Bloomberg BNA

Daily Tax Report®

Reproduced with permission from Daily Tax Report, 191 DTR J-1, 10/2/13. Copyright © 2013 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

When Worlds Collide: Litigation Insights for M&A Attorneys and Tax Advisers

BY ANNE M. LOCKNER

It is a common scenario—a company wants to buy or sell another company and turns for help to mergers and acquisitions attorneys and tax advisers from the top legal and accounting firms in the country; together, these advisers work to create a deal structure that best suits their client's business and tax objectives and, hopefully, minimizes unnecessary risk.

But sometimes those advisers may fail to fully appreciate how tax law and regulations can collide with the actual structure of the deal if some aspect of it comes under scrutiny in future litigation. Even if the tax and business strategies were brilliant, they can end up increasing a client company's litigation exposure because the litigation ramifications of those choices made during the deal—or how they get documented—haven't been fully considered.

This article will discuss concrete strategies to structure agreements that both maximize deal advantage and mitigate harm if and when the deal goes bad. It also gives examples of scenarios where tax treatment can vary from what one might otherwise expect. It is by no means an exhaustive treatise on all scenarios that could arise. Rather, the goal is to apprise you that these scenarios can potentially exist and recommend strategies for exploring whether these are issues that you should consider when structuring your next deal.

The Order of Steps to a Transaction

Deal attorneys often structure the steps of a transaction very carefully and in a specific, particular order to effectuate a business goal. In these kinds of scenarios, one step must precede the next.

For tax purposes, however, the Internal Revenue Service and the tax advisers may entirely ignore a transaction's critical steps because they operate under something known as the ''acceleration rule.'' This rule, resulting from the revenue regulations relating to consolidated entities, can result in the IRS and tax advisers considering the steps of a transaction in an entirely different order than what was legally intended.

Anne M. Lockner is a partner in Robins, Kaplan, Miller & Ciresi L.L.P.'s business litigation group. She has handled cases involving complex financial transactions, privacy, technology, accounting, securities, bankruptcy, corporate structure, tax and logistics issues to name a few. She has tried cases and argued appeals in federal and state courts throughout the country. She can be reached at amlockner@rkmc.com.

The legal order of the steps is irrelevant for tax purposes because tax law—specifically Treasury regulations that relate to consolidated entities—provides that certain steps will be considered to have occurred first, regardless of whether that is how the deal was legally structured.

For instance, it may be important legally that an acquisition target's debt be eliminated in some way immediately after the actual sale of stock occurs. In that kind of deal, the stock purchase agreement would carefully provide that the sale of stock is followed by the forgiveness of debt. But the IRS requires that the intercompany debt be considered settled before the sale of the stock, regardless of whether that is how it legally happened for accounting purposes.

For tax purposes, the IRS and tax advisers may entirely ignore a transaction's critical steps because they operate under something known as the ''acceleration rule.''

The stated purpose of Treasury Regulations Section 1.1502-13 is to provide ''rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions.''[1] To that end, the section provides ''rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).''[2]

The regulations make clear that ''[t]o the extent the timing rules of this section are inconsistent with [an entity's accounting practices], the timing rules of [Treas.

[1] Treas. Reg. Section 1.1502-13(a)(1).
[2] Id.

COPYRIGHT © 2013 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

Reg. Section 1.1502-13] control.''[3] This rule ''provides additional rules for taking the items into account'' in circumstances, for instance, where a member of a consolidated entity becomes a non-member as part of the transaction.[4] In those situations, the tax law deems an ''acceleration'' of the accounting for the transaction.

For example, ''[i]f a transaction occurs in part while S and B[5] are members [of the same consolidated entity] and in part while they are not members, the transaction is treated as occurring when performance by either S or B takes place, or when payment for performance would be taken into account under the rules of this section if it were an intercompany transaction, whichever is earliest.''[6]

The Nature of the Transaction

In other instances, the Internal Revenue Code completely ignores the legal structure of a deal. For instance, if the parties to a stock sale make an election under Section 338(h), the IRS treats the stock sale as an asset sale for tax purposes only. A Section 338(h) election is a common feature in many corporate sales and acquisitions, and it creates a ''fictitious'' world where there is an ''Old Target'' that sells its assets to ''New Target,'' but in the non-tax world, Old Target and New Target are one in the same—the Target.

