Bloomberg Tax

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New Rules — Same Game: Impact of 2017 Tax Act on Acquisition Agreements and Related Due Diligence

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I. OVERVIEW

Various provisions of the 2017 tax act will affect the mergers and acquisitions (M&A) market and how the ''game'' is played. The principal tax goals with respect to the acquisition or disposition of a business entity remain the same (i.e., same game), but the tax calculus with respect to such acquisition or disposition have changed as a result of the changes to the Code (new rules). The 2017 tax act (Pub. L. No. 115-97) was signed into law by President Trump on December 22, 2017, and has been characterized as the most fundamental change to the tax code in over 30 years. The preliminary effects on acquisition structure and related due diligence are discussed herein; however, the long term effect of the 2017 tax act must await the passage of time.

This article provides an overview of the framework of the acquisition agreement and related tax provisions. We first discuss the principal tax objectives often considered by purchasers and sellers of a business, including structure of the transaction. We then provide a general framework of the acquisition agreement and describe the typical tax provisions often included therein. Finally, we discuss various new provisions included in the 2017 tax act and how those provisions may affect the structure of a transaction as well as the acquisition agreement.

II. TAX OBJECTIVES (GOALS) OF THE M&A TRANSACTION

A. General

The principal tax considerations with respect to the acquisition or disposition of a business entity fall into three broad categories: (1) allocation of risks and/or benefits with respect to legacy tax liabilities or tax assets associated with the acquired business (historic tax liabilities and tax assets); (2) existence of any tax liabilities or tax benefits arising as a result of the acquisition or disposition, including change of control payments, transfer taxes, special elections available to purchaser or seller, or collateral tax consequences associated with or arising in connection with the transaction (transactional tax consequences); and (3) future tax consequences (costs and/or benefits) associated with the income and operations of the acquired business, principally in the form of the potential recovery of the purchase price for the acquired business through amortization or depreciation charges, financing of the acquisition (internally or externally), and the potential shifting of future income or profits to lower tax jurisdictions (domestic or foreign) (future tax attributes and obligations).

In general, the typical acquisition agreement addresses these tax considerations in:

- structure of the acquisition (assets vs. stock and/or interests),[1]
- purchase price (payment mechanisms or allocation of the consideration),

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[1] The form of consideration to be paid to the buyer (cash/equity/seller financing) including any contingent consideration

- representations and indemnification provisions (due diligence and risk allocation), and
- tax covenants (elections, straddle periods, return preparation, filing responsibilities and related future tax obligations).

B. Historic Tax Liabilities and Tax Attributes

The purchaser of a business is likely concerned with the risk of assuming unknown or contingent liabilities of the target entity related to the prior conduct of the business. The potential for unknown or contingent tax liabilities will depend on a variety of factors, including (1) the federal income tax classification of the entity conducting the business as either a ''flow-through'' entity or a separate taxable entity; (2) whether the entity has engaged in transactions whereby it has the potential for successor liability; and (3) whether the entity is or has ever been a member of an affiliated group of corporations filing a consolidated return.

In general, the transfer of the business by a sale of assets and the assumption of specific liabilities limits the risk of inheriting the seller's tax liabilities to those instances where a particular provision of law imposes successor liability on the purchaser. Accordingly, the structure of a transaction as either the acquisition of an entity conducting the business or the assets and liabilities that constitute the business can have a significant impact on the risk of inheriting unknown tax liabilities of the business.

Furthermore, a business entity may also have favorable ''tax attributes'' that can be acquired only through the acquisition of the business entity. These attributes include net operating losses of the entity, the historic basis in the entities' assets (to the extent such basis exceeds the basis the purchaser would obtain upon a taxable asset acquisition), favorable tax credits, and other favorable tax attributes.[2] The tax consequences associated with a given structure are only one element as to acquisition structure and there are a number of non-tax considerations that will impact the ultimate acquisition structure.

In general, outside the context of the acquisition of a publicly traded entity, the parties will typically arrange for a sharing of the risk of unknown tax liabilities on a ''pre-closing'' or ''post-closing'' basis, or a ''your watch'' or ''my watch'' basis, and provide some type of recovery through indemnification, insurance or otherwise.[3] An acquisition agreement that contemplates such an allocation may consider a statement in the agreement to guide the interpretation of the contract and to aid in the resolution of any future disputes as to the party that is bearing the risk of the particular tax liability to the extent not otherwise specifically addressed.

> **Example: Interpretation.** Except where the Agreement provides to the contrary, the parties intend that liability for Taxes of the Target attributable to a Pre-Closing Tax period are a responsibility of Seller and that in the event of any ambiguity with respect to such liability this Agreement should be interpreted to reflect that intent.

C. Transactional Tax Consequences

In addition to the legacy tax liabilities and tax attributes of the target business, the transaction may itself create a tax liability or give rise to favorable tax attributes.

For example, transfer taxes may be imposed on the disposition of the business in either an ''entity'' or an ''asset'' transaction. Any such tax is a cost of the transaction that will be borne by the purchaser, the seller, or shared. The elimination of intercompany debt in connection with an acquisition may create dividend and withholding taxes, particularly in the context of a cross-border acquisition, and any tax liability should be addressed in the acquisition agreement. Unwanted assets may be distributed from the target entity with federal and/or state tax consequences. The acquisition may give rise to change of control payments related to past compensation for services that provide a tax benefit or attribute.

D. Future Tax Attributes and Tax Obligations

The acquisition agreement should address tax matters that arise or occur in a post-closing period but that have a connection to a pre-closing period. These tax matters include tax elections of the entity (if such

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and the buyer financing are also elements of the acquisition structure.

[2] Any tax attributes of the target entity may be subject to limitations under various Code provisions, e.g., §382, §384, and §269.

[3] The effective time of the closing to allocate income or deductions between the buyer and seller has tax implications and the tax treatment may be at variance from the accounting period. For example, the purchase price may provide an adjustment for working capital or indebtedness that is determined at the beginning of the closing date while the tax period may not end until the end of the closing date. Items that arise on the closing date may generate a tax benefit or create a tax liability and the agreement should reflect that allocation of those items into the proper period and proper party that is allocated the tax benefit or tax liability.

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elections remain in effect), the ability to utilize post-closing losses to offset pre-closing income, nexus and permanent establishment issues that arise on integration, and the classification of service providers as employees or independent contractors. The location of the assets within the purchaser group as well as any financing of the transaction and related borrower and subsidiary or parent guarantees and the tax effect should be considered in the context of the acquisition.

III. TRANSACTION STRUCTURE: TAX CONSIDERATIONS

An acquisition of a business will be structured either as the acquisition of part or all of the assets and assumption of certain liabilities of the target business (asset transaction) or more frequently, the acquisition of a business entity conducting the business. The federal income tax treatment of the transaction as an asset transaction with the purchaser obtaining a cost tax basis in the acquired assets is not limited to an asset transaction. A purchaser may achieve a cost tax basis in the target assets through the acquisition of the business entity depending on the federal income tax classification of the business entity as a corporation, a partnership, or disregarded entity, and in certain cases, whether an election is made under §338(h)(10) or §336(e), or whether a structural variation to the acquisition results in a §1012 cost basis in the acquired assets.[4]

In general, a purchase of assets via a pure asset acquisition (a long form asset acquisition) for fair market value will not create successor liability to the buyer for income taxes of the seller. However, a business entity will retain liability for its own legacy taxes, even if the transaction is treated for federal income tax purposes as an asset type transaction. In such case, a purchaser will have exposure to the taxes of the business entity (as well as any successor liability of that entity, e.g., joint and several liability for any period the target was a member of the consolidated group pursuant to Reg. §1.1502-6). The tax representations, tax indemnification, and related due diligence in this case should be broad enough to address the tax risks.

> **Example:** Target is a corporation that has elected to be classified as an S corporation. Due diligence has revealed some question as to the validity of the S election. If the transaction is structured as a long form asset acquisition and the purchaser pays fair market value for those assets, the purchaser generally will not assume liabilities (including contingent tax liabilities) of the business entity. A modification of the transaction structure such that the purchaser acquires a wholly owned disregarded entity that had conducted the business would not avoid liability for any entity level taxes imposed on the business where that entity is a successor entity (or under state law the same entity).[5] The purchaser of the business entity, in such case, would have exposure for the taxes of the entity.

> **Example:** TLLC is a disregarded entity that is wholly owned by P, the common parent of an affiliated group of corporations that file a consolidated return. TLLC converted from a corporation (TCorp) to a limited liability company (TLLC) in a transaction treated as a liquidation governed by §332 and §337. Prior to conversion TCorp was a member of the P consolidated group. TLLC is a successor to TCorp with potential liability for Taxes of TCorp including any liability under Reg. §1.1502-6 for the period TCorp was a member of the P consolidated group.

IV. DUE DILIGENCE

A. General

In general, the role of tax "due diligence" in an M&A transaction is to identify and quantify the potential tax liabilities of the seller. In addition, to the extent the business has favorable tax attributes the due diligence process will involve a determination of the "value" of those attributes. The due diligence function will also address the ongoing tax consequences of the integrated business with the purchasers existing operations (if any). The due diligence function is generally undertaken independent of, but is integral to, the acquisition agreement.

B. Purpose

In general, the due diligence function is focused on: (1) pre-existing tax liabilities of the business; (2) li-

[4] A forward merger of a target corporation into an acquiring corporation for cash is treated as an asset acquisition. Rev. Rul. 69-6. In such case any corporate gain recognized to the target will become an assumed liability of the entity into which the target has merged as a result of the merger.

[5] A target corporation that is transferred to a new corporation followed by a conversion of the target corporation to a limited liability company should constitute a reorganization within the meaning of §368(a)(1)(F). *See* Rev. Rul. 2008-18. Any tax liabilities of the target corporation would remain liabilities of the disregarded entity.

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abilities or attributes created as a result of the acquisition; and (3) tax issues that may arise following the acquisition as the business is integrated into the purchaser's business. The tax representations in the acquisition agreement augment and assist the due diligence function.

V. FRAMEWORK OF M&A AGREEMENT: TAX PROVISIONS

A. General

The structure of the transaction as a pure or long form asset acquisition versus the acquisition of a business entity will have a significant bearing on the risk that a purchaser will succeed to any unknown tax liabilities of the seller or the business entity. As a result, the tax provisions of an asset acquisition agreement will likely differ from those where the purchase is of an entity conducting the business. The provisions most likely to be impacted are the underlying tax representations and tax covenants. Nevertheless, due to the possibility of successor liability, the representations requested from the seller even in a pure asset acquisition would typically cover the seller's conduct related to the filing and payment of its taxes.

Whether structured as an asset or entity acquisition the acquisition agreement will generally be organized in the following manner:

- Purchase Price & Acquisition Structure
- Representations (Purchaser & Seller)
- Covenants (Pre & Post Closing)
- Indemnification
- Closing Conditions
- Other (Including Definitions)

Each of these sections can impact the risk allocation between the purchaser and seller for the tax liabilities and attributes of the target assets or entity, as well as how the parties address tax considerations and issues at or that follow closing of the acquisition. The relevance of any of these sections will depend on the overall parties to the transaction, the target entity or its assets, and the consideration to be paid to the parties to the transaction (among other issues). A review of the acquisition agreement should not be limited to the ''tax sections'' and the tax advisor should have a thorough understanding of the underlying business transaction and the operative provisions of the agreement as well as any other collateral agreements.

