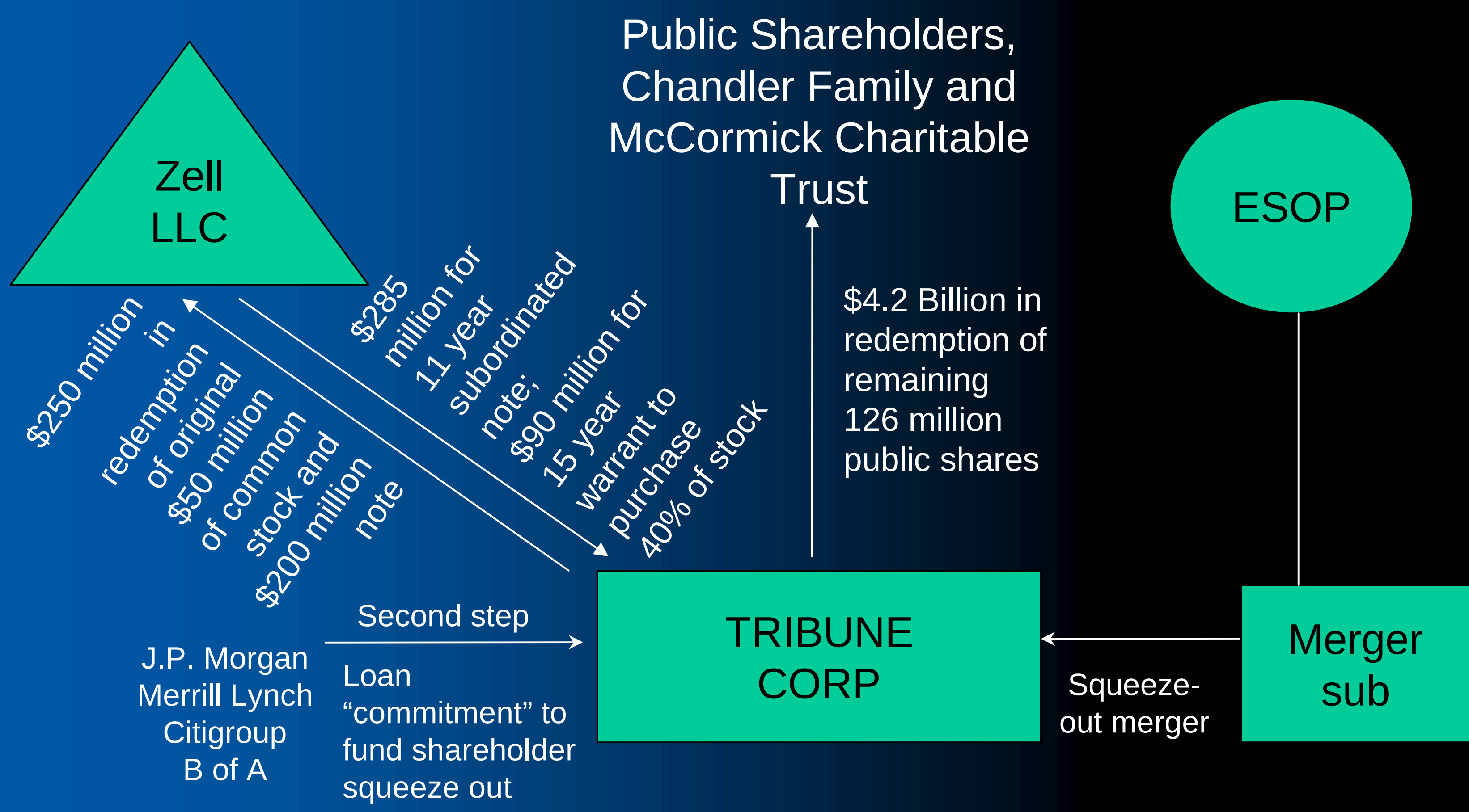
On April 1



THE ESOP NOTE is to be paid through its use of annual contributions from Tribune Corp. to the ESOP and/or distributions paid on the Tribune stock held by the ESOP.

Agreed to on April 1; carried out on April 25





To be carried out after shareholder, FCC, MLB and other approvals, probably in the 4th quarter
Zell LCC's original investment is redeemed; Zell LLC will invest $225 million in a subordinated, 11-year note and $90 million for a 15 year warrant to purchase 40% of the stock for a price starting at $500 million, ratcheting up to $600 million over time.

