Tax Issues in Mergers and Acquisitions

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Before we get started…

- Today’s presentation slides can be downloaded at www.wolfandco.com/webinars/2015.
- The session will last about an hour, and we’ll have time for Q & A throughout the presentation.
- Our audience will be muted during the session.
- Please send your questions in using the “Questions Box” located on the webinar’s control panel.
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Meet Our Presenters

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Today’s Agenda

• Due Diligence
• Stock Acquisitions
• Asset Acquisitions
• Deductible vs. Nondeductible Expenses
• Golden Parachute (IRC Section 280G)
• IRC Section 382
• Tax Bad Debt Reserve Recapture
• Other Issues
Due Diligence

• Have all required tax returns been filed? Are they accurate?
• Identification of permanent and temporary differences
• Elections and disclosures
• Information reporting
  – W-2s
  – 1099s
  – 1098s
• Compensation agreements and qualified plans
Stock Acquisitions

• One financial institution acquires the stock of another, or a mutual bank is absorbed by another bank

• Tax attributes and basis carry over for tax purposes

• Acquisition accounting adjustments – offset goodwill net of tax

• Code Section 338(h)(10) election
Asset Acquisitions

- Seller still exists as a separate entity
- Buyer does not inherit liabilities, unless specified
- Target’s assets and liabilities generally recorded at fair value for both book and tax purposes
- Purchase price broken out between asset categories and recorded accordingly
- Form 8594 Asset Acquisition Statement
Asset Acquisitions (cont.)

• Excess of purchase price over fair market value of assets = intangible assets (such as customer lists, Goodwill)

• In an asset acquisition, most intangible assets are amortized over 180 months for tax purposes
### Asset Acquisition Example

- **Branch Acquisition with the following FMVs:**

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Loans</td>
<td>$15,000,000</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>$500,000</td>
</tr>
<tr>
<td>Interest Rec.</td>
<td>$200,000</td>
</tr>
<tr>
<td>FMV of Assets</td>
<td>$16,700,000</td>
</tr>
<tr>
<td>Deposits</td>
<td>$19,000,000</td>
</tr>
</tbody>
</table>
• Without intangibles, the seller would pay the buyer $2,300,000

• Assume further:
  – Core deposit intangible $500,000
  – Goodwill $200,000

• Fair market value of assets increased to $17,400,000, seller now pays $1,600,000 to buyer
M&A Expenses

• “Bright line” test – focuses on the earlier of:
  – The date of execution of the letter of intent, or
  – The date the material terms are approved by the Board

• Costs before this date are generally investigatory (deductible), costs after this date are generally facilitative (capitalized)
M&A Expenses

• Certain costs are “inherently facilitative” and are always capitalized no matter when incurred:
  – Preparation and review of merger agreement
  – Appraisals
  – Fairness opinions
  – Negotiating the structure of the transaction
  – Preparation of proxy solicitation
  – Obtaining regulatory approval
  – Conveying property between the parties
M&A Expenses

• Certain costs do not facilitate the transaction and are deductible no matter when incurred
  – Employee compensation
  – Overhead
  – Director fees for attendance at regular meetings, but not special meetings
  – Amounts paid to integrate business operations
M&A Expenses

• Success-based fees (such as investment banker fees) formerly source of controversy

  – Under prior rules, needed detailed analysis of time spent by the investment banker to determine how much is deductible

  – In 2011, IRS issued a Revenue Procedure that allows a safe harbor deductibility amount of 70% of success-based payments, with an election in the return
M&A Expenses

• Which corporation takes certain deductions?
  – Depends upon language in agreements
  – Change in control payments paid to target’s executives shortly after the merger should generally be deducted on the target’s final tax return
  – These payments include payouts of stock options, stock appreciation rights and restricted stock, as well as vesting of deferred compensation
  – Target’s deductible financial advisory and investment banking fees should be deducted on the target’s final tax return
Golden Parachute Payments

• IRC Section 280G disallows a deduction for “excess parachute payments” made to “disqualified individuals” pursuant to a change in control.
• A person who receives an excess parachute payment must pay a 20% excise tax on that amount.
• Issue should be addressed during due diligence
Golden Parachute Payments

• “Disqualified individual” – performs services for the bank and is an officer, shareholder, or “highly compensated individual (highest-paid 1% of employees)

• “Excess parachute payment” – excess of parachute payment over “base amount”

• “Base amount” – average annual taxable compensation over the previous 5-year period
Golden Parachute Payments

• “Parachute payment” – payment in the nature of compensation which is:

  – Contingent on a change in ownership or control of the bank, or of a substantial amount of assets, and
  – The present value of payments equals or exceeds 3 times the base amount
Golden Parachute Payments

- Payment is contingent on a change in control if the executive either acquires a right to receive the payment, or receives the payment sooner than he otherwise would have, if not for the change in control.