The discussion and the examples that follow are provisions that as appropriate may be subject to inclusion within an agreement. In drafting the provisions, it is important to include within the definition of buyer, seller, or target any subsidiaries or affiliated entities to the extent such provision is intended to apply to the relevant entity or to address consolidated or combined tax reporting consideration. In addition, in a pure asset acquisition where one of the assets is an entity the agreement should treat that particular asset as an entity and modify the provisions accordingly.

B. Purchase Price & Acquisition Structure

1. General

The purchase price section of the acquisition agreement identifies the consideration to be paid to the seller and other parties and the assets purchased and any liabilities assumed by the purchaser. In an asset transaction, the purchase price section identifies the acquired assets to be acquired and the liabilities to be assumed by the purchaser. Often times, the section also identifies the assets not acquired and the liabilities not assumed. The purchase price may be in the form of cash, a debt obligation of the purchaser, or equity of the purchaser (or combination thereof). Finally, this section generally sets forth the parties to whom the consideration is to be paid, including any amounts paid to option holders, lenders, or other third parties, including service providers.

The agreement typically provides that any amounts due a party are reduced by any withholding tax imposed on the receipt of such payment by the applicable party.

> **Example:** Notwithstanding any provision in the Agreement to the contrary, Buyer shall be entitled to deduct and withhold from any consideration otherwise payable under the terms of this Agreement such amounts as it is required to deduct and withhold pursuant to any provision of Law related to or regarding Taxes. To the extent that amounts are so withheld by Buyer, such withheld amounts (i) shall be remitted by Buyer to the applicable Governmental Authority in accordance with applicable Law and (ii) shall be treated for all purposes of this Agreement as having been paid to the recipients in respect of which such deduction and withholding were made by Buyer.

2. Purchase Price Adjustments

a. Working Capital: Equity Adjustments

The purchase price will often include an adjustment for the operations of the business from an earlier date

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when the parties agreed on a tentative price to the closing date. Such an adjustment may be based on changes to the ''working capital'' or the ''equity'' of the entity from the earlier measurement date. An important exercise for the tax advisor is to understand how any tax reserves or tax refunds are reflected in the definition of ''working capital'' or ''net equity'' to the extent such items are an adjustment to the purchase price. Similarly, if the financial statements provided for ''deferred'' tax assets or ''deferred'' tax liabilities, how those items are calculated and any impact such items have on any purchase price adjustment.[6]

> **Example:** Working capital includes as an asset certain tax refunds to be paid to the target entity. If the contract provides that the seller retains any tax refunds the seller will receive the benefit of the refunds in both working capital and upon receipt. The contact could modify the working capital calculation to reduce any tax refunds from the calculation or provide that the refunds are to be retained by the buyer to the extent such refunds were taken into account in calculating working capital.

The purchase price may provide for the seller to retain ''Cash,'' or alternatively the purchase price may be reduced by ''Indebtedness.'' These definitions should be carefully reviewed to determine whether they include tax assets or tax liabilities, and if so, whether inclusion reflects the business transaction.

> **Example:** The purchase price is increased by Closing Cash, and cash is excluded from the definition of Working Capital. If cash is distributed to seller and that distribution results in a tax, the agreement should presumably allocate that tax liability among the parties as a pre-closing tax and as a reduction in the purchase price. If the cash is retained in the business entity but taxable on distribution, a reduction in purchase price to account for the tax liability may be appropriate. An agreement may exclude or reduce cash by any tax imposed on a distribution or transfer.
>
> **Definition:** Closing Cash means the aggregate cash and cash equivalents of the Target Entities and Subsidiaries on a consolidated basis **excluding Trapped Cash**, as of the Closing.
>
> **Definition:** Trapped Cash means cash which, following Closing, that is not able to be distributed, contributed, or otherwise transferred (whether by dividend, redemption, loan, contribution, or otherwise) to Buyer or another member of the Buyer Group or is otherwise not freely available to a member of the Buyer Group or where the distribution, contribution, or other transfer of such cash (whether by dividend, redemption, loan, contribution, or otherwise as a loan or otherwise) would result in the incurrence of [material] costs or expenses (including any withholding or other Tax obligation) or where such distribution, contribution, or transfer (whether by dividend, redemption, loan, contribution, or otherwise) would present a material risk of liability for the member of the Buyer Group, its directors or officers.

b. Earn-Out

An earn-out may serve to bridge the gap between a purchaser and seller as to the value of a business. Any withholding tax with respect to payments on the earn-out as well as any information reporting with respect to imputed interest should be reflected in the acquisition agreement.[7]

c. Escrow

A portion of the consideration may be placed in escrow to secure the seller's indemnification obligations under the agreement. The agreement may be structured to permit the seller, to the extent possible, to utilize the installment method for any amounts subject to the escrow, e.g., by allocating the escrow to installment sale eligible assets.

> **Example:** The Consideration shall be allocated among the Purchased Assets in a manner consistent with the appraisal, which shall be prepared in accordance with §1060 of the Internal Revenue Code of 1986, as amended (the ''Code'') and any similar provision of state, local, or foreign law as applicable; provided, that the Purchaser Note shall be allocated to goodwill and other intangibles in

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[6] A deferred tax asset or deferred tax liability is an accounting concept under generally accepted accounting principles (GAAP) generally calculated with respect to timing differences between financial and tax items. In general, a deferred tax asset or liability reflects a non-cash asset or liability of a seller that may not be relevant to a buyer. Its existence, however, may indicate certain tax attributes, e.g., net operating losses, deferred revenues, etc. that warrant additional due diligence and may be taken into account in the acquisition structure or tax provisions of the agreement.

[7] If the transaction provides compensatory payments with respect to service providers and such service providers share in the escrow the withholding, information reporting, and payment mechanics should be reflected in the purchase agreement and the escrow agreement.

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accordance with Rev. Rul. 68-13, 1968-1 CB 195.[8]

The escrow may provide the party obligated to report any earnings on the escrow and the mechanics for such reporting. The seller, if it intends to utilize the installment method for reporting with respect to the escrow proceeds, may seek to structure the arrangement so that the escrow is owned by the purchaser and is not considered ''payment'' to the seller. If payments released from the escrow could be subject to a withholding obligation the escrow should contemplate such withholding and reporting obligation.

> **Example:** The Company and Purchaser agree for all tax purposes that: (i) the right of the Seller to the Escrow Amount shall be treated as deferred contingent purchase price eligible for installment sale treatment under §453 of the Code and any corresponding provisions of state, local, or non-U.S. law, as appropriate; (ii) interest may be imputed on such amount, as required by §483 or §1274 of the Code; and (iii) Purchaser shall be treated as the owner of the Escrow Amount and all interest and earnings earned from the investment and reinvestment of the Escrow Amount, or portion thereof, shall be allocable to Purchaser.

If the transaction is intended to qualify as a tax-free reorganization within the meaning of §368, the escrow should be structured to constitute permitted consideration. In general, an exchanging shareholder in a §368 reorganization may defer the recognition of gain only with respect to equity received in the exchange. If the right to an escrow or earn-out is considered a separate property interest (rather than the assets held in the escrow), the escrow may be considered property other than that which is to be permitted without the recognition of gain. The agreement might contain the following provision:

> **Example:** The holding of any shares of Issuer in escrow pursuant to this Agreement is intended to comply with the guidelines set forth for escrowed shares in Revenue Procedure 84-42, 1984-1 C.B. 521 and Rev. Proc. 77-37, 1977-2 C.B. 568. This Agreement shall be interpreted consistent with and, if necessary, adjusted to comply with that intent.

[8] Installment reporting is not permitted with respect to certain ordinary income assets including depreciation recapture. This provision is intended to allocate the installment note to those assets eligible for installment reporting pursuant to §453.

3. §1060 Allocation

a. General

If the transaction is structured as an asset acquisition that constitutes an ''applicable asset acquisition'' the agreement will likely address the allocation of the consideration (which includes the assumed liabilities) among the business assets acquired or sold. The purchaser and the seller may have adverse tax interests with respect to the allocation. As noted below, as a result of the 2017 tax act changes that permit the expensing of certain tangible personal property, the allocation of the purchase price and how the acquisition agreement addresses the allocation mechanics may take on a greater significance in the negotiations between the parties.

An example of a covenant providing for the allocations follows:

> **Example:** Seller shall prepare a schedule allocating the Purchase Price in accordance with section 1060 of the Code and the Regulations thereunder. Seller shall deliver such schedule to Buyer within ___ days after the Closing Date and shall permit Buyer ___ days to review and comment. Seller shall make such revisions to the schedule as are reasonably requested by Buyer within ___ days of receiving Buyer's comments, and the parties shall use reasonable efforts to resolve any disagreement with the schedule. In the event the parties agree to a schedule, Seller and Buyer shall file all Tax Returns consistent with such allocations and neither Seller nor Buyer shall take any tax position that is inconsistent with such allocation unless required by applicable law. Notwithstanding the foregoing, in the event that Buyer and Seller are not able to arrive at a mutually agreeable allocation, each of Seller and Buyer may adopt a separate allocation of the purchase price as such party shall determine, and each party may use its own separate allocation in filing its own Tax Returns.[9]

b. Liabilities

If the transaction is structured as an asset acquisition (including any ''deemed asset acquisition'') any assumed liabilities will give rise to an amount realized by the seller and should be treated as additional purchase price for purposes of determining the purchas-

[9] Changes resulting from the 2017 tax act may impact whether parties desire to go their own way. *See* Expensing of Certain Tangible Personal Property, discussed below.

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er's cost basis in the assets.[10] If the liabilities have not economically accrued the purchaser would ordinarily have an adjustment to the basis in its assets at such time as economic performance occurs.[11] Certain contingent liabilities or obligations may be more appropriately allocated to the purchaser and deducted rather than capitalized. These various liabilities should be identified as part of the due diligence process and as appropriate addressed in the allocation of the purchase price.[12]

c. Covenant Not to Compete

Whether structured as an asset acquisition, deemed asset acquisition, or stock acquisition, the parties may negotiate for a covenant not to compete with respect to certain key shareholders and employees. In general, any amount of purchase price allocated to the covenant not to compete will be recovered over a 15-year period. The recipient is subject to tax on such amounts as ordinary income, which in the case of an individual would likely be less favorable than capital gain. A purchaser of stock would be permitted an amortization deduction with respect to such amounts rather than including such amount in the basis of the purchased stock. Aside from the tax consequences with respect to the amount allocated to the covenant the value ascribed to such covenant may be relevant for purposes of determining damages if the covenant not to compete were breached.

d. Reporting

In the case of an applicable asset acquisition, if the parties agree in writing on the purchase price allocation or the fair market value of any assets, the parties are bound by such agreement unless the Secretary determines the allocation is inappropriate.[13]

4. Tax Characterization

a. General

The agreement may provide for a particular characterization of the overall transaction for federal tax purposes and may impose a covenant on the parties to report the transaction consistent with such characterization.

b. Examples

Plan of Reorganization: This Agreement is intended to constitute a ''plan of reorganization'' within the meaning of Treasury Regulation section 1.368-3(g). Each party hereto shall use its commercially reasonable efforts to cause the Merger to qualify, and will not knowingly take any actions or cause any actions to be taken which could reasonably be expected to prevent the Merger from qualifying, as reorganization within the meaning of section 368 of the Code.