Can Tribune Corp. Elect Subchapter S After the Merger?

- Is the interest of Zell LLC a “second class of stock” in violation of section 1361(b)(1)(D)?
- Can an ESOP be an owner of a subchapter S corp?

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- Section 512(e) generally treats the income that flows through a Sub S corporation to an IRA or an §401(a) trust shareholder as "unrelated business taxable income." Will the income that flows through to the ESOP be UBTI?

- Section 1374 imposes a corporate level tax on S Corps which were formerly C Corps which dispose of assets within 10 years after converting to S Corp status.
  - Will Tribune’s substantial gain on the sale of the Cubs be subject to tax?

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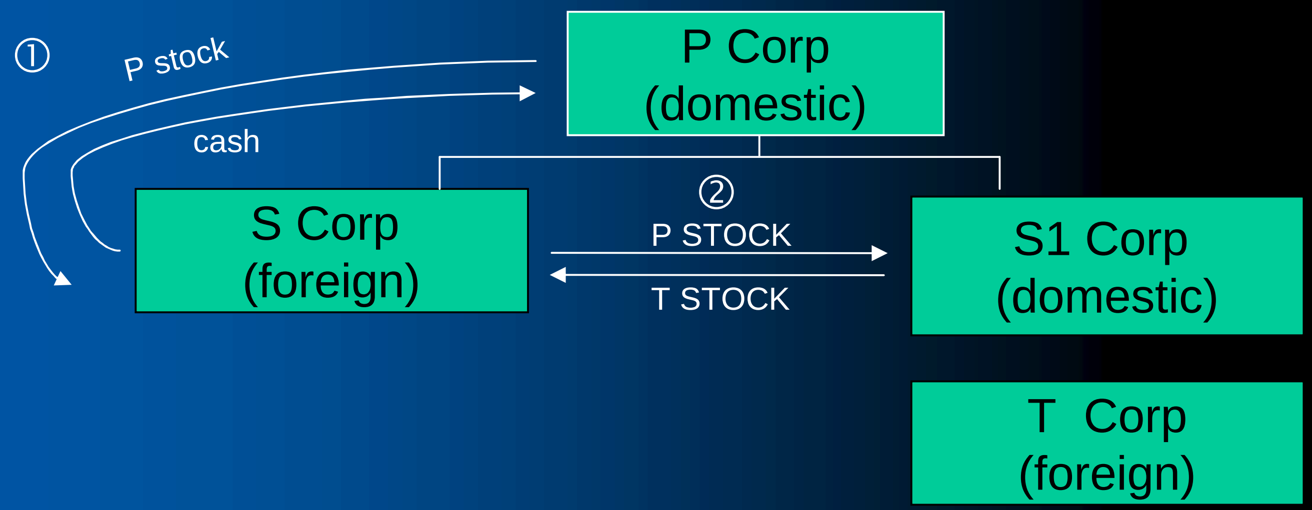
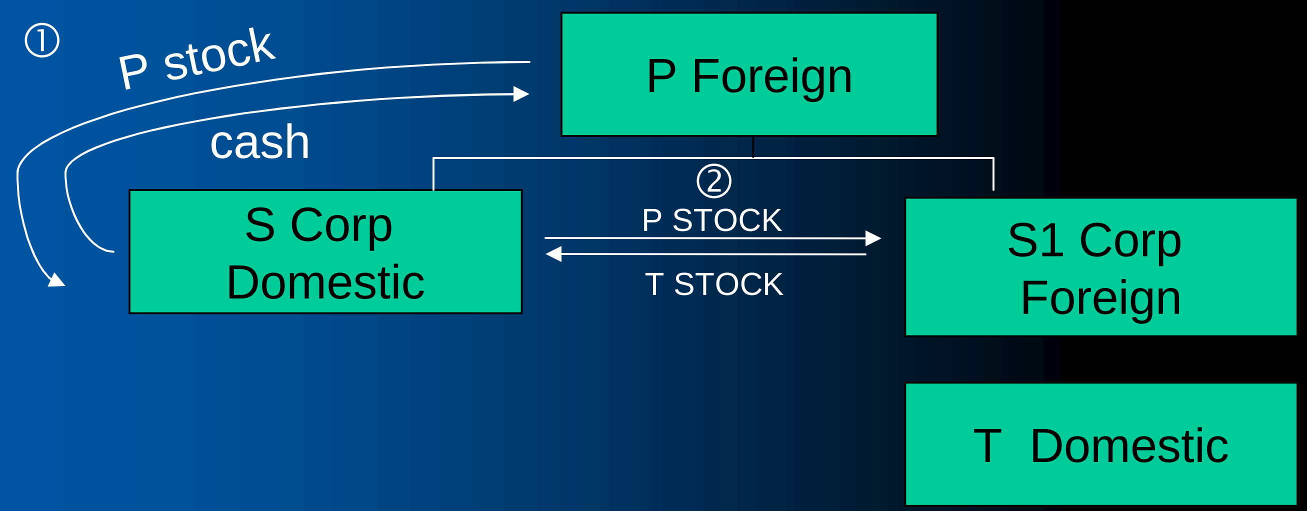
Killer B's