If a Section 338 election is made, then the tax code treats the entire transaction as if there were two steps. First, the target of the sale is treated as if it has sold ''all of its assets at the close of the acquisition date at fair market value in a single transaction.''[7] Second, the Old Target is deemed to have distributed all of its assets to the selling corporation, is liquidated, and then ceases to exist.[8] The target of the sale is then treated ''as a new corporation which purchased all of the assets'' of the Old Target.[9]

According to the regulation, the ''new target is treated as a new corporation that is unrelated to old target'' and that has lost all associated tax attributes.[10] Section 338(h)(10) is the Section 338 provision that applies where the election is made jointly by the purchasing corporation and a selling consolidated group.[11]

Courts throughout the country accept the use of a Section 338 election.[12] In *GE Life & Annuity Co. v. United States*, the court described a Section 338 election as ''a congressionally created fiction or deemed sale of all of the acquired corporation's assets to its fictional alter ego.''[13] In *Am. States Ins. Co. v. Hamer*, the court granted summary judgment to the taxpayer in reliance on the Illinois Department of Revenue's admission that under Section 338(h)(10) it treats entities as ''two corporations—the 'old,' liquidating [entity] and the 'new' [entity],'' which is deemed an unrelated entity.[14]

Two Different Realities: What Could Go Wrong?

While a Section 338(h)(10) election is a commonly used mechanism and the acceleration rule is commonly applied, does anyone really appreciate how this could play out down the road?

While a Section 338(h)(10) election is a commonly used mechanism and the acceleration rule is commonly applied, does anyone really appreciate how this could play out down the road?

Consider the following scenario—which is dramatically simplified for the illustrative purposes. Seller Inc. decides to sell its troubled, debt-laden Target to Buyer Inc. But Buyer will only acquire Target on a debt-free basis. Seller agrees to effectuate the elimination of debt by either forgiving or assuming the debt, but only in exchange for certain ''excluded assets'' held by Target after the stock sale. Therefore, the deal attorneys structure the deal in the following manner:

- Seller sells Target to Buyer for $1 and the assumption of liabilities; and
- Target then sells the ''excluded assets'' to Seller, and in exchange, Seller forgives and assumes Target's debts.

Several years after the deal's closing, a dispute arises and the structure of this transaction, as well as the financial condition of Target at the time of the sale, are relevant issues of the case.

What does the evidence look like? Well, there are two types of documents. There are the work papers of the deal attorneys and the non-privileged communications between them. And they clearly show the evolution of negotiations that got the parties to the two-step structure above.

But there are also tax work papers and communications with the IRS that set forth the tax analysis that goes along with the structure of the deal. And what do those papers show?

---

[3] Id. at (a)(3).

[4] Id. at (a)(6).

[5] ''S is the member transferring property or providing services, and B is the member receiving the property or services.'' Treas. Reg. Section 1.1502-13(b)(1)(i).

[6] Treas. Reg. Section 1.1502-13(b)(1)(D)(ii).

[7] Section 338(a)(1).

[8] Section 338(a)(2); Treas. Reg. Section 1.338(h)(10)-1(d)(4)(i).

[9] Section 338(a)(2).

[10] Treas. Reg. Section 1.338-1(b)(1).

[11] Section 338(h)(10). Section 338(h)(10) elections are intended to address situations where the target is a wholly owned subsidiary of a corporation. C.D. Block, *Corporate Taxation: Examples and Explanations*, at 303. In these situations, absent more specific provisions, the application of Section 338 would result in double taxation as to the selling corporation and its shareholders. Id. at 304.

[12] See, e.g., *GE Life & Annuity Co. v. United States*, 127 F. Supp. 2d 794 (E.D. Va. 2000), *judgment modified on unrelated grounds*, No. CIV A 3:00cv148 (E.D. Va. 2002); see also *Am. States Ins. Co. v. Hamer*, 816 N.E.2d 659, 667 (Ill. App. Ct. 2004) (granting summary judgment to taxpayer); *Brunswick Corp. v. United States*, 2008 BL 281826 (N.D. Ill. 2008).

[13] *GE Life & Annuity Co.*, 127 F. Supp. 2d at 798, *judgment modified on unrelated grounds*, No. CIV A 3:00cv148 (E.D. Va. 2002).