Integrated Transaction: The parties intend and agree that, taken together, the Mergers, for U.S. federal income tax purposes, shall, consistent with Rev. Rul. 2001-46, 2001-2 C.B. 321, constitute a tax-free reorganization under section 368(a)(1)(A) of the Code and shall not maintain a position on their respective U.S. federal income tax returns or otherwise that is inconsistent therewith.

Partnership Interest Acquisition: Sellers and Buyers agree that for U.S. federal income Tax purposes, they will treat the sale of interests in the Target as resulting in the termination of Target pursuant to Rev. Rul. 99-6, 1999-1 C.B. 432, Sellers being treated as having sold interests in the Target, and Buyers being treated as having purchased all of the assets of the Target.

C. Representations

1. General

In general, representations speak to the condition of the asset, the business, or the business entity at the signing of the agreement and at the closing date. Tax representations serve three basic functions: (1) to provide a condition to closing where there is a signing and subsequent closing; (2) as a due diligence function to ascertain any known risks; and (3) to provide a basis for indemnification.

The representations should be crafted to reflect the structure of the acquisition, the objectives of the purchaser and seller (e.g., aggressive or friendly), and the risk allocation between them. Rarely will an extensive set of representations be greeted with enthusiasm by the party required to make them. One should be able to articulate the underlying purpose in terms of risk allocation and/or due diligence review of representations, as well as any other provisions of the agreement. Any provisions that are burdensome, that do not reflect the underlying risk allocation, or that do not serve a specific purpose will be poorly received by your corporate colleagues, your client, and the other party to the transaction. The purpose of the tax provi-

[10] Reg. §1.1001-2(a).

[11] Reg. §1.338-5(b)(2); §1.338-7.

[12] In general contingent liabilities are included in the tax basis of the acquired asset at such time as economic performance has occurred. *See Illinois Tool Works, Inc. & Subsidiaries v. Commissioner*, 117 T.C. 39 (2001), *aff'd*, 355 F.3d 997 (7th Cir. 2004) (contingent liabilities assumed by buyer were required to be capitalized in basis of purchased assets). If the assumed liability is a seller's obligation to perform on certain contracts, e.g., deferred revenue, the tax consequences to the buyer are unclear. *See James M. Pierce Corp v. Commissioner*, 326 F.2d 67 (8th Cir. 1964); New York State Bar Association Tax Section Report 1281 — Treatment of Deferred Revenue by the Buyer in Taxable Asset Acquisitions (Jan. 7, 2013).

[13] §1060(a); *See Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967).

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sions should not be to demonstrate the cleverness of the draftsperson.

Representations may be qualified by ''knowledge'' or subject to a ''materiality'' threshold, which may or may not serve to allocate the risk of unknown pre-closing tax liabilities between the parties. Representations are generally subject to a disclosure schedule, which may list exceptions to cause the representation to be accurate. Such a disclosure schedule will preclude a claim for indemnification for a breach of a representation. However, as described below, a separate tax indemnification for pre-closing taxes of the seller or the entity may indemnify the purchaser even if such items were disclosed or limited by knowledge or materiality. Further, the disclosure of an exception to a particular representation may result in that item being excluded from insurance coverage in a transaction where the parties purchase representation and warranty insurance.

2. Principal Representations

a. Tax Returns Filed and Taxes Paid

This representation is intended to cover any tax liability of the entity in an entity acquisition (including liability with respect to taxes of a consolidated or combined group of which the entity was a member) as well as the possibility of any successor liability in an asset type acquisition.[14] In an asset acquisition a seller may take the position that it need not make representations as to whether it has filed its tax returns and paid its taxes as any such liabilities would generally not attach to the assets and that any representations should be limited to the assets acquired. The representation only speaks to taxes and tax returns that are due as of the date of the representation and will not cover ''straddle period'' taxes or ''straddle period'' returns or return periods that end as a result of the closing.

> **Representation:** Target[15] has filed or caused to be filed, with the appropriate agencies, on a timely basis, all Tax Returns required to be filed, and has paid or caused to be paid, all Taxes due and owing, whether or not reflected on such Tax Returns. Such Tax Returns are true, accurate and complete [in all material respects].

The acquisition agreement may provide a separate representation regarding withholding taxes.

> **Representation:** Target has timely and properly withheld and paid all Taxes required to have been withheld and paid in connection with any amounts paid or owing to any employee, independent contractor, creditor, stockholder or other third party.

b. Successor Liability

A representation that the acquired entity is not liable as a successor with respect to any party as a result of joining in the filing of a consolidated or combined return or as a transferee under contract or at law is a common representation. In an asset acquisition, as applicable, the representation would be with respect to the acquired assets or any successor liability that may arise on the transaction.

> **Representation:** Target (i) is not and never has been a member of an ''affiliated group'' within the meaning of section 1504 of the Code and (ii) does not have any liability for the Taxes of any person under Treasury regulation 1.1502-6 (or similar provision of state, local or non-U.S. Law) as a transferee or successor, by contract or otherwise.

c. Tax Audits

A representation regarding past or pending tax audits is a common representation and would serve primarily a ''due diligence'' function.

> **Representation:** No Tax audits or administrative or judicial Tax proceedings are pending or being conducted [or threatened] with respect to the Target. Target has not received any [written] (i) notice indicating an intent to open an audit or other review (ii) request for information related to [material] Tax matters; or (iii) notice of deficiency or proposed adjustment for any amount of Tax proposed, asserted, or assessed by any Tax authority against the Target.

d. Other Representations

Statute of Limitations

> **Representation:** There is not in force any waiver or agreement for any extension of time for the assessment or payment of any [material or income] Tax assessment or deficiency of or with respect to Target.

[14] The definition of taxes should be carefully considered and would normally include interest and penalties. The definition of tax return should likewise be considered as to scope and purpose and would likely include estimated tax filings and information returns and may encompass schedules and items not normally considered a tax return.

[15] The defined term to reference the acquired entity (e.g., Target) must be drafted to encompass as appropriate all members of the relevant group of business entities that are to be acquired and any successor entities. A representation intended to address a successor (or successor liability) or a tax borne by a party but imposed on the relevant asset or other third party (withholding) should be drafted to address the appropriate scope of the representation and related allocation of risk.

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Reportable and Listed Transactions

> **Representation:** Target has not participated (within the meaning of Treasury Regulations §1.6011-4(c)(3)) in any ''reportable transaction'' within the meaning of Treasury Regulations §1.6011-4(b)(1)-(4) or similar provision of state, local or foreign law. Target has disclosed on its Tax Returns all positions taken therein that would give rise to a substantial understatement of Tax within the meaning of section 6662 of the Code (or any similar provision of state, local, or foreign Law).

Returns Furnished

> **Representation:** True, correct and complete copies of all Tax examination reports and statements of deficiencies assessed against, or agreed to, with respect to the Target with any Tax Authority have been delivered to Purchaser.

> **Representation:** True, correct and complete copies of all [material / income] Tax Returns with respect to which the statute of limitations has not expired have been delivered to the Purchaser.

Tax Liens

> **Representation:** There are no encumbrances or liens on any of the assets of Target that arose in connection with any failure (or alleged failure) to pay any Tax.

Tax Reserves

The existence of reserves to pay pre-closing taxes would generally be relevant only if such reserves were reflected as an equity adjustment or purchase price adjustment and there was not a mechanism to otherwise address pre-closing taxes.

> **Representation:** The amount of any Tax reserves (excluding any reserve for deferred Taxes) for all Taxable periods (or portion thereof) ending on or before [Closing Date] is or will be sufficient to fully pay any such Taxes up to and including the [Closing Date].

Compensation Agreements

> **Representation:** Target has not entered into any compensatory agreements with respect to the performance of services which payment thereunder would result in a nondeductible expense to Target pursuant to section 162(m), section 404, section 409A, section 280G of the Code (determined without regard to section 280G(b)(4)), or an excise tax to the recipient of such payment pursuant to section 4999 of the Code.

Improper Payments

As noted more fully below, the 2017 tax act further limited the deduction with respect to certain payments made to governmental authorities.

> **Representation:** Target has not made any payments that are not deductible pursuant to section 162(c) or section 162(f).

Tax Allocation or Tax Sharing Agreements

Commercial transactions often include provisions that address liability for property, sales and use tax as well as other taxes. As such, a representation with respect to tax sharing agreements may carve out from is scope ordinary course contracts.

> **Representation:** Target is not a party to or bound by any Tax indemnity sharing or allocation agreements or arrangements with any Person [other than in the ordinary course where such provision is ancillary to that agreement].

Accounting Methods

> **Representation:** Set forth on schedule ____ are all [material accounting] elections that will apply to Target or the Target assets following the Closing.

Tax Exempt Use Property

> **Representation:** None of the property owned by Target is tax-exempt use property within the meaning of section 168(h) of the Code.

Partner in a Partnership

> **Representation:** Target is not a partner in any joint venture, partnership or other arrangement or contract that could be treated as a partnership for federal income tax purposes.

Deferred Income

The business entity may have received deposits or other amounts that it has not reflected in its taxable income under its method of accounting. A purchaser may be required to include such amounts in income without receipt of the revenue. The tax with respect to such deferred income would not generally be attributable to a pre-closing tax period. The issue can arise in both an entity or asset type acquisition.

> **Representation:** Target will not be required to include any material item of income in, or exclude any material item of deduction from,

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taxable income for any taxable period (or portion thereof) ending after the Closing Date as a result of any: (i) change in method of accounting for a taxable period ending on or prior to the Closing Date **[or change in method of accounting required as a result of the acquisition]**; (ii) ''closing agreement'' as described in Code section 7121 (or any corresponding or similar provision of state, local, or foreign Income Tax Law) executed on or prior to the Closing Date; (iii) intercompany transaction or any excess loss account as defined in Treasury Regulations sections 1.1502-13 and 1.1502-19 (or any corresponding or similar provision of state, local, or foreign Income Tax Law) entered into or created on or prior to the Closing Date; (iv) installment sale or open transaction disposition made on or prior to the Closing Date; (v) cash method of accounting or long-term contract method of accounting utilized prior to the Closing Date; or (vi) prepaid amount received on or prior to the Closing Date (vii) election under Code §108(i) or **(viii) application of section 965 of the Code (including any election under section 965(h) of the Code)** .[16]

Permanent Establishment

Representation: Target is not subject to Tax in any jurisdiction, other than the country in which it is organized, by virtue of having, or being deemed to have, a permanent establishment, fixed place of business, or similar presence.

Tax Attributes

A representation as to tax attributes would give rise to damages in a post-closing taxable period if breach of such representation gives rise to damages. Depending on whether such attributes are ''priced'' into the transaction, the seller will likely resist such representation.

Representation: Except as a result of the transactions required by this Agreement, none of the Company's Tax Attributes are subject to any limitations, reductions, or diminutions in value as a result of section 362(e), section 269, section 382, section 383, section 384, any Treasury regulations issued pursuant to section 1502 or any corresponding or similar provisions of state, local, or non-U.S. law). Set forth on schedule ___ as of the end of the Taxable period immediately preceding the Closing Date is the aggregate tax basis of the Target's assets, any regular or AMT net operating loss carry forwards,[17] any foreign tax credit carryforward or any other credit carryforward.