In Notice 2006-85, the Service expressed concern about this transaction.



- P takes the position that it recognizes no gain or loss on issuing its stock for cash, per section 1032.
- S1 takes the position that it recognizes no gain or loss on the disposition of T stock for P stock, per section 368(a)(1)(B).
- P and S take the position that S has not made a divided distribution or an increase in its investment in U.S. property, since S disposed of the P stock in the same quarter in which it acquired the stock.

The service also expressed concern about the following transaction:



- In this transaction, the Service is concerned that S has repatriated U.S. earnings to P without paying a withholding tax on dividends.
- If both P and S were foreign, the Service expressed concern that the transaction could facilitate avoiding Subpart F inclusions to P's United States shareholders.

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In Notice 2006-85, the Service announced it will propose regulations, effective from September 22, 2006:

1. Where P or S, or both, are foreign;
2. pursuant to a reorganization, S acquires P stock from P in exchange for property; and
3. S uses the P stock to acquire stock or assets of P

Regulations will provide that:

the prepayment from S to P is a section 301 distribution, despite section 1032, a recognition of gain by P from the sale or exchange of property, and a reduction in P's basis in S stock.

- In Notice 2007-48, the Service announced it will propose, effective from May 31, 2007, similar regulations to apply when S acquires P stock from one or more P shareholders, all or a portion of the P stock that is used to acquire stock or assets of T, even if T is unrelated to P or S before the transaction.

Mergers and Acquisitions
State and Local Tax Issues

Speakers: Christine Cagnina
Richard Leavy

State Tax Issues on Mergers and Acquisitions

- Due Diligence
- Tax Issues on the Transaction
- Prospective Planning Issues

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Due Diligence – Revenue Issues

- Identification of the goods and services provided by the company
- Bundling of goods and services
- Categorization of customers:
  Retail:
  - Wholesale/resale;
  - Exempt user;
  - Exempt organization;
  - Government.

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Due Diligence - Nexus Issues

- States in which the company has a permanent physical presence (e.g., employees, agents, real property, tangible personal, or tangible personal property)
- States in which the company has sent employees, agents, or other representatives to solicit sales on its behalf more than five times
- States in which the company has sent employees, agents, or other representatives to meet with existing clients more than five times
- States in which the company has clients located (either billing address or user address)

Due Diligence - Income/Franchise Tax Issues

- Filing Issues
  - States in which the company files a state income, franchise, or other "business activity" tax return
  - States in which the company joins in a combined (unitary) state income, franchise, or other "business activity" tax return with affiliates
  - States in which the company joins in a consolidated (based on the federal affiliated group) state income, franchise, or other "business activity" tax return with affiliates

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Due Diligence – Income/Franchise Tax Issues

- Apportionment Issues
  - Basis on which revenues are assigned a source for sales factor apportionment purposes for each state in which the company files a state income, franchise, or other "business activity" tax return or joins in the return of an affiliate (i.e., the greatest cost of performance, apportioned cost of performance, customer address)
  - States in which the company has clients with a physical billing address for the services provided by the company and the percentage of revenue attributed to the customers in such states
  - States in which the company has clients with users of the services provided by the company and the percentage of revenue attributed to the users in such states
  - States in which the company has payroll expense localized (employee, agent, independent contractor)
  - States in which the company has real or personal property located

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Due Diligence - Sales, Use, and Gross Receipts Tax Issues