- If change in control triggers accelerated vesting of nonqualified deferred compensation, the accelerated vesting is contingent on the change in control.
Golden Parachute Payments

• A parachute payment can be reduced by establishing by “clear and convincing evidence” that a payment is reasonable compensation for services performed

• Non-compete agreements are compensation for services only if the agreement substantially constrains the ability to perform services, and it’s likely that the agreement will be enforced

• Severance payments are not compensation for services performed
Golden Parachute Payments

• Example:
  – Base amount $250,000
  – Change in control payment $800,000

• Because payment exceeds 3 times the base amount, the $800,000 is a parachute payment

• $800,000 less $250,000 = $550,000, which is the excess parachute payment and is nondeductible

• Individual pays excise tax of $110,000 (20%)
Golden Parachute Payments

• Example (cont.)

• If change in control payment is $700,000, which is less than 3 times the base amount, there is no parachute payment, so no disallowed deduction and no excise tax to the individual.
Golden Parachute Payments

• “Clawback Provisions”
  – Included in many Change in Control agreements
  – Preclude a payment in excess of amount deductible under Code Section 280G
  – Often require a calculation to determine the maximum payment permitted without triggering the limitation
• Annual limitation of the amount of carryovers, NOLs, capital losses, credits, and net unrealized built-in losses ("NUBILs") that can be deducted subsequent to an ownership change

• Annual limitation – value of target corporation immediately before the ownership change multiplied by the IRS-issued monthly long-term exempt rate
  – Use the highest rate for 3 month period ending with the ownership change
  – Tax exempt rate for July 2015 = 2.74%
Code Section 382

• NUBIL = the amount of loss recognized in a hypothetical sale of assets immediately before the ownership change

• Calculation: amount realized if all assets sold at FMV to a third party that assumed all of its liabilities, decreased by the sum of deductible liabilities that would be realized
Code Section 382

• Example:
  – Target has one asset with FMV of $100 and adjusted basis of $90
  – Target has deductible liabilities of $30
  – NUBIL = $20 ($100 realized less $90 basis less $30 deductible liability)

• If NUBIL does not exceed the lower of 15% of the FMV of assets or $10 million, NUBIL is considered to be zero.
• Recognized built-in loss ("RBIL") = loss on disposition of assets on which there were unrealized built-in losses at the time of the acquisition

• RBILs after 5-year period beginning with the acquisition date are not subject to the limitation

• RBILs related to loans are limited for only 12 months
Code Section 382

• Unused losses, credits or NUBILs can be carried forward, but not past the original carryover period.

• Absorbed in the following order:
  1. Realized capital loss from target
  2. Capital loss carryovers
  3. Recognized built-in ordinary losses
  4. Net operating loss carryovers
  5. Credit carryovers
If the target corporation has had 1 or more previous ownership changes:

- Losses attributable to the period preceding the ownership change are treated as part of the loss with respect to both ownership changes.

- Later ownership change may result in a lesser (but never greater) section 382 limitation with respect to such losses.
Bad Debt Reserve Recapture

• If a former thrift bank makes a large distribution to its parent to acquire another bank, there may be recapture of the bank’s tax bad debt reserve.

• Code Section 593 permitted a bad debt deduction based on taxable income rather than net charge-offs.

• Tax bad debt reserve accumulated, reflecting the excess of bad debt deductions over net charge-offs.
Bad Debt Reserve Recapture

• Taxable income method repealed for tax years beginning after 12/31/1995

• If the bank makes a distribution to its parent or shareholders in excess of its earnings and profits ("E&P"), it must recapture a portion of the tax bad debt reserve

• Amount to be recaptured is the amount, less the tax provision on the recapture, that equals the distribution in excess of E&P
Bad Debt Reserve Recapture

• There is no deferred tax, so the tax effect of recapture is a charge to the tax provision without corresponding book income.

• Depending on the circumstances, the bank may need an E&P study to determine amount of recapture, if any.
Other Issues

• Short period final return for target
  – Beginning of target’s tax year through acquisition date
  – Considered a full tax year for carryforwards

• Information reporting – need coordination
  – W-2s, 941s, 1098s, 1099s
  – Over-withholding of FICA
  – 401(k) withholdings in excess of statutory limitation
Other Issues

- Code Section 162(m)
  - $1 million limit on deductible compensation for covered employees in a publicly traded corporation
  - Covered employee: on the last day of the year:
    • Chief executive, or
    • Others whose salary is required to be reported to shareholders
  - Often, target’s executives are not subject to this limitation in the acquisition year
- Subsidiaries – liquidate, merge, or keep?
Questions?

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