[14] *Am. States Ins. Co.*, 816 N.E.2d at 667.

 COPYRIGHT © 2013 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

First, they will show that the order of the steps is exactly the opposite as set forth in the deal attorneys' work papers. Under the ''acceleration rule,'' they will consider the debts being satisfied first—treating the elimination as though it were made as an intercompany transaction. Second, if looking at the tax papers for the Seller's returns, they will show the transaction as being one of an asset sale followed by a liquidation of Target. But legally and factually, Target still exists—but exists under the ownership of Buyer.

As a result of these ''tax fictions'' provided for in the Internal Revenue Code, in a non-tax legal dispute down the road, the tax work papers can be used by an adversary in unintended ways.

For example, the tax advisers of the seller of Target are doing the taxes for ''Old Target,'' whereas the advisers for the acquirer of Target are concerned with the taxes for ''New Target.'' But as a practical matter, tax advisers often don't use the ''Old'' or ''New'' designation in their work papers. They just describe ''Target'' and treat it as a member of the consolidated entity for which they are preparing returns. If a dispute later arises and the transaction is later the subject of litigation, tax work papers may become relevant—or at least discoverable. And the implicit understanding in the tax world—that the seller is talking about Old Target and the acquirer is describing New Target—isn't expressly stated.

In those situations—where beneficial to their argument—the adversary's advisers may try to take certain statements made in the context of a ''tax fiction'' world and suggest those statements should be applied in a non-tax legal world when that shouldn't be the case. To help them along, they can turn to the tax work papers that, on their face, can give the initial appearance of what is technically known in the litigation world as ''bad documents.'' Though bad documents can often be explained, the more explanation required, the weaker your case appears.

Deal attorneys and tax advisers, however, shouldn't necessarily change the advice and recommendations to their clients on how to structure a deal to achieve business objectives and maximize tax benefits. But they can do a lot—with little additional effort—to mitigate the problems that can arise for a company long after the deal is done.

Putting Litigation Considerations Into the Deal

Tips for Tax Advisers

■ Be aware of where the Internal Revenue Code and the IRS regulations create a ''fiction'' that may create an alternative universe from what is happening legally and recognize that while this may seem self-evident to those of you who are used to living in the tax world, attorneys, judges and jurors generally don't live in that world and think a ''tax fiction'' sounds fishy. The acceleration rule that applies due to the consolidated entity regulations and Section 338(h) elections that treat stock sales as asset sales for tax purposes are two examples.

■ Where those fictions arise or potentially arise when working with your client and M&A attorneys to structure a deal, highlight these differences so that everyone appreciates the difference between the legal structure and how the tax authorities will view that same structure.

■ When drafting work papers that address an issue related to a tax fiction, don't leave the fact of a tax fiction implicit. Specifically call out how this tax fiction differs from the legal structure of the deal. Yes, perhaps the IRS will think you are stating the obvious, but such an explanation could benefit your client immeasurably down the road. And the failure to do so could create huge obstacles.

■ Don't just assume that because you explained the distinction in one work paper, you don't need to mention it again. In litigation, your client's adversary will try to find the one document that causes confusion and will ignore the one where you provided the explanation. If nothing else, be sure to incorporate by reference the document that explains the distinction so that it will be harder for an adversary to use your work product against your own client.

Tips for M&A Attorneys

■ Understand and appreciate what the tax goals are that the tax advisers are trying secure and the mechanisms they plan to use to achieve those goals.

■ Next, explore whether those mechanisms could have any unintended consequences to your goals and objectives. Educate the tax advisers on their need to follow the tips above. Oftentimes, while tax advisers are usually involved during the deal, many of their tax work papers are developed long after the deal is done when the taxes are being audited where you won't have any input.

■ Where you see the potential for unintended consequences, encourage the tax advisers to make explicit any implicit assumptions they may be making, including those instances where tax law ignores or treats a transaction differently than how it is legally structured. In short, ask the tax advisers to consider the practice tips above.

Conclusion

Complex transactions benefit from the advantages offered by sophisticated deal structures and the insights of the professionals who help craft them. But not every deal has a happy ending. The possibility of future litigation shouldn't change the structure of a deal, but it should inform choices about documentation and communication of critical choices to help lower risks in case that possible litigation becomes a reality.