- States in which the company is registered for sales, use, gross receipts, or other transaction-tax purposes
- States for which the company collects sales, use, gross receipts, or other transaction-taxes from customers

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Due Diligence – Incentives Issues

- State or local tax or economic incentives applied for or received
- State or local tax or economic incentives claimed as-of-right

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Due Diligence - Audit Issues

- Unclaimed property or state tax audits the company is currently undergoing
- Unclaimed property or state tax audits the company has undergone during the past five years

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Due Diligence – Reserve Issues

- Identify and describe any reserves made for state unclaimed property liability
- Identify and describe any reserves made for sales, use, gross receipts, or other transaction-based tax liability
- Identify and describe any reserves made for state income, franchise, or other "business activity" tax liability

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Tax Issues on the Transaction

- Income and Business Activity Tax Issues
- Transaction Taxes
- Bulk Filing Issues
- Straddle Periods
- Filing Responsibility

Transaction - Income and Business Activity Tax Issues

- Federal Conformity
- Business/Nonbusiness Characterization of Gain

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Transaction - Transaction Taxes

- Sales and Use Taxes
- Real Estate Transfer Tax
- Stock Transfer Tax
- Documentary Transfer/Issuance Tax

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Transaction - Bulk Transfer Filing Issues

- Successor Liability
- Tax Clearance
- Tax on the Transaction

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Transaction - Straddle Periods

- Apportionment of Taxes
  - Income and Business Activity Taxes
  - Ad Valorem Taxes
  - Other Taxes
  - Unclaimed Property

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Transaction - Responsibility for Filing and Right of Review

- Seller Rights and Obligations for Pre-Closing Periods
  - Indemnification
  - Right to Claim Refunds
- Buyer Rights for Post-Closing Periods
  - Consistency and Indemnification
  - Addition of Jurisdictions

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Prospective Planning

- Structural Planning Issues
- Operational Planning Issues

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Structural Planning Issues

- Location/Deductibility of Acquisition Indebtedness
- Selection/Management of the Unitary Group
- Nexus Management

Operational Planning Issues

- Public Law 86-272 Planning
- Factor Planning
- Nexus Management

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FIN 48 Considerations in M&A Transactions

Speakers: Jason Bazar
John Hildy

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Agenda

- FIN 48 Overview
- Acquisition Due Diligence
- Negotiation of the Acquisition Agreement
- Post-Closing Compliance
- Privilege and IRS Audit Implications

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FIN 48 Overview:
Two-Step Process

- Recognition: A tax benefit from a UTP may only be recognized if it is "more likely than not" that the position is sustainable based solely on its technical merits (i.e., excluding detection risk) and any relevant administrative practices
- Measurement: The tax benefit of a qualifying position is the greatest amount of benefit that is cumulatively >50% likely of being realized
- Subsequent Recognition and Measurement
  - Should be based on new information, not mere changes in judgment
  - Previously unrecognized tax benefits should be recognized (derecognized) in the period the position reaches (falls below) the recognition threshold, which may occur prior to final resolution of the matter
  - Subsequently unrecognized positions should be recognized in the period in which SOL expires, or the issue is "effectively settled"

FIN 48 Overview:
Examples of Potential Units of Account

- New Transaction-Related Uncertainties
  - Character of Income
  - Income Recognition
  - Accounting Methods
  - Merger & Acquisition Transactions
  - Purchase Price Allocations (Valuation)
  - Transaction Cost Analyses
  - Executive compensation/Stock options
  - IRC Sec. 382
  - IP Migration
  - Withholding Tax

- Old Inherited Uncertainties
  - Net Operating Losses
  - Credits
  - Transfer Pricing
  - Treaty Positions
  - PE / Nexus
  - R&E Credit
  - IRC Sec. 199
  - FTC
  - Subpart F
  - Tax Holidays
  - Intangible Holding Companies
  - Cross Border Financing
  - Cash Repatriation

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Acquisition Due Diligence:
Target's FIN 48 Disclosures

- Tabular reconciliation of aggregate unrecognized tax benefits at beginning and end of period;
- Total amount of unrecognized benefit that, if recognized, would affect the effective rate (i.e., "permanent" items);
- Amounts of interests and penalties;
- Description of open tax years by major taxing jurisdiction;
- For positions for which it is <u>reasonably possible</u> that the total amount of unrecognized benefit will <u>significantly increase or decrease</u> in the next 12 months:
  - nature of the uncertainty
  - nature of the event that could occur in the next 12 months
  - estimate of range of change (or statement that no estimate is possible)