Representation: The aggregate net operating losses of the consolidated group of which Target is the common parent that are apportioned to each of the subsidiaries under Treasury Regulation §1.1502-21 and that will be carried forward from the Tax period ending on the Closing Date to Buyer's federal income tax consolidated group for the Tax period that includes the Closing Date will be no less than the amounts set forth on Schedule ___, no portion of any such net operating loss carryforward will expire within the next ___ years, and no such net operating loss carryforward is subject to any limitation under section 382 (other than by reason of the transactions contemplated by this Agreement).

Representation: There are no tax credits, grants or similar amounts that are or could be subject to claw back or recapture as a result of (A) the transactions contemplated by this Agreement, or (B) a failure by any Target to satisfy one or more requirements on which the credit, grant or similar amount is or was conditioned.

Tax Exempt Financing

Representation: None of the assets of the Target have been financed with or directly or indirectly secures any debt the interest on which is tax-exempt under section 103(a) of the Code. The Target is not a borrower or guarantor of any outstanding industrial revenue bonds, and the Target is not a tenant, principal user or related person to any principal user (within the meaning of section 144(a) of the Code) of any property that has been financed or improved with the proceeds of any industrial revenue bonds.

Transfer Pricing

Representation: Target and each affiliate is in compliance with all applicable transfer

[16] See discussion below as to the 2017 tax act imposition of a ''transition tax'' on certain U.S. shareholders with respect to their share of untaxed earnings of certain foreign corporations pursuant to §965.

[17] As described more fully below, the 2017 tax act repealed the corporate alternative minimum tax and provides for a cash refund of prior AMT credits in certain circumstances. *See* §53(e). If the target entity has AMT credit carryover of any significance the parties will likely provide a mechanism to value those attributes and provide indemnification with respect to that value.

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pricing laws and regulations (including section 482 of the Codes and its corresponding Treasury regulations), including the maintenance of contemporaneous documentation substantiating the transfer pricing practices and methodology of the Target and each affiliate. All deliveries, services and other transactions between Target and any affiliate have been and are on arm's length terms and are performed accordingly.

Power of Attorney

Representation: No power of attorney with respect to any taxes has been executed or filed with any taxing authority by or on behalf of the Target that will remain outstanding following the closing.

Section 355

Representation: Neither the Target nor any Target subsidiary has constituted a ''distributing corporation'' or a ''controlled corporation'' in a distribution intended to qualify for tax-free treatment under section 355 of the Code [within the last [__] years].

Unclaimed Property

The inclusion within the tax representations of liability to a state with respect to unclaimed property or escheat laws can be an issue between the purchaser and seller counsel. Although the parties often argue about whether the liability is a ''Tax,'' the real point for negotiation is how the risks with respect to that liability are allocated in the acquisition agreement. For example, tax representations are typically ''Fundamental Representations'' and have a dollar one indemnity or are the subject of a specific tax indemnification. Inclusion of unclaimed property within the definition of Tax in such case would result in dollar one indemnity, which may or may not reflect the allocation of risk. If the risk of escheat liability is a non-fundamental representations such amounts would typically be subject to indemnification limits (i.e., basket or deductible).

Representation: Target has either (i) filed or caused to be filed with the appropriate Governmental Authority all unclaimed property reports required to be filed and have remitted to the appropriate Governmental Authority all unclaimed property required to be remitted, or (ii) delivered or paid all unclaimed property to its proper recipient.

Tax Holidays and Exemptions

Representation: The Target is in compliance in all material respects with all terms and conditions of any Tax exemption, Tax holiday or other Tax reduction agreement or order of a Taxing Authority.

Private Letter Rulings

Representation: There is no private letter ruling from the IRS or comparable ruling from any other Taxing Authority addressed to the Target.

Government Grants

Representation: The Target has not applied for, or received, any grants or other subsidies of any Government or public entity or authority or similar entity or authority.

FIRPTA

In general, a representation as to the status of an entity that it is not a U.S. real property holding corporation does not protect the purchaser, and the parties will require as a closing condition that the relevant filing be made by the company to the IRS certifying as to the corporation's status. As an alternative, a purchaser may rely on an affidavit that the seller is a U.S. person (as provided in the applicable regulations).

Representation: Target is not, nor has it been during the applicable time period set forth in section 897(c)(1)(A)(ii) of the Code, a United States real property holding corporation within the meaning of section 897(c)(2).

Section 367 Transactions

Representation: The Target is not a party to a gain recognition agreement under section 367 of the Code.

Overall Foreign Loss

Representation: The Target has not incurred (or been allocated) an ''overall foreign loss'' as defined in section 904(f)(2) of the Code which has not been previously recaptured in full as provided in sections 904(f)(1) and/or 904(f)(3) of the Code.

Controlled Foreign Corporation

As discussed below, the definition of a controlled foreign corporation (CFC) and U.S. shareholder have been expanded by the 2017 tax act. The change will likely be reflected in the acquisition agreement and additional due diligence will be necessary where the issue is or may be significant.

Representation: The Target is not a stockholder of (i) a ''controlled foreign corporation'' as defined in section 957 of the Code (or any similar provision of foreign, state or

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local Law) or (ii) a ''passive foreign investment company'' within the meaning of section 1297 of the Code.

Specified Foreign Corporation

Representation: Target is not a stockholder of a ''specified foreign corporation'' as defined in Section 965(e) of the Code (or any similar provision of state, local or foreign Law).

D. Covenants

1. General

In general, the covenants in the acquisition agreement are obligations imposed on the parties to take or refrain from taking certain actions following the execution of the agreement. The covenants may relate to the conduct of the business following the signing of the agreement and prior to its closing as well as actions following the closing. A covenant may be limited by a reasonable efforts standard. Any breach of a covenant would generally be subject to the indemnification provisions but may be subject to a different period for survivability and have different monetary consequences, e.g., deductible or limits.

2. Pre-Closing Covenants

Pre-closing tax covenants ordinarily require the seller to conduct the business consistent with past practices. Typical covenants limit the seller or the entity from making any ''material'' elections or amending returns without consent of the purchaser.

Example: Except (i) as required by applicable Law, or (ii) with the prior written consent of the Buyer (which consent shall not unreasonably conditioned, withheld or delayed with respect to any action or transaction taken or entered into in the ordinary course of business consistent with past practice), during the period commencing on the date hereof and ending at the earlier of the Closing Date and the termination of this Agreement in accordance with its terms, the Company will not take any action or enter into any transaction that would result in any of the following:

(xvii) any making of, or any change in, any Tax election, any change in any tax accounting method, filing an amended return, surrendering any right to claim a refund, extending the statute of limitations (other than in the ordinary course) or any settlement of any claim for Taxes.

3. Closing (Post-Closing) Covenants

Closing covenants and post-closing covenants ordinarily relate to tax matters that arose at or following closing. The delivery of any tax related documents as a condition to closing is a covenant that should be satisfied at or prior to closing (alternatively, the delivery could be waived). Post-closing tax covenants are a common feature of acquisition agreements and often address the following areas:

a. Transfer Taxes

Both an asset acquisition and the acquisition of a business entity may give rise to non-income transfer taxes. Regardless of the party that is obligated under applicable law to pay any such tax the acquisition agreement will often allocate such tax between purchaser and seller.

Example: All transfer, documentary, sales, use, stamp, registration and other such Taxes and all conveyance fees, recording charges and other fees and charges (including any penalties and interest) incurred in connection with consummation of the transactions contemplated by this Agreement shall be paid [50%] by the Buyer and [50%] by the Seller when due, regardless of whether such Taxes are technically owed by Seller or Buyer. [Buyer/Seller] will, at its own expense, file all necessary Tax Returns and other documentation with respect to all such Taxes, fees and charges, and if required by applicable Law, [Buyer/Sellers] will join in the execution of any such Tax Returns and other documentation.

b. Pre-Closing and Straddle Tax Periods

The closing date may cause the taxable period of the relevant target return to close or alternatively the return may cross over or straddle the closing date (''straddle period returns''). Depending on the acquisition structure and the particular tax at issue either the purchaser or the seller may be obligated as the owner of the asset or the entity to prepare and file any return and pay any taxes with respect to a pre-closing or straddle period. In general, in pure asset acquisition, taxes that straddle a closing period are typically limited to real or personal property taxes as the buyer takes the property subject to the obligation to pay taxes related to ownership of the relevant asset. Such taxes are generally allocated among the parties based on the number of days the asset is owned by the seller/purchaser. Issues can arise if the taxes are due in advance or arrears. If the acquisition results in a revaluation of the property for such purposes, the purchaser should take such additional tax into account in its overall consideration of the tax aspects of the transaction. The acquisition agreement should address these issues.

As noted below, absent a §338(g) election, the acquisition of a foreign corporation may not close the

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tax year and any tax that is required to be included in the income of a U.S. Shareholder for federal income tax purposes may be imposed on the purchaser. Further, the tax period for purposes of determining any tax imposed under foreign law would likely not close regardless of any U.S. tax election and as such that tax liability would be a tax of the acquired entity and treated as a ''straddle period tax.''

Filing and Preparation of Returns

The issues for consideration include which party is responsible for preparing the return (in cases where the return is due after closing), any review rights, the time for such review, and whether comments are required to be included. If the acquisition causes the taxable period to end, the seller typically prepares the income tax return with review rights by the purchaser.[18] If the acquisition does not cause the taxable period to end and the purchaser is responsible for filing the applicable return, the purchaser would typically prepare such return with review rights to the seller to the extent the seller had indemnification responsibility for the pre-closing portion of such taxable period.

The preparation and filing responsibilities for the tax returns may be different depending on whether the tax is an income tax or a non-income tax. The agreement may require the purchaser to prepare the return consistent with the seller's past practices to the extent the tax positions are at a sufficient level, e.g., ''substantial authority,'' ''more likely than not,'' etc. The agreement may also include the specific tax treatment of certain transaction related matters, including whether the parties agree that the target's tax year will close and how transaction expenses should be reported.

Payment of Taxes

The tax covenants typically address the parties' obligation to pay to the purchaser any portion of the taxes due (or refund any taxes) to the extent such taxes are attributable to a pre-closing tax period (including any straddle period). If the transaction is intended to allocate pre-closing taxes to the seller and post-closing taxes to the purchaser, the tax will need to be allocated in the case of any ''straddle period'' return. The allocation would typically be a closing of the books method for all taxes other than period taxes, which would be allocated based on the number of days in the taxable year pre- and post-closing. If the purchaser is obligated to pay to seller any pre-closing taxes, such amounts should be reduced by those taxes that were taken into account in any equity or working capital adjustment in the calculation of the purchase price. Similarly, any refunds should be for the seller's benefit only to the extent such refund was not taken into account as an asset in the calculation of any working capital adjustment.

If there are change of control payments that give rise to a deduction in either a ''pre-closing'' or ''post-closing'' taxable period, the acquisition agreement should address the party that will obtain the tax benefit of such payments and, as appropriate, allocate such benefit among the purchaser and the seller.

c. Amended Returns and Tax Refunds

The agreement may address the purchaser's ability to amend a previously filed tax return with respect to a pre-closing period or file a return in a jurisdiction where the seller had not previously filed with respect to pre-closing tax periods. Typically, if the seller is responsible for pre-closing tax periods, the return can only be filed with the seller's consent and to the extent required by law. Any tax refunds with respect to such amended returns would generally be for the seller's benefit if the seller is responsible for the taxes of pre-closing periods.

