Tax Considerations in Acquisitions: No Such Thing as A Free Lunch?

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I recently attended the 18th Annual Advanced ALI-ABA seminar with the everyman's title "Corporate Mergers and Acquisitions." Held in San Francisco March 6 and 7, 2003, it was more interesting and educational—and even entertaining—than the average CLE schtick. The program covered M&A strategies and techniques, reviewed several substantive legal areas, and even included a mock negotiation.

Hands down, my favorite presentation was by Lewis Steinberg, an attorney with Cravath, Swaine & Moore, in New York, and a professor at New York University. He gave a very polished and, at the same time, lively discussion on "Tax Considerations in Structuring and Negotiating the Acquisition." The hallmark of the presentation was its easy flow. In plain English, it provided a simple framework for considering the tax aspects of an acquisition.

Perhaps, not surprisingly, this simple view of the forest (not the individual trees that tax lawyers tend to obsess over) was really aimed at the corporate lawyer. Such nontax afficionados were supposed to get an overview of how to look at the transaction with the peculiar myopia (or panavision?) of a tax lawyer. This kind of broad background may be intended for corporate lawyers, but it clearly benefits tax practices, too. Indeed, tax specialists tend to get mired in the details.

Steinberg's forest-for-the-trees tax discussion reviewed the basic issues in structuring and negotiating an acquisition or divestiture. He included such fundamentals as:

- whether to structure the deal as a taxable versus tax-free acquisition;
- tax-advantaged financing techniques;
- allocating purchase prices; and
- amortizing goodwill and other intangibles.

An acquisition can be evaluated on the basis of one of three global deal models: (1) a tax-free deal, (2) a taxable stock deal, and (3) a taxable asset deal. A tax-free deal, like a stock swap, is just what it says, tax-free. A taxable stock sale has one layer of tax at the corporate level.

A taxable asset sale has two layers of tax—one at the corporate level, and a second at the shareholder level. Steinberg supposed that if General Motors were to sell its assets and issue a liquidating dividend or distribution, the corporation would pay a corporate income tax, and then the shareholder would pay an individual income tax.

Who Are You?

Steinberg reminded attendees about their partisan role. If you represent the seller, you often want a tax-free deal to minimize your taxes. If you represent the buyer, on the other hand, you presumably want a taxable deal to maximize your tax write-offs, and to receive assets or stock with a higher basis. That way when you eventually sell the assets or stock, you minimize the gain.

Therefore, the value of the deal may depend on whether the deal is taxable. The moral of the story? Steinberg quipped that all of this means there's no such thing as a free lunch. Still, the buyer and seller are not necessarily adversaries when it comes to tax considerations.

Ultimately, they just have to play by the same rules, those established by the Internal Revenue Service—and they have to take into account that certain assets may (or may not) be more valuable with a higher basis. For example, goodwill is amortizable over 15 years, a building is depreciable over 39 years, and land is not depreciable at all.

If you represent the seller, the next best thing (if you can't buy assets and get a step up) is to buy stock. But for the buyer, of course, stock is a nondepreciable asset. The worst alternative for the seller is the asset sale because there are two levels of tax. However, there are exceptions to even this maxim. If you are selling an S corporation, a corporation with losses, a consolidated subsidiary, or only some of the corporation's assets, then an asset sale might not be too disadvantageous after all. Plus, rules within these rules (if you have an NOL, how many years does it have to run?) can impact the mix.

Mr. Steinberg reviewed tax-free deals by the numbers (well, more by the letters, I guess), highlighting type A, B, C, (a)(2)(D), and (A)(2)(E) "Reorgs." I.R.C. §368. He cautioned all the corporate lawyers in the room not to change anything at the last moment without running it by the tax lawyers (that's one of the Ten Commandments, right?).

Indeed, changing the deal so that even one dollar of cash is paid might convert a deal that is intended to be tax-free into a taxable deal. Yikes! Of course, the tax lawyer will know that there is a huge difference between having the dollar paid by the acquirer and having it paid by the target corporation, but sometimes such seemingly inocous changes can be made at the last minute and may wreak havoc on the tax affects of the otherwise well-planned deal.

Spins, Etc.

Mr. Steinberg briefly discussed divisive deals, such as spin-offs, which can be either tax-free or can take the form of a taxable dividend (for example, AT&T spun-off Lucent Technologies as a stand-alone company), split-offs involving a distribution of stock in exchange for the redemption of a subsidiary's stock, or split-ups involving a distribution and then a liquidation. I.R.C. §355. Finally, there was brief mention of Morris Trust transactions, which are akin to a spin-off and then a merger. These transactions used to be tax-free but now face the high hurdle of a corporate level tax.

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Every corporate lawyer should at least have a basic knowledge of the tax ramifications of an acquisition to better understand the deal. (Of course, after learning the basics, the corporate lawyer should let the tax lawyer handle the tax aspects of the deal!) In all, Mr. Steinberg gave the corporate lawyers a new way of approaching their acquisition negotiations. Plus, sometimes even M&A tax specialists can benefit from a review of much of the global M&A tax playing field to reassess their own fundamentals, their own deal-making savvy.