5 Ways To Avoid Tax Blunders In M&A Deals

By Ama Sarfo

Law360, New York (January 21, 2014, 5:06 PM ET) -- Tax attorneys are instrumental in helping mergers and acquisitions flow smoothly and in helping targets and buyers avoid unnecessary taxes that could otherwise kill a deal, but if tax counsel aren't organized and holistic in their approach, a deal can easily go sour anyway.

In particular, tax counsel on M&A transactions have the sizable responsibility to think ahead as to how a deal might evolve as well as to how a target company or acquiring company might change, and they also must consider all risks that may arise, according to David Sreter, Ernst & Young LLP’s global and Americas transaction tax leader.

“What we often say, when on the buyer’s side, is that tax attorneys cannot operate in a vacuum, as if tax is the only thing happening in the transaction,” Sreter said. “First and foremost, you need to understand the transaction, the business objectives and what's motivating the parties involved. And you also must know your client’s appetite and understanding of risk from the tax side.”

Here, experts share five tips to help tax attorneys avoid making short-sighted mistakes on M&A deals:

Stock or Asset?

In general, the parties in an M&A deal determine whether a buyer will obtain stock or assets in the transaction, but clients nonetheless look to tax attorneys to identify what the most advantageous deal structure will be, experts say.

According to Wood LLP managing partner Robert Wood, that task requires tax attorneys to be well educated about both constituents in the deal — the target and the buyer.

And in global deals, it requires U.S. tax counsel to shore up their international colleagues as soon as possible, said Thomas May, a Baker & McKenzie LLP tax partner.

“When you're doing an asset sale, there is a tax imposed on the transfer of those assets in many jurisdictions,” May said. “The tax could be a 1 percent tax on the fair market value of the assets, so you want to try to avoid those as much as possible, because you can't take a foreign tax credit for those — they're just costs.”

Determine If The Target Corporation Is Valid

S-corporations — which pass income, losses, deductions and credits on to their shareholders — are a popular kind of corporation, but they can easily sink an otherwise promising merger if their corporate status isn’t valid, according to Andy Torosyan, a tax partner with accounting firm Holthouse Carlin & Van Trigt.

“There are many ways to invalidate status — maybe a shareholder’s spouse didn’t sign an original S-corp election and they live in community property state, or the corporation made repeated disproportionate distributions to shareholders,” Torosyan told Law360.

No matter the reason, if a target S-corp loses its election and becomes a C-corporation, it will be subject to double taxation, meaning tax attorneys must keep a sharp eye out for validity issues at the beginning of a transaction, Torosyan said.

“It can cause a deal to go sideways very quickly,” he added. “So it’s necessary for tax attorneys to think ahead of the seller and think about ways to restructure the business to clean up any problems that might exist.”

Tackle Your Administrative Tasks

When a company sells a division and the division’s financial and tax people are left behind, tax attorneys on the buyer’s side will need to retain those services until they can get their own people up to speed, May said.

“Consistent with that, in most agreements you have tax representations and warranties, and you have a provision that governs cooperation for filing tax returns and handling tax audits, so tax attorneys must structure who's in charge of filing tax returns,” May said.

Tax attorneys, particularly those on the buyer’s side, should also ensure that the target’s books and records are in accordance with generally accepted accounting principles, Torosyan added.

“They often aren’t, and that is a big-ticket item we see that's often overlooked,” he said.

Think With Your Business Mind

Tax attorneys are known for having academic minds, but when it comes to mergers and acquisitions, they've got to abandon their penchant for theoretical thinking and think about cold, hard dollars, experts say.

"The problem is that tax people sometimes aren't responsive enough to business goals," Wood said. "Something may make tax sense, but it won't make business sense, so communication is key to ensure that tax solutions do meet the client's goals."

And that communication must be with all the stakeholders — lawyers, bankers and accountants — in order to ensure that the tax parts of the transaction are aligned with the deal's entire life cycle, Sreter said.

"You will put the tax side at risk of not raising its profile at the appropriate time or missing a key business issue," he added.

Consider Your Post-Deal Role

Closing a deal is certainly cause for celebration, but tax attorneys can't walk away at closing and assume the matter is over, because there are always loose ends to tie up and issues that can pop up post-closing, experts say.

For example, there will always be tax return and information return reporting issues, elections that need to be filed and statements that need to be filed, Wood said. Torosyan added that tax attorneys also have to watch out for purchase price allocation finalizations and purchase price adjustments in the first year after a deal is completed.

"Someone on the tax side must make a list of things that need to happen post closing," Wood said. "It sounds pretty pedestrian, and some tax lawyers want to relegate that kind of stuff to accountants, but it's really important that tax attorneys focus on those issues and take them seriously."

--Editing by Jeremy Barker and Kat Laskowski.