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Acquisition Due Diligence: Other Communication

- Understand units of account and methodology
- Work papers and supporting documentation
- Non-privileged documentation

Negotiation of Agreement:
Post-Closing Rights

- Cooperation Covenant
- Access to Work Papers and Supporting Documentation
- Consider Target Employee Retention or Consultancy Arrangements

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Negotiation of Agreement:
Tax Indemnification / Purchase Price Adjustments

- Carve-Outs for Reserved Tax Liabilities (Buyer Issue)
- Treas. Reg. § 1.1502-6 Liability (Buyer issue)
- Post-Close Activities of Buyer (Seller Issue)
- Public Deals – Impact of No Tax Indemnity Provision

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Post-Close:
Impact on Acquirer's Financials

- Subsequent changes must be based on new information, not mere changes in judgment
- Integration of inherited uncertainties raises interesting questions
  - Reconciliation of inconsistent positions
  - Possibility of revisions to target's reserves

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Post-Close:
FIN 48 Implementation and SOX 404 Controls

- Establish controls and processes at both entity-level and transaction processing level:
  - Proper unit of account
  - Identification and communication of UTPs
  - Probability assessment
  - Measurement assessments
  - Financial statement presentation and disclosures
  - Develop a structure for periodic review involving personnel in financial reporting, tax planning and tax audit roles including, if necessary, review by senior management and the audit committee
  - Integrate newly acquired businesses into existing FIN 48 administrative compliance structure

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Implications of FIN 48:
Privilege

- Prior to FIN 48, under AU 9326 auditors were increasingly requesting disclosure of opinions and other tax advice
- Now, due to FIN 48 companies may create additional documentation and analyses specifically to support the FIN 48 position
- Disclosure of attorney/tax advisor advice
  - Likely results in waiver of attorney-client privilege and section 7525 tax advisor privilege
  - Cases are mixed on whether disclosure also results in waiver of work product protections

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Implications of FIN 48:
IRS Developments

- IRS is conducting mandatory 6-hour CPE on FIN 48
- LMSB has issued a Field Examiner's Guide
- IRS Policy of Restraint historically limits requests for tax accrual workpapers
    - IRS is reviewing the Policy in light of FIN 48
    - In the meantime, FIN 48 workpapers are tax accrual workpapers, but:
        - FAS 109 ETR reconciliations are <u>not</u> tax accrual workpapers (CC-2007-015)
        - "Revenue Agents should not be reluctant to pursue matters mentioned in FIN 48 disclosures" (Field Guide)

Appendix

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FASB's Sample Disclosures
"Tabular Reconciliation"

The Company adopted the provisions of FASB Interpretation No. 48, *Uncertainty in Income Taxes* on January 1, 2007. As a result of the implementation of Interpretation 48, the Company recognized approximately a $200 million increase in the liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 2007, balance of retained earnings. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	(in millions)
Balance at January 1, 2007	$370,000
Additions based on tax positions related to the current year	10,000
Additions for tax positions of prior years	30,000
Reductions for tax positions of prior years	(60,000)
Settlements	(40,000)
Balance at December 31, 2007	$310,000

FASB's Sample Disclosures

"Interest & Penalty"

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended December 31, 2007, 2006, and 2005, the Company recognized approximately $10, $11, and $12 million in interest and penalties. The Company had approximately $60 and $50 million for the payment of interest and penalties accrued at December 31, 2007, and 2006, respectively.

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FASB's Sample Disclosures
"Open Years" and "12-Month"

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions the Company is no longer subject to U.S. federal, state and local, or non-US income tax examinations by tax authorities for years before 2001. The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 2002 through 2004 in the first quarter of 2007 that is anticipated to be completed by the end of 2008. As of December 31, 2007, the IRS has proposed certain significant adjustments to the Company's transfer pricing and research credits tax positions. Management is currently evaluating those proposed adjustments to determine if it agrees, but if accepted, the Company does not anticipate the adjustments would result in a material change to its financial position. However, the Company anticipates that it is reasonably possible that an additional payment in the range of $80 to $100 million will be made by the end of 2008.