If the acquisition is of a corporation, the agreement should address any refunds arising from the carry back of losses generated in a post-closing period into a pre-closing period. Note, however, that the 2017 tax act has restricted the ability to carry back losses, as discussed below.

d. Post-Closing Tax Audits

If the seller (or purchaser) has an indemnification obligation with respect to pre-closing tax periods (or otherwise), the acquisition agreement should address the responsibilities of the parties in the event of an audit that could give rise to an indemnification claim. As a general rule the party that is responsible for indemnification will seek to control the contest with review rights and cooperation obligations on both parties to the agreement. The acquisition agreement may provide a special tax claims section or treat tax claims under the general third party claims section.

Note: The parties may desire the commencement of an audit to toll any period for claims under the indemnification provisions.

e. Record Retention/Cooperation

Depending on the acquisition structure and what business records were acquired as part of the acquisition, the acquisition agreement should provide for the retention of the necessary tax records to prepare and file returns and contest any audits. The acquisition agreement should provide for reasonable cooperation in providing information. Depending on the acquisi-

[18] In general, a tax return must be signed by an officer of the entity or duly authorized party. The agreement may wish to address this issue independent of how the agreement allocates responsibility for preparing and filing the return.

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tion structure, the parties may execute a ''transition services agreement'' that addresses the seller's obligations to assist with the preparation and filing of the post-closing tax returns. As an alternative to representing information regarding target's tax attributes a covenant may be requested that the seller provides certain tax information.

f. Purchase Price Allocation

In the case of an applicable asset acquisition within the meaning of §1060, the agreement will generally provide for an allocation of the consideration among the acquired assets (including any covenant not to compete). Such allocation will generally be binding on the parties.[19]

g. Termination of Agreements

The acquisition agreement also typically provides for the termination of any tax sharing agreements that impose an obligation on the target entity with respect to any post-closing periods. In addition, the agreement may require the revocation of any powers of attorney granted with respect to the target in favor of any other person. A purchaser may request that all intercompany agreements between related entities be cancelled or terminated at or prior to closing to avoid collateral tax consequences associated with cancellation or termination of such agreements, e.g., withholding tax obligations, cancellation of indebtedness, or otherwise. The scope of the covenant should be reviewed to ensure the agreements can be revoked. The parties may negotiate to a ''best efforts'' standard.

> **Example: Covenant — Powers of Attorney.** Target or Buyer shall terminate any powers of attorney granted by Target prior to the Closing relating to Taxes and such powers of attorney will be of no effect following the Closing.

> **Example: Covenant — Tax Sharing Agreements.** Any tax allocation or sharing agreement or arrangement, whether or not written, that may have been entered into by Seller on the one hand, and the Target, on the other hand, shall be terminated as to the Target and Seller as of the Closing Date, and no payments which are owed by or to the Target pursuant thereto shall be made thereunder. After the Closing Date, neither the Target, on the one hand, nor Seller, on the other hand, shall have any further rights or liabilities thereunder with respect to the other party or parties.

> **Example: Covenant — Elimination of Intercompany Obligations.** Seller shall take such action as is necessary to eliminate any intercompany payable or receivable between (i) Seller (or any member of Seller Group) and Target (or any member of the Target Group) and (ii) Target (or any member of the Target Group) and any other member of the Target Group.

h. Other

Elections

§338(h)(10) Election. If the transaction is eligible for a joint election under §338(h)(10) and the parties have agreed to make the election, the agreement should provide the mechanics of the election, including the allocation of the purchase price.[20] The seller may seek indemnification for any incremental taxes of such election, require a gross-up of the incremental tax associated with the election, or require any benefits resulting from the election to be shared.

Consolidated Return Elections. A number of special elections are relevant if the target entity is a member of a consolidated return and are best addressed in the acquisition agreement or the parties may have unexpected tax consequences. For example, if a subsidiary is sold at a loss and such loss is ''duplicated'' in the assets of the subsidiary, absent an election to reduce the stock basis prior to the loss the acquired entity may be required to reduce the basis in its assets (See Reg. §1.1502-36(d)). The following covenant may be used to address this possibility:

> **Covenant.** Seller shall, to the extent necessary to prevent the application of Treasury Regulation section 1.1502-36(d) to reduce the Tax attributes of Target, at the time and in the manner provided at Treasury Regulations section 1.1502-36(e)(5), to make the election described in Treasury Regulations section 1.1502-36(d)(6) to reduce Seller's basis in Target stock.

Tax Free Transactions

The purchaser's actions with respect to the target corporation can affect the qualification of a transaction as a reorganization pursuant to §368. Accordingly, the acquisition agreement may include a covenant on the purchaser and the entity in such a circumstance.

> **Covenant.** Neither the Issuing Corporation nor the Target Corporation will take or cause

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[19] *See* §1060 Allocation, above, for more details and examples.

[20] If a §338(h)(10) election is not available, a §336(e) election may be utilized. The §336(e) election is similar to the §338(h)(10) election in that both result in a deemed asset sale; however, certain mechanics, including how to make the election and when it can be made, differ.

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to be taken any action, or agree to take or cause to be taken any action, that would prevent the Merger from qualifying as a reorganization under the provisions of section 368(a) of the Code.

Covenant. Buyer represents and covenants, solely for tax purposes, now, and as of the Closing Date, the following: (i) prior to the Merger, it will be in ''control'' of merger corporation within the meaning of section 368(c) of the Code; (ii) it has no present plan or intention to, and will not for a period of 24 months following the Closing, liquidate Target or merge Target with or into another corporation, or sell, distribute or otherwise dispose of the Target stock, except for transfers of stock described in section 368(a)(2)(C) of the Code or Treasury Regulation section 1.368-2(k)(2), or cause the Target to sell or otherwise dispose of any of its assets except for dispositions made in the ordinary course of business or transfers described in section 368(a)(2)(C) or Treasury Regulation section 1.368-2(k)(2); and (iii) that it presently intends to and will for a period of at least [24 months] following the Closing continue the Target's historic business or use a significant portion of Target's business assets in business in a manner that satisfies the continuity of business enterprise requirement set forth in Treasury Regulation section 1.368-1(d). Buyer and Seller each covenant that they will not take any action following the Closing that would result in the Target failing to hold ''substantially all'' of its assets within the meaning of section 368(a)(2)(E) of the Code.

E. Indemnification

1. General

The agreement may contain a provision providing for the indemnification of the purchaser in the event of a breach of the representations or the covenants in the agreement. The indemnification may have an overall cap on the seller's indemnification obligation and may be limited to claims over a minimum threshold amount (deductible). The indemnification may survive for a limited period of time or for the applicable statute of limitations.

a. Representations and Warranties

The agreement may limit the purchaser's recovery under an indemnification solely to losses arising from the breach of the applicable tax representations. In such case any qualifications of those representations as to knowledge or materiality may serve to limit a purchaser's recovery for pre-closing tax liabilities of the acquired entity or the acquired assets. Furthermore, if an item is set forth on a disclosure schedule the item may be outside the scope of the indemnification provision. A representation, however, in certain instances may be broader than the liability for pre-closing taxes and cover a post-closing tax liability to the extent the inaccuracy of the representation affects that tax period.

b. Pre-Closing and Closing Taxes

The indemnification section may provide, in addition to or as a substitute for, a specific tax indemnity for any pre-closing tax liabilities imposed on the acquired entity or the acquired assets. While such provision may provide protection for taxes arising in a pre-closing period, it generally would not provide a recovery with respect to a post-closing tax period, e.g., a net operating loss was reduced or eliminated, or the subject property was subject to a longer depreciable period as tax-exempt use property. A specific tax indemnity may also provide for indemnification with respect to any taxes arising out of the transactions contemplated by the agreement. Some sellers seek to carve out all post-closing taxes from an indemnity, though this may not be appropriate, depending on the item under consideration and the underlying ''deal'' struck by the parties.

Indemnification: Seller shall indemnify the Buyer for Target's Taxes or its liability, if any (for example, by reason of transferee liability or application of Treasury regulation section 1.1502-6) for Taxes of others (i) for any Tax period (or portion thereof) ending on or before the Closing Date, and (ii) as a result of the transactions contemplated by this Agreement (except to the extent and in such amount as such Taxes are reflected as an accrued liability and taken into account in the determination of the Purchase Price). Such Tax indemnification obligation shall be in addition to, but not duplicative of, Seller's indemnification obligation with respect to a breach of a Tax Representation or Tax Covenant contained in the general indemnification section of this Agreement.

c. Buyer Acts

The seller may seek to limit the scope of the indemnification by excluding certain acts of the purchaser following the acquisition. Such a limitation may be limited to exclude those acts specifically provided for under the terms of the agreement or as otherwise required by law. While such a provision may seem eminently reasonable, such a provision should be care-

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fully constructed as it may serve to alter the tax risks and responsibilities in a manner not contemplated by the parties.

> **Indemnification:** ''Buyer Tax Act'' means (a) an action of Buyer, the Company or any Subsidiary occurring on the Closing Date but after the Closing that is not in the Ordinary Course and is not otherwise expressly provided for in this Agreement; and (b) without the consent of Seller, which consent shall not unreasonably withheld, conditioned or delayed, (i) amending, re-filing or supplementing any Tax Return of the Company or any Subsidiary for a Pre-Closing Tax Period or Straddle Period except as otherwise permitted by this Agreement, (ii) filing any Tax Return of the Company or any Subsidiary for a Pre-Closing Tax Period or Straddle Period in any jurisdiction if the Company or such Subsidiary did not file a comparable Tax Return involving similar Tax items in such jurisdiction in the immediately preceding taxable period, (iii) initiating any voluntary disclosure agreement or program, or similar disclosure process, with any Tax Authority regarding any Tax or Tax Return of the Company or any Subsidiary for a Pre-Closing Tax Period or Straddle Period, and (iv) making any Tax election pursuant to section 338(g) of the Code (or any corresponding provision of state, local or foreign Law) with respect to the Company or any Subsidiary.

2. Character of Payments

The agreement will likely provide that any payments under the indemnification provisions are characterized as an adjustment to the purchase price to the extent permitted by law. Such a provision is intended to avoid the receipt of the indemnification payment as additional income.

> **Covenant:** For all Tax purposes, all indemnification payments under this Agreement shall be treated by the parties as adjustments to the Purchase Price to the extent permitted by applicable Law.

3. Tax Benefit/Tax Detriment

The agreement may provide that in determining any loss that is subject to indemnification, the amount of the loss is reduced by any tax benefit to the indemnified party. A frequently negotiated point is whether the benefit is in actual dollars when realized or is of a present value amount at some assumed tax rate, discount rate, and utilization.

If the item does not give rise to an immediate deduction, or the indemnified party is in a loss position, an ''actual amount'' when and if realized can hold the payment obligation open for a number of years. However, a reduction in an otherwise indemnified loss when payment of such amount does not provide a current benefit may seem unfair as well. If the agreement provides for the tax benefit to be taken into account in the calculation of loss one can expect that the other party to the agreement will request that losses include any tax detriment with respect to the receipt of the indemnification payment.[21]

F. Closing Conditions and Deliverables

1. General

The agreement may provide that certain conditions must be satisfied in order for one or both parties to close the transaction. A common closing condition would be that the representations and warranties be true, correct, and complete as of the closing. Such a closing condition will likely be qualified that such failure of the accuracy of the representations be material to the transaction as a whole. The closing could be conditioned on the receipt of an opinion of counsel as to the tax qualification of the transaction where such qualification is fundamental to the transaction. The delivery of certain certificates and related documents may be a closing deliverable rather than a condition to closing.

