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## M&A Tax Considerations for Small- and Middle-Market Purchasers

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**W**hat is going through the mind of a small- or middle-market company's C-level executive exploring how to grow his or her company through an acquisition? The answer is typically centered around how best to achieve the greatest return to the shareholders on the company's investment in the enterprise being acquired. The acquiring company's management will need to fully appreciate the series of tax complexities to be considered, or else it runs the risk of the anticipated return on investment being adversely impacted by certain tax exposures of the acquired enterprise that may unwittingly be assumed by the acquiring company. How does an acquiring company avoid – or at least mitigate – such a dilemma? The answer begins with careful planning around properly structuring a transaction, as well as conducting an appropriate level of tax due diligence.

A purchaser aims to structure an M&A transaction in as tax efficient a manner as possible while preserving any available tax attributes (e.g., net operating losses, tax credits) and minimizing the amount of potential tax exposures assumed. A purchaser first needs to carefully consider how to optimally structure an M&A transaction from a tax perspective. When company stock is acquired, the purchaser receives carryover tax basis in the underlying assets of the company. Therefore, a purchaser may be seeking to structure the transaction to achieve a “step-up” in the tax basis of the underlying assets to the fair market value paid for the company. This step-up would generate future tax deductions for the company, including a tax deduction for the amortization of goodwill not otherwise available in an ordinary stock acquisition. How is this step-

up achieved? The options available to the purchaser include, for example, acquiring assets in lieu of stock, jointly making a Section 338(h)(10) election, if applicable, with the seller or acquiring 100 percent of the partnership interests in an LLC under Revenue Ruling 99-6. In any one of these transaction structures, the price paid by the purchaser (including certain liabilities assumed) will be allocated to the underlying assets of the company utilizing the respective fair market values of such assets with the residual generating tax basis in goodwill. In addition, a purchaser will have to consider whether the company being acquired has any tax attributes and the potential limitation under Section 382 upon the future utilization of such attributes. A purchaser may have to consider the opportunity cost between achieving a step-up and preserving certain tax at-

tributes and, therefore, analyze the implications of structuring an M&A transaction to accomplish one objective potentially at the expense of the other. A purchaser will likewise need to consider the appropriate tax treatment of certain costs incurred to facilitate an M&A transaction.

The intended benefits of an M&A

transaction can be adversely impacted by potential tax exposures assumed by the purchaser. The purchaser should consult with the appropriate advisors to perform tax due diligence on the company being acquired as a means of mitigating the impact of assuming any potential tax exposures. When a purchaser acquires the

stock of a company, all of the company's historical federal, international, state and local income and non-income tax liabilities are assumed by the purchaser. If the purchaser acquires assets in lieu of stock, the purchaser may continue to be subject to successor liability for certain historical tax liabilities of the company. Tax due diligence provides a purchaser with the opportunity to identify a company's potential tax exposures for purposes of negotiating certain favorable terms in the acquisition agreement, either to protect against such exposures through a series of representations, warranties and indemnities or to trade-off protection against such exposures in exchange for certain other deal-related concessions in the agreement. In addition, tax due diligence provides a means of validating certain assertions about a company being acquired that may prove to be critical for accomplishing the structuring objectives of an M&A transaction. For example, a Section 338(h)(10) election to achieve a step-up for an S corporation being acquired can only be made if such a company is truly a valid S corporation and has not historically undertaken any transactions that may have created a second class of stock and, thus, invalidated its S corporation status.

Purchasers of companies have a number of tax considerations to keep in mind when undertaking an M&A transaction. It is highly recommended that purchasers consult with the appropriate advisors, including a public accounting firm that specializes in transaction structuring and tax due diligence. Ignorance is not bliss when it comes to tax considerations in an M&A transaction and, therefore, purchasers will be better equipped to achieve the intended benefits of their transaction only to the extent that tax matters have been properly considered prior to the closing of any prospective deal. ■

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