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Executive Compensation in M&A Transactions

Speaker: Ed Pionke

Section 409A Issues in M&A Transactions

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Brief Overview

- Section 409A applies to nonqualified deferred compensation
  - For ease of thinking, that is any arrangement where a person has a legally binding right in year 1 (whether or not vested) to compensation that is payable in a later year
  - Some exceptions but very rule intensive

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- Initial deferral elections
- Subsequent deferral elections and changes to elections
- Timing
  - Specified date
  - Event: Death, disability, CIC, separation from service

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Why is 409A Definition of CIC Important?

- Payment of deferred compensation can only be made on account of CIC events if definition is consistent with 409A
- Plan not required to permit payments on CIC but, if it does, definition must satisfy 409A definition
- Final regulations also contain special rules that apply only if a transaction constitutes a CIC within the meaning of the regulations

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What is a CIC for 409A Purposes?

- Change in Ownership or Control
  - Acquisition of more than 50% of total FMV or total voting power; may use higher threshold but generally may not change retroactively

- Change in Effective Control
  - Acquisition of 30 percent or more of total voting power; may use higher threshold but generally may not change retroactively
  - Change in majority of board members within 12 months period without endorsement of current board members; may use higher threshold than a majority but generally may not change retroactively

- Change in ownership of substantial portion of assets
  - Acquisition within 12 months of assets having gross FMV (determined without liabilities) equal to 40 percent or more of the all assets; may use higher threshold but generally may not change retroactively

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- Even if definition is 409A compliant, special payment rules apply
  - Payments only to employees of relevant corporation

Other Issues Relevant to 409A CIC Definition

- Transaction-Based Compensation
- Special plan termination rules

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Other 409A Issues in Corporate Transactions

- Separation from service
- Identification of Key Employees
- Stock Rights and Other Equity-Based Compensation

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Common Issues

- Agreements with Severance
  - Employment
  - Severance
  - CIC
- Performance-Based Compensation
- Initial Eligibility

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Purchase and Sale of Partnership Interests

Speaker: Alan Van Dyke

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Purchases and Sales of Partnership Interests

- Discussion will focus on:
  - Purchases and Sales of interests in strategic joint ventures conducted in partnership form
- Discussion will <u>not</u> focus on:
  - Special consideration that may attend passive investment partnerships; or
  - Tax-motivated transactions conducted in partnership form

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Entity-Level Tax Liabilities

- Because partnerships are not subject to US federal income tax, entity-level federal income tax liabilities are not a concern.
  - It is important to understand what your rights are regarding tax reporting and tax contests, including for returns filed and audits defended after you are no longer a partner, for years in which you were.

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Entity-Level Tax Liabilities (Con't)

- Some states impose entity-level income taxes.
  - If the parent is also subject to the tax, there may be a crediting mechanism that reduces entity-level tax.
  - Partnerships are usually subject to non-income taxes, such as property taxes, sales and use taxes and payroll taxes, and may also have withholding responsibilities.

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Buyer's Structuring Issues

- Purchase may cause a deemed termination.
- You need a 754 election in place to receive a step-up. If one is not in place, agreement to make one should be part of the purchase agreement.
  - In some cases where there is a built-in loss in the interest, there may be a forced 754 election.

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Buyer's Structuring Issues (Con't)

- 197 anti-churning rules.
  - If the partnership is already in existence and buyer and seller are not related – should not be an issue.
  - If JV is newly formed as a result of the transaction, need to work around potentially adverse rules.
  - Purchase of undivided interests followed by a drop-down creates anti-churning issue.
  - Formation of partnership interest prior to sale followed by a sale of an interest, must be looked at closely to avoid recharacterization as asset purchase.

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Seller's Structuring Issues

- Consecutive under Section 751.
  - Character differences.
  - Possible ordinary gain, capital loss.
  - Contractual allocation of purchase price desirable.

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Seller’s Structuring Issues (Con’t)

- Possible redemption with non-cash assets.
  - Could result in gain deferral.
- Possible redemption with debt proceeds.
  - 707(a)(2)(B) analysis.
- Need to preserve rights to participate in preparing of tax returns, tax audits after sale.

Seller's Structuring Issues (Con't)

- Sales of interest vs. sale of interest in assets.
  - Possible differences in state tax.
  - Possible basis differences.
  - Possible holding period differences.
    - Bifurcated holding period in interest depending on when capital contributions were made.
    - Character of gain on asset sale as long term or short term is determined by partnership's holding period, not partners'.