A covenant that requires certain closing ''deliverables'' could be either (1) a condition to the closing, the failure of which would be grounds for not consummating the transaction, or (2) a covenant that would not prevent the closing, but as with any covenant, could give rise to damages as a result of such failure.

2. Representations and Warranties

If the closing is conditioned on the accuracy of the representations, the failure of the tax representations to be true at closing (subject to any applicable overall level of materiality) would permit the purchaser to avoid closing.

3. Tax Specific — Examples

a. FIRPTA Certificates

If the transaction is an asset acquisition in which one or more of the assets is an interest in U.S. real

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[21] If the transaction is treated for federal income tax purposes as an asset or deemed asset acquisition, an adjustment to the purchase price will reduce the basis of the acquired property; the purchaser's payment of the item generally would be capitalized to the asset and in such case no tax benefit to the purchaser. If the transaction were the acquisition of stock, presumably the amount of the indemnity payment would be deemed a contribution to the corporation and deductible or capitalized by the corporation with a corresponding impact on the stock basis. The tax benefit or detriment of such payment requires a more complicated analysis.

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property, the purchaser will want a certificate of non-foreign status to avoid the potential for a withholding obligation. If the transaction is the disposition of stock in a domestic corporation, the purchaser will likewise want a certificate of non-foreign status or otherwise follow those necessary procedures to establish the corporation is not a U.S. real property holding company.

> **Example: FIRPTA Certificate.** Buyer shall have received a certificate, duly completed and executed pursuant to sections 1.897-2(h) and 1.1445-2(c) of the Treasury Regulations, issued by Target, certifying under penalties of perjury that an interest Target is not a United States real property interest within the meaning of Section 897 of the Code, together with proof of mailing the required notice to the IRS.

b. Tax Clearance Letters

The agreement may provide as a closing deliverable evidence that the transferor is not subject to any taxes that could give rise to successor liability to the purchaser. Such a ''tax clearance certificate'' would most often arise in an asset acquisition where state law may impose successor liability on the purchaser of assets.

c. Tax Opinion

The agreement may have as a condition to closing that the parties have received an opinion of tax counsel as to the character of the transaction for federal income tax purposes. Such a condition would be most common where the tax consequences of the transaction are paramount to the transaction, e.g., the transaction qualifies as a reorganization pursuant to §368. If an opinion is a condition to closing the parties should consider whether a neutral party may be requested to provide an opinion where a change in economic circumstances unrelated to the tax treatment may affect one of the parties interest in closing the transaction.

> **Example:** (d) Tax Opinion. Seller shall have received an opinion of Seller's Counsel (or, if Seller's Counsel is unable to deliver such an opinion, of nationally recognized counsel selected by mutual agreement of the parties or failing such agreement pursuant to the procedures set forth in section ___ hereof), dated as of the Closing Date, to the effect that, on the basis of certain facts, representations and assumptions set forth in such opinion, the [Transaction] will qualify for the [Intended Tax Treatment].

d. IRS Forms W-9 or Applicable W-8

The agreement may have as a closing deliverable evidence of the status of any shareholders and exemption from withholding.

G. Other

1. Definitions

The agreement will likely contain an extensive set of definitions that will broaden or narrow the operative provisions of the agreement and must be carefully reviewed. In particular, certain definitions are more applicable to the tax aspects of the transaction and will affect the allocation of the parties' responsibilities for taxes under the agreement.

a. Taxes

The definition of taxes is broad and generally includes any associated interest or penalties. In general, the definition would be limited to impositions by governmental authorities. The definition often includes an obligation for taxes of a third party by way of contract or successor. The definition may also include an obligation under a state ''escheat'' statute e.g., unclaimed property.

b. Tax Returns

The definition of Tax Return is another commonly defined term. The definition could be limited to the returns filed with the relevant governmental authority or it may be more broadly defined to include schedules and workpapers. Tax Returns usually include amended returns, so care should be paid to how the term is used in any tax return preparation covenants.

c. Other

Other common definitions found in acquisition agreement that more specifically relate to taxes include income taxes, non-income tax returns, straddle period taxes, pre-closing taxable periods, and post-closing taxable periods, and can have an important role in the definition of working capital.

VI. 2017 TAX ACT: EFFECT ON THE AGREEMENT

A. General

As more fully discussed herein, a number of the changes made by the 2017 tax act could expose a purchaser of a corporation or other business entity to historic tax liabilities of the target entity. As a result, the tax provisions of the acquisition agreement will require greater focus on due diligence through representations and indemnification or other contractual protection (e.g., representation and warranty insurance) to address the risks of contingent tax liabilities.

The full impact of the 2017 tax act will undoubtedly take a significant amount of time to be fully absorbed and reflected in acquisition structures. Nevertheless, provisions of the 2017 tax act and their likely

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impact on acquisition structure and the related acquisition agreement are set forth in the discussion that follows.

B. Impact on M&A Agreement & Related Due Diligence

1. General

The effect of the 2017 tax act on acquisition structure will depend on the tax profile of the purchaser and seller and the tax attributes of the target entity. The structure as a stock acquisition or asset acquisition and the financing of the acquisition will be impacted by a number of factors, principal of which are: (1) the corporate rate reduction, (2) the 100% expensing of tangible personal property, (3) limitations on the use and carryback of net operating losses, and (4) the characterization of gain or loss as ordinary or capital to the seller. The acquisition structure utilized by the purchaser will be affected by those factors as well as the interest limitations applicable to ''business interest'' and the potential availability of the §199A deduction.

Any cross-border aspects of the transaction will be significantly impacted by the 2017 Tax Act changes to the international provisions with respect to both inbound and outbound investment and are briefly described below.

The effect of the 2017 tax act changes on an acquisition structure and the related financing will depend on the particular characteristics of the purchaser and the target entity or seller. The lower tax rate applicable to ''C'' corporations may affect the choice of entity of business entity with a result of more ''C'' corporation target entities. The lower rate may reduce the amount a ''C'' corporation purchaser is willing to pay for any favorable tax attributes, such as net operating losses or change of control payments. The lower corporate rate and interest deduction limitations may reduce leverage or cause leverage to be incurred in taxing jurisdictions with a higher effective rate.

2. Rate Reduction

a. General

The tax rate applicable to individual taxpayers was reduced from 39.6% to 37% while the maximum rate applicable to long term capital gains remained at 20%. The 3.8% tax rate on net investment income was retained by the 2017 tax act. The tax rate applicable to C corporations was reduced from a maximum rate of 35% to 21%. The 2017 tax act repealed the corporate alternative minimum tax.

b. M&A Implications

The reduction in rates will be one variable in the tax cost and benefits when considering whether an asset or entity sale is preferable, especially in the case of an entity organized as a C corporation and subject to double taxation on an asset transaction. The tax benefit or shield provided by depreciation and amortization deductions to a purchaser will depend on the form of business in which the purchaser operates. Target entities currently organized as flow-through entities (partnerships or S corporations) may elect to be treated as C corporations to benefit from the lower corporate rate with the tradeoff of double taxation on an asset sale or distribution of corporate earnings from the business entity.

3. Expensing of Certain Tangible Personal Property

a. General

The 2017 tax act permits a 100% depreciation deduction (expensing) with respect to qualified property in the first tax year the property is placed in service. Qualified property has been expanded to included used property acquired by purchase (other than from a related party). In general, qualified property is tangible personal property that has a recovery period of 20 years or less, computer software, or qualified improvement property. Bonus depreciation does not apply to goodwill or other intangible assets, which continue to be amortized on a 15-year basis.

b. M&A Implications

The ability to immediately expense certain tangible property will provide a greater tax benefit to the purchaser and depending on the type of business and the tax profile of the purchaser would be a positive factor in the structure of the transaction as an asset acquisition where the business was conducted by a C corporation (despite the double taxation) or in an asset acquisition to allocate the purchase price to assets that qualify for the immediate deduction. A seller may resist an allocation of the purchase price to qualified property where the taxpayer is not indifferent to ordinary versus capital characterization and the purchase price allocation would cause gain to be characterized as ''recapture'' and taxed as ordinary income. In asset transactions where the parties have adverse tax interests expect more negotiations with respect to the purchase price allocation and possible reluctance to permit a ''go your own way approach.''

4. Limitation on Business Interest Deduction

a. General

The 2017 tax act imposes a limitation on the deduction for interest paid or accrued on a debt incurred in a ''trade or business'' equal to 30% of the sum of: (1) ''business interest income,'' (2) ''adjusted taxable income,'' and (3) ''floor plan interest.'' The limitation applies without regard to the type of business entity

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or whether the interest is paid to a related or unrelated party. A taxpayer may elect to exclude any real property trade or business interest and any farming business interest. Special rules apply with respect to interest incurred by a business entity classified as a partnership or an S corporation. Interest not allowed as a deduction may be carried forward indefinitely.

b. M&A Implications

The limitations on business interest deductions may affect acquisition structure and debt placement, particularly in cross-border transactions. The limitations may encourage equity financed acquisitions, including the use of preferred stock. The interest limitation could create a tax attribute that has value to a potential purchaser in the context of an acquisition of a C corporation with a carryover. A target entity with a carryover may prefer a transaction structured as an asset type acquisition where the limitation provides a shield against the gain on the disposition. The limitation will require additional due diligence with respect to both the limitation and whether a taxpayer that has elected (if permitted) with respect to an applicable business to be outside the limitations.

A seller with a carryforward of interest that has not been deducted due to the limitation may be expected to treat that carryforward as a tax attribute for which the seller is paid all or part of its value to the purchaser. The seller may request either direct payment of the benefit of the use of the limitation as a ''transaction tax deduction'' or as a ''set off'' to indemnity obligations.

> **Example:** Any amount of interest that is not allowed as a deduction under section 163(j) shall be treated as a Transaction Tax Deduction in the year such interest is permitted to be deducted pursuant to section 163(j)(2).

> **Example:** The Sellers shall be entitled to [__] percent of any income Tax savings realized by Buyer (or any of its Affiliates) with respect to a Post-Closing Tax Period attributable to Transaction Tax Deductions.

> **Example:** Any amount otherwise payable by the Seller as an indemnification shall be reduced to the extent of any Transaction Tax Deductions that are actually realized in cash or as a reduction in Taxes otherwise due (determined on a ''with and without'' basis) in the Post-Closing Tax Period.

> **Example:** ''Tax Assets'' means (i) the NOLs (together with any interest disallowed under section 163(j) of the Code with respect to the taxable year of target) ending on the Closing Date) and (ii) the Transaction Tax Deductions (to the extent not reflected in the NOLs).

> **Example:** ''Transaction Tax Deductions'' means the sum of all items of loss or deduction for federal income tax purposes resulting from or attributable to (A) payments (or exercise) in respect of Options as contemplated by this Agreement (including the employer portion of any employment and payroll Taxes payable in connection therewith) or any other payments hereunder that are in the nature of compensation for federal income tax purposes (including the employer portion of any employment and payroll Taxes payable in connection therewith), (B) the repayment of Indebtedness at Closing or as contemplated by this Agreement, (C) the amount of Company Transaction Expenses (including the employer portion of any employment and payroll Taxes payable in connection therewith) and (D) any other fees, costs, expenses and other amounts incurred by the Group Companies in connection with the transactions contemplated hereby, to the extent that such payments in this clause (D) are more likely than not deductible for federal income tax purposes and **(E) the amount of any carryforward of disallowed business interest under Section 163(j) of the Code from the Pre-Closing Tax Period ending on the Closing Date to any Post-Closing Tax Period**, but only to the extent such carryforward arises as a result of Transaction Tax Deductions in clauses (A) through (D) claimed in such Pre-Closing Tax Period.

5. NOL Limitations

a. General

In general, the 2017 tax act no longer permits a taxpayer to carry back a net operating loss (NOL) incurred in a taxable year ending after 2017 to a prior taxable year to use as a deduction to offset income in that prior taxable year and obtain a refund of income taxes paid. Instead, the 2017 tax act only allows NOLs to be carried forward and used to offset future taxable income. Further, the NOLs can only offset 80% of a taxpayer's taxable income. Special rules apply with respect to the effective date applicable to a fiscal year taxpayer.

b. M&A Implications

The rate reduction will reduce the value of any NOL that is a tax attribute of the target corporation in the case of the acquisition of a C corporation with an NOL. Furthermore, the limitation on the ability to carry back an NOL into a prior taxable year will have an effect on change of control and similar type deductions that arise upon a business acquisition and typi-

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cally fall onto a seller's tax return. If the acquisition causes the tax year to end, and the change of control payments exceed the income through the closing date, the NOL created by the payments must be carried forward subject to the limitations on the use of the NOL by the purchaser of the business entity. In such a case an asset versus stock sale (or asset equivalent transaction, e.g., §338 election) might provide for a more optimal tax structure for both the purchaser and seller depending on the tax profile of the parties. In a stock sale where the parties price the tax attribute created by the NOL into the purchase price, additional due diligence will be required and any limitations arising as a result of the acquisition e.g., §382, will impact the value.

6. International Provisions

a. Overview

The 2017 tax act changes to the U.S. taxation of international transactions were among the most fundamental changes to the structure of the Code. These changes are of particular significance to the structure and related due diligence with respect to cross-border M&A transactions and in particular the taxation of outbound investment by U.S. corporations. In addition the 2017 tax act changes have a focus on preserving the U.S. tax base with respect to U.S. corporations and entities conducting business within the United States. These provisions will significantly affect the structure, financing, and related due diligence associated with cross-border M&A transactions. A brief summary of certain of the changes follow, with an emphasis on those provisions that will likely impact M&A transactions.

b. Transition Tax: §965

General

The 2017 tax act amended §965[22] to require certain U.S. shareholders to include in gross income their share of the untaxed foreign earnings with respect to their interest in certain foreign corporations. Specifically, §965 requires a U.S. Shareholder of a deferred foreign income corporation (DFIC) to treat as ''subpart F income'' such U.S. Shareholder's share of ''accumulated post-1986 deferred foreign income'' (the ''§965(a) Amount'').[23] A DFIC is, with respect to any ''U.S. Shareholder'', a ''specified foreign corporation'' that has accumulated post-1986 foreign income'' as of November 2, 2017 or December 31, 2017 of greater than zero. A specified foreign corporation is any (1) controlled foreign corporation and (2) any foreign corporation to which one or more domestic corporations is a ''U.S. Shareholder'' (''Specified Foreign Corporation''). A taxpayer can elect to pay the tax imposed by §965 in installments over an eight-year period.

M&A Implications

The §965 Transition Tax is one of the most significant provisions of the 2017 tax act, and its potential application to impose a tax liability on the purchase of an entity will require it to be addressed in the acquisition agreement and related due diligence. In that regard, a purchaser will seek to avoid potential liability through the structure of the acquisition and/or indemnification and related due diligence. If the target has elected to pay the tax in installments, a purchaser may wish to treat the tax as a deduction in purchase price rather than seeking payment on a within and without basis. The due diligence required to determine the U.S. Shareholder's share of ''accumulated post-1986 deferred foreign income'' will be significant as it will be affected by factors such as whether a §338(g) election was effected with respect to a prior acquisition of a target CFC and the amount of any previously taxed income. If the foreign corporation has a year-end other than December 31, a purchase during the calendar year ended December 31, 2018 could require the purchaser to include the §965(a) amount in its gross income.

The contract is likely to contain both representations and covenants that specifically address the §965 Transition Tax and allocate the liability for the tax and the risk that the U.S. shareholder has under-reported the tax. In that regard contractual protections may include:

> **Tax Representation.** Purchaser is not required to include any amounts in income as a result of the application of section 965 of the Code.
>
> **Tax Representation.** Neither the Company nor any Subsidiary is a stockholder of a ''specified foreign corporation'' as defined in section 965(e) of the Code (or any similar provision of state, local or foreign Law).
>
> **Tax Representation.** Neither the Company nor any Subsidiary has any liability for any ''accumulated post-1986 deferred foreign income'' (as defined in section 965 of the Code).

In stock acquisitions, the tax year of the foreign company may not close, which may cause the purchaser to be responsible for the tax.

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[22] On Aug. 1, 2018, Treasury and the IRS released 249 pages of proposed regulations under §965 (REG-104226-18).

[23] For tax years of foreign corporations beginning before Jan. 1, 2018, a U.S. shareholder is a U.S. person who owns (directly, indirectly, or constructively) 10% or more of the total combined voting power of all classes of stock of a foreign corporation (U.S. Shareholder). A U.S. person for this purpose is defined in §957(c).

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Straddle Period. Any inclusion in gross income required by section 965 of the Code shall be allocable to the Pre-Closing Portion and any Tax resulting from such gross income, if separately stated, shall be attributable to the Pre-Closing Portion.

Tax Payment. The Seller shall pay any Tax imposed under section 965 of the Code or attributable to any subpart F income (including any increase thereto under section 965 of the Code) required to be included in income in a Post-Closing Period solely to the extent such subpart F income is attributable to income or earnings of the Company Group for a Pre-Closing Period (or Pre-Closing Straddle Period Portion).

Tax Payment. Seller shall pay any and all Taxes payable pursuant to section 965 of the Code, whether or not an election was made under section 965(h) of the Code.

A tax covenant may explicitly disallow the election to pay the tax in installments:

Installment Election. The Company shall not make the election permitted by section 965(h) of the Code to pay any Tax liability in installments.

c. Global Intangibles Low Taxed Income (GILTI): §951A

General

Section 951A as enacted as part of the 2017 tax act imposes a tax on a U.S. shareholder's controlled foreign corporation's net income (not otherwise subject to U.S. tax) less a deemed return with respect to its depreciable tangible property (tested income).[24] The tax may be reduced by a foreign tax credit under §960 such that if the foreign earnings are subject to a minimum local tax, there is no incremental U.S. tax on such earnings. Section 951A is effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which the tax years of such foreign corporations end. Section 951A applies only to U.S. shareholders that own stock of the foreign corporation on the last day of the foreign corporation's taxable year in which it is a CFC.

M&A Implications

Because the acquisition of a U.S. corporation with foreign subsidiaries, or acquisition of a foreign subsidiary, may not close the foreign subsidiary's tax year a purchasing entity can be liable for taxes attributable to a pre-closing period and reflected in the agreement as a straddle period tax. A purchaser may wish to make a §338(g) election to close the tax year and avoid the straddle period allocation of income and obtain a fair market value basis in the foreign corporation's assets.

Straddle Period. For purposes of any amount that is required to be included under section 951(a) or section 951A of the Code for any entity in the Target Group for the taxable period that includes the Closing Date, any such income shall be treated as part of a Straddle Period and the amount of income required to be included for the Pre-Closing Straddle Period Portion (the ''Pre-Closing 951 Amount'') shall be determined based on an interim closing-of-the-books as of [___] on the Closing Date; provided that the calculation of the Pre-Closing 951 Amount shall include the concepts under section 951(a)(2)(B) of the Code.

d. Controlled Foreign Corporations

General

§957 — U.S. Shareholder: Prior to the 2017 tax act, the determination of whether a U.S. person constituted a U.S. shareholder was based solely on whether the person owned directly or indirectly 10% or more of the voting power of a foreign corporation, regardless of the percentage of the stock owned as determine by value. The 2017 tax act changed the definition of a U.S. shareholder to be based on direct or indirect ownership of either 10% of voting power or 10% of value of the foreign corporation.

§958 — Downward Attribution: Prior to the 2017 tax act, shares of a foreign corporation held by a foreign corporation parent that controlled a U.S. corporation were not attributed to that U.S. corporation such as to cause the foreign corporation to be treated as a CFC (no downward attribution). The 2017 tax act modified the attribution rules such that shares of a foreign corporation held by the foreign shareholder of a controlled U.S. corporation are attributed to that U.S. corporation to cause the foreign subsidiary to be treated as a CFC.

M&A Implications

Representation/Due Diligence. Loan agreements that determine CFC status solely on voting stock may result in an inclusion under §956 where shares of that foreign subsidiary are pledged as collateral on a loan. The 2017 tax act will require additional due diligence review and related representations with respect to loan and financing agreements where shares of a foreign

[24] As described below, the 2017 tax act expanded the definition of both a U.S. shareholder and a controlled foreign corporation.

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subsidiary are pledged or the foreign subsidiary provides a guarantee.

Due diligence review will need to identify any U.S. subsidiary of a foreign corporation for possible subpart F inclusion with respect to holding a minority interest in a foreign corporation or information reporting obligations with respect to holding an interest.[25]

e. Sale of Partnership Interests: §1446

General

The 2017 tax act added §1446(f) and §864(c)(8) to the Code. Section 1446(f) treats a foreign person's gain from the disposition of an interest in an entity classified as a tax partnership as U.S. source income that is effectively connected to a U.S. trade or business (ECI) to the extent a disposition of the partnership assets would generate ECI under §864(c)(8). A purchaser is required to withhold 10% of the amount realized in such transaction. Any person who disposes of a partnership is presumed to be a foreign person unless such person provides certain information to the purchaser. If the seller is a foreign person, such seller may provide certain documentation, e.g., that the partnership's ECI over the previous three years is less than 25% of total income, or no gain will be realized with respect to the transaction, each as described in Notice 2018-29 to reduce or eliminate required withholding, to the extent such withholding may be reduced or eliminated. This provision does not currently apply to publicly traded partnerships.

M&A Implications

Closing Condition Deliverable. Since withholding at a rate equal to 10% of the amount realized is required in the absence of documentation proving that withholding is not required, the acquisition agreement with respect to the sale of a partnership interest should include as deliverables (i) an IRS Form W-9 and non-foreign person affidavit, in the case of a U.S. person as seller or (ii) an affidavit as described in IRS Notice 2018-29. In addition, a purchaser should ensure the withholding provision permits withholding pursuant to §1446(f).

f. Other International Provisions

The changes to the U.S. taxation of international transactions were among the most significant and far reaching provisions of the 2017 tax act and will have a significant effect on the structure and documentation of cross-border transactions. Other international changes contained in the 2017 tax act that may affect the structure not addressed above are described briefly below.

Foreign Source Dividend Deduction: §245A

A partial exemption system was enacted as a feature of the 2017 tax act, which provides an exemption from U.S. taxation with respect to certain dividends received by certain U.S. shareholders from foreign corporations.

Foreign Derived Intangibles Income

The 2017 tax act provides a deduction to certain taxpayers with respect to a percentage of foreign derived intangibles income (FDII) earned by such taxpayer. In general, the deduction is equal to the sum of: (1) 37.5% of the FDII of the domestic corporation for the tax year, plus (2) 50% of (a) the amount (if any) that is included in the gross income of the domestic corporation under §951A for the tax year (GILTI Amount), and (b) the amount treated as a dividend received by the corporation under §78 that is attributable to the GILTI Amount. FDII is intended to reflect, on a formulaic basis, the portion of a taxpayer's intangible income that is derived from serving foreign markets.

Tax on Base Erosion Payments of Taxpayers (BEAT): §59A

Section 59A, as added by the 2017 tax act, creates a new minimum tax with respect to certain taxpayers that have sufficient gross receipts and derive a sufficient level of "base erosion tax benefits." Under §59A, a corporation must pay a base erosion minimum tax amount (BEMTA) in addition to its regular tax liability after credits. The BEMTA is generally equal to the excess of (1) a fixed percentage of a corporation's modified taxable income (taxable income determined without regard to any base erosion tax benefit related to any base erosion payment, and without regard to a portion of its NOL deduction) over (2) its regular tax liability (reduced by certain credits). The fixed percentage is generally 5% for taxable years beginning in 2018, 10% for years beginning after 2018 and before 2026, and 12.5 % for years after 2025.

Related Hybrid Payments: §267A

Section 267A, as added by the 2017 tax act, denies a deduction for any "disqualified related party amount" paid or accrued pursuant to a "hybrid transaction" or by, or to, a "hybrid entity." A disqualified related party amount is any interest or royalty paid or accrued to certain related parties to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. A "hybrid transaction" is (1) any transaction, series of transactions, agreement, or in-

[25] *See* Notice 2018-13.

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strument, (2) one or more payments with respect to which are treated as interest or royalties for federal income tax purposes, and (3) which are not so treated for purposes of the tax law of the foreign country in which the recipient of such payment is resident for tax purposes or is subject to tax. A ''hybrid entity'' is any entity which is either: (1) treated as fiscally transparent for federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for federal income tax purposes.

7. Other 2017 Tax Changes Impacting M&A Transactions

a. Carried Interests Holding Period: §1061(a)

General

Prior to the 2017 tax act, an interest that consisted of the right to receive future partnership profits and given to a partner in exchange for performing services was nontaxable to the recipient, with any income or gain upon a disposition of the assets of the partnership based on the character and holding period to the entity.

The 2017 tax act extended the holding period requirement to three years to obtain long-term capital gain treatment with respect to any ''applicable partnership interest.'' An ''applicable partnership interest'' is a partnership interest transferred to a taxpayer in connection with the performance of services in any applicable trade or business, which is the activity of raising or returning capital or investing in or disposing of securities, commodities, real estate held for rent or investment, cash, or options or derivative contracts with respect to these assets.

M&A Implications

Acquisition Structure. The 2017 tax act change with respect to carried interest in respect of an applicable partnership may impact the structure of any equity interest granted to service providers. A seller of an entity may wish to structure a transaction for ''rollover treatment'' with respect to outstanding interests subject to extended holding period under the 2017 tax act. A seller subject to the rule may negotiate for a gross up to compensate for the additional tax liability associated with the change.

b. Certain Advance Payments

General

An accrual method taxpayer includes items in income when all events have occurred and the amount can be determined with reasonable accuracy. Prior to the 2017 tax act, inclusion could be deferred for sales of goods held primarily for sale to customers in the ordinary course, and for certain long-term contracts. The deferral period for sale of goods was until the earlier of (1) the year in which payments are accruable under taxpayer's accounting method and (2) the year in which payments are included in gross receipts under accounting method for financial reports. Under the law in effect prior to the 2017 tax act a taxpayer could defer inclusion in income for certain advance payments for services. In general, a taxpayer was required to include the payment in the year received to the extent payment was recognized as revenue in the taxpayer's applicable financial statements with any remaining amount in income in the following year.

In general, under the 2017 tax act an accrual method taxpayer must include amounts in income no later than when amounts are included for financial accounting purposes. A taxpayer may defer certain advance payments until one year following inclusion in income for financial accounting purposes.

M&A Implications

Representation / Due Diligence. As a result of the change, a target entity should have less book/tax ''deferred revenue'' with respect to such prepaid income. A target entity may be required to accelerate taxable income as a result of GAAP changes to income recognition with a corresponding change in accounting method and §481 adjustments. The change will require additional due diligence and related representations with respect to deferred revenue and any §481 adjustments.

c. Self-Created Intangibles: §1221(a)(3)

General

Prior to the 2017 tax act, §1221(a)(3) excluded from the definition of a capital asset certain self-created assets generally considered in the nature of literary or items subject to copyright protection.

The 2017 tax act changed the exclusion from the definition of a capital asset certain ''self-created'' patent rights and similar intellectual property. A ''self-created asset'' transferred to a corporation or partnership in a §721 or §351 transaction retains the ordinary income taint (including future appreciation).

M&A Implications

Acquisition Structure. The change may affect the structure of the acquisition or disposition where the target entity has ''self-created assets'' that will not be eligible for capital gain treatment. The parties may wish to ''identify'' and ''value'' those assets in the case of an applicable asset allocation subject to section §1060 or sale of an interest in a partnership

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where the seller desires capital gain treatment. In addition, a provision in which the purchaser agrees to ''gross-up'' a seller for the additional tax based on the character of the gain will require identification, valuation and additional due diligence with respect to such assets may negotiate. The standard §1060 allocation mechanism contained in a typical purchase agreement may not be sufficient to properly allocate the purchase price to such assets.

Representation / Due Diligence. The acquisition agreement may require a representation that none of the assets in the hands of target entity consist of assets excluded from the definition of a capital asset by virtue of §1221(a)(3), as amended by the 2017 tax act, and require due diligence with respect to those items, if material.

d. Technical Termination: §708

General

Under the law in effect prior to the 2017 tax act, a partnership had a ''technical termination'' if, within a 12-month period, there was a sale or exchange of 50% or more of the total interest in partnership capital and profits. A technical termination ended the partnership's year and the newly formed partnership was a new entity eligible to make elections available to a newly formed partnership. The 2017 tax act repealed this provision such that a sale or exchange in such case will not result in a ''technical termination'' and termination of the partnership.

M&A Implications

Tax Covenant. Because a purchase of 50% or more of the interests in partnership profits or capital will not terminate the entity, a purchaser of an interest cannot rely on the technical termination provisions to ''terminate'' the old partnership. As a result of the continuation of the entity, the target entity's elections and accounting methods survive and the purchaser must due diligence those elections and methods. Further, the tax return of the target entity will not close and becomes a ''straddle period'' for purposes of the acquisition agreement. A ''closing of the books'' method may be utilized to achieve the same income/loss effect of a technical termination. The acquisition agreement should contain covenants with respect to filing returns and payment of taxes will need to reflect that the entity's tax year has not closed.

e. Corporate AMT Repeal

General

Under the law in effect prior to the 2017 tax act, corporations were subject to a corporate level alternative minimum tax (AMT). A corporation subject to AMT in a tax year could claim a credit against its regular income tax liability for AMT paid in a prior year. Unused AMT credits were carried forward indefinitely.

The 2017 tax act repealed the corporate AMT. Any unused AMT credits may be used to offset regular income tax liability. Any excess credits not available to offset regular income tax liability are refundable in an amount equal to 50% of any excess AMT credits in 2018 – 2021 with 100% refundable in 2022.

M&A Implications

Purchase Price — Tax Asset. Any refundable AMT credits may be treated as a tax asset akin to a tax refund for which a seller will request additional purchase price. Any value ascribed to the excess AMT credits that are reflected in the purchase price will require due diligence and indemnification or similar means to protect the purchaser.

f. Excessive Compensation: §162(m)

General

Section 162(m) in effect prior to the 2017 tax act provided that a publicly held corporation may not deduct applicable employee compensation in excess of $1 million paid to any ''covered employee.'' A ''covered employee'' included the CEO and the four most highly compensated employees. Specified commissions, compensation based on performance goals, and income payable under a contract in effect on February 17, 1993, were excluded from the §162(m) deduction limitation.

The 2017 tax act expanded the definition of covered employees to include CEO, CFO, and the three highest compensated officers. The exceptions for commissions and compensation based on performance goals were repealed. The 2017 tax act expanded the limitation to publicly traded domestic corporations and foreign corporations traded through American Depository Receipts, or ADRs. The coverage includes certain non-publicly traded corporations if ''the securities of which are required to be registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l).''

M&A Implications

Representation / Due Diligence. Section 162(m) is more likely to apply with respect to compensation payments and additional due diligence and related representations will be required to diligence compensation paid to employees of corporations subject to the rules. Specific due diligence representations with respect to the expanded §162(m) are more likely to be included to capture potential exposure.

g. Fines and Penalties: §162(f), §6050X

General

Section 162(f), prior to amendment by the 2017 tax act, prohibited a deduction of fines or similar penal-

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ties paid to a government for the violation of any law as to trade or business expenses including amounts paid in settlement of a taxpayer's actual or potential liability for such fines and penalties. Deductions, however, were generally allowed for amounts paid to a government as compensatory damages, including single damages under the False Claims Act and for remediation of property under the environmental laws. The ability to deduct an amount paid to a government was generally determined based on whether the governing statute's purpose was punitive or compensatory.

The 2017 tax act revised §162(f) to provide a general prohibition against deduction as a business expense for any payments made to or at the direction of a government, a governmental entity, or certain nongovernmental self-regulatory entities in connection with a violation of law or an investigation involving a potential violation of law. A deduction is permitted for payments that ''constitute restitution (including remediation of property) for damage or harm'' related to the violation or potential violation of law or that were made ''to come into compliance with any law which was violated or otherwise involved'' in an investigation. Amounts paid to reimburse the costs of investigation or litigation are not deductible as restitution or otherwise. A court order or settlement agreement must identify the amounts paid as restitution or payments made to come into compliance with applicable law in order for deduction regardless of the nature of the payment. The 2017 tax act requires that the governmental or self-regulatory entity involved must file an information return with the IRS (with a copy to the taxpayer) specifying the amounts considered deductible under these new standards.

M&A Implications

Representation / Due Diligence / Indemnification. Representation and related due diligence to cover exposure for such payments depending on the potential magnitude of the risk particularly in regulated industries where a corporation has frequent litigation and settlements with a governmental agency. If an indemnification provision is reduced for any ''tax benefit'', any post-closing resolution by the purchaser should consider the tax effect of any indemnification claim with respect to payments to a governmental agency to avoid tax affecting a nondeductible item.

VII. SUMMARY

The 2017 tax act reflects a significant and fundamental change to the taxation of business income, and in particular, business income earned outside of the United States. The provisions will affect the structure and financing of M&A transactions. The tax effect of the 2017 tax act changes will impact the valuation that purchasers and sellers ascribe to the businesses to the extent income taxes effect valuation, particularly where there are significant net operating losses, change of control, or other tax attributes with respect to the target business entity.

The 2017 tax act changes will require additional due diligence. Provisions of the acquisition agreement will need to reflect these changes to ensure that tax risks associated with any legacy liabilities of the business entity are appropriately allocated among the parties consistent with the underlying business transaction. Nevertheless, while the rules are different, the fundamental objective of the tax professional in its review and negotiation of the M&A contract (the game) remains the same.

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