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Wall Street
Market Trends in Global M&A

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Objectives

- Taxable, tax-deferred and tax-free transactions
- Stock vs. asset deals
- Diligence and other things to think about before the deal
- Papering the deal/allocating risk
- International M&A: US tax considerations and case studies

Taxable, Tax-Deferred and Tax-Free Transactions

Taxable Transactions

- Acquisitions of stock
  - Target treated as a corporation
- Acquisitions of assets (actual or deemed)
- Acquisitions of partnership interests
  - Target treated as a partnership; acquisition of less than all interests
- Seller recognizes gain in an amount equal to the FMV of the consideration over seller's basis

Tax-Deferred Transactions

- Installment sales
  - Applies when at least one payment received in a subsequent tax year
    - E.g., earn-outs and other purchase price adjustments
  - Seller recognizes gain proportionally across payments

Tax-Free Transactions

- Section 1031 exchanges
  - No gain or loss recognized on exchange of ‘property’ held for productive use in a trade or business or for investment if such ‘property’ is exchange solely for ‘property’ of a like kind
- Opportunity zones
  - Where taxpayers dispose of appreciated property to unrelated parties and reinvest in designated “Opportunity Zones,” may be able to (i) defer, and potentially reduce, gains from such property and (ii) potentially realize tax-free gain on Opportunity Zone invests
- Spin-offs
  - If certain requirements are satisfied, a spin-off may be tax-free to both the distributing corporation and the shareholders receiving the distribution
    - If a spin-off does not satisfy these requirements, the transaction would be taxable to both the distributing corporation (at 21%) and the shareholders receiving the distribution (at rates up to 37%)

Tax-Free Transactions (continued)

– Reorganizations:
  - “A” reorganization – statutory merger
  - “B” reorganization – acquisition of stock of target with stock of acquirer
  - “C” reorganization – acquisition of substantially all the assets of the target corporation solely in exchange for voting stock of acquirer transferred to target

  - Permits buyer to use stock rather than cash as consideration
  - No gain to seller on receipt of stock consideration in good reorganization
  - No gain to buyer on the issuance of stock consideration

  - Note: Just because it is a merger does not mean it is tax-free

Stock vs. Asset Deals (and What Counts As an Asset Deal for Tax Purposes)

Stock v. Asset Deals

Corporate considerations

- Acquisition of Stock / Stock Sale
  - Sellers are all equity holders, and each must agree to deal (or be dragged)
  - Target company becomes a subsidiary
  - Requires a thorough understanding of existing equity structure and identification of all equity holders
  - Target entity retains liabilities / Buyer picks up historic liabilities
  - May avoid anti-assignment restrictions
- Acquisition of Assets / Asset Sale
  - Seller is the Target company itself
  - Requires careful identification of relevant assets and excluded assets as each asset separately transfers and each contract is assigned.
  - Can be selective regarding liabilities
  - Anti-assignment provisions can be problematic
  - Generally requires approval by only a majority of shareholders

Stock v. Asset Deals

Additional general considerations

- Corporate Structure
- Location of assets
- Shared assets
- Ownership make up
- Required approvals
- Historical liabilities
- Litigation
- Environmental
- Data security

Stock vs. Asset Deals

Tax considerations

- Acquisition of stock
  - Buyer gets cost basis in stock, no step-up in underlying assets
  - Seller likely has less gain – assuming a higher basis in stock
  - Seller will generally prefer to sell stock

- Acquisition of assets
  - Buyer gets cost basis in assets
  - Seller likely has more gain – assuming a higher basis in stock
    - In case of corporate seller, may have two levels of tax
  - Buyer will general prefer to acquire assets

Stock vs. Asset Deals

Tax considerations (continued)

Deemed acquisition of assets

- Taxable forward merger
  - Treated as a sale of target's assets followed by a distribution of the cash in liquidation
- 338(h)(10) election
  - Treated as an asset sale to "new" target followed by the liquidation of "old" target
- Section 336(e) election
  - Generally has the same consequences as a section 338(h)(10) election, but may be available in cases where a section 338(h)(10) election is not

Stock vs. Asset Deals

Tax considerations (continued)

Deemed acquisition of assets (continued)

- Section 338(g) election
  - Target recognizes gain on deemed sale of its assets and selling shareholders recognize gain on sale of target stock
  - Rare except in acquisitions of non-US targets
- Purchase of entire pass-through entity is treated as a purchase of the assets of the entity
- Purchase of a partial interest in a disregarded entity is treated as a purchase of a share of the assets followed by a contribution of those assets to a new partnership

Impact of Tax Reform

- Corporate rate reduced from 35% to 21%: Reduces the cost of taxable dispositions to US corporate sellers, but reduces the value of step-ups (and other tax attributes, such as interest deductions and net operating losses) to US corporate buyers
- Bonus depreciation: Permits current expensing of certain newly acquired depreciable property
- Interest limitation: Section 163(j) limits ability to deduct interest expense

Diligence and Other Things to Think About Before the Deal

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- Classification of target
  - Tax classification: corporation (C or S), partnership or disregarded entity
  - US vs. non-US
- Transaction structure
  - Taxable, tax-deferred or tax-free deal
  - Stock vs. asset deal
  - Where in the structure will the investment be held
- Tax and other diligence of target’s business

Diligence and Other Things to Think About Before the Deal (continued)

- Financing
- Considerations when selling
  - Excluded assets
  - Employees
  - Location of assets within structure
- Integrating the business
  - Will you need to move people or assets?
  - Transition services to be provided by seller?
  - Intercompany agreements and charges?
  - Operational considerations

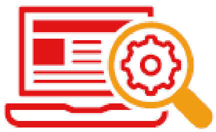
Papering the Deal / Allocating Risk

Impact of a Seller's Market on Transaction Terms

Our Market Monitor is an annual review of Global M&A trends in the US, UK/Europe and Asia, based on a review of the 500+ deals we close each year, interviews with our global M&A Partners and an analysis of market trends and publically available information.

Key findings:

The continued rise of the locked box and other developments related to purchase price



Rep and warranty insurance has changed the M&A landscape

Convergence of European practices (but less so US)

Buyer's market has become a seller's market (in some sectors and for some targets)

Key Terms at a Glance

	US	Europe	Asia
Purchase price adjustments	Purchase price adjustments are the norm Locked box is much less common	A more even split of purchase price adjustments and locked box deals, with locked box becoming more popular in the last decade	Purchase price adjustments are the norm. Locked box is much less common. Note: rare in Vietnam.
Deal conditionality	Risk only passes to the buyer at closing: - MAE - Purchase price adjustment - Reps and warranties materiality accurate at closing	Negotiable (split signing and closing seen in only 43% of European deals, compared to 85% in the US)	The majority of deals in Asia Pacific are conditional (84%)
De minimis	Much less common in the US, but becoming more common (35%)	Used in 72% of deals in the UK	Fairly common in Asia (74%), albeit rate in China (but becoming more common)
Basket / threshold	Occurs in almost all US deals (98%) 70% operate as true deductible and remainder are first dollar recovery/ tipping baskets Tend to be lower than Europe (95% were 1% or less as % of consideration)	Basket/threshold limitation occurs in 68% of European deals First dollar recovery/tipping baskets are more common in Europe Less consistency in Europe re size of basket	Fairly common (rate in China and Vietnam but becoming more common) Tend to be higher than in US/Europe (about 1.0% of purchase price) First dollar recovery is more common than excess
Seller liability cap	Cash escrow or hold back of 10%-15% of purchase price as security, which is often the same as the cap	40% of deals in Europe have cap of 25% or less; Escrows/hold backs less common	Usually negotiated down from 100% and ranges from 10-100%. Commonly 100% in Vietnam and Thailand, albeit in Thailand key warranties are often unlimited. In most countries, 20-50% is common for business and operational warranties.

Key Terms at a Glance (continued)

	US	Europe	Asia
Disclosure	Specific disclosure schedules Vendor due diligence is uncommon	General disclosure has become common Vendor due diligence reports often prepared, particularly for auction processes	General disclosure is increasingly common. Specific disclosure schedules is common. Vendor due diligence is becoming more popular. No consistency across countries in Asia.
Buyer's knowledge	Buyer knowledge limitations are not common Neither are reverse warranties "Sand-bagging" is negotiated	Buyer knowledge qualifies the warranties Buyers commonly give reverse warranties	Buyer knowledge limitations are rare in China, Japan, Thailand, Vietnam and Philippines, but fairly common in Hong Kong, Taiwan, Indonesia, Malaysia and Singapore. In Indonesia, buyer knowledge qualifies the warranties (but not the indemnities).
Materiality scrape	Buyer is entitled is disregard materiality qualifications in the reps for the purpose of establishing whether the de Minimis or basket thresholds have been met and calculating damages	Extremely rare in European deals	Commonly seen in deals across Asia, but often not quantified. Quantified amounts only in Thailand and Vietnam. Only specific warranties are quantified in Singapore (e.g. contract value).
Tax	Coverage for tax indemnity? New exclusions?	Synthetic tax indemnity?	Other than Singapore, China, Hong Kong and Japan, it is fairly common to have tax indemnity, which is usually included in the purchase agreement.

Contracting for risk

R&W Insurance v. Indemnity Escrow

- “Traditional” private transaction indemnity escrow structure
  - Percentage of transaction value held in escrow for a specified period of time for payment of indemnification claims and specific liabilities
- Why R&W Insurance?
  - Seller’s market; attractive policy features
  - Enables bidder to offer lower indemnity caps and smaller (if any) escrow holdbacks, making bid more attractive
  - More and more “zero-recourse” deals
  - “Required” by PE/VC backed portfolio companies

Contracting for Risk (continued)

R&W Insurance – Basic Terms and Trends in the US

Protect against unknown breach of Seller/Target R&Ws

Almost always for the benefit of Buyer

Size limitations are disappearing

Term: up to 6 years of coverage

Price: 2.5% - 3.0% of coverage amount (minimum premium of ~ $150k)

Retention: 0.75% - 1.25% of enterprise value

Exclusions: include known issues, asbestos, pensions, environmental, NOLs, FCPA

International M&A:
US Tax Considerations

International M&A: US Tax Considerations

- Transition tax/participation exemption: One time transition tax imposed on previously untaxed earnings of non-US subsidiaries; going forward, earnings generally can be repatriated without incremental US tax cost
- GILTI: Current US tax on global intangible low-taxed income (GILTI) of non-US subsidiaries
  - May have substantial impact on transaction structure
- FDII: Deduction reduces the effective rate of US tax on certain sales of property, and provisions of services, to non-US persons (foreign-derived intangible income or FDII)
  - Sales of assets, but not stock, may qualify for lower rate on FDII

International M&A: US Tax Considerations (continued)

- BEAT: Base erosion and anti-abuse tax (BEAT) acts as an alternative minimum tax that disallows deductions for certain payments to related persons
- Anti-Hybrid Rules: Section 267A disallows the deduction of certain interest paid pursuant to a hybrid transaction or by, or to, a hybrid entity

International M&A: US Tax Considerations (continued)

Post TJCA, it's all about the rate

Current Income Category	Pre-Tax Reform Treatment	Post-Tax Reform Treatment
Non-FDII income/loss in US	• 35% corporate tax rate	• 21% corporate tax rate
FDII income/loss in US	• 35% corporate tax rate, generally less foreign tax credits ("FTCs")	• 13.125%-21% rate less FTCs
Subpart F income/loss	• 35% rate less FTCs (subject to high-tax exception)	• 21% rate less FTCs (subject to high-tax exception)
GILTI	• None until repatriation	• 0-10.5% US rate / at least 10.5%-13.125% global rate (subject to high-tax exception)
Other CFC income and 10/50 dividends	• Earnings taxed on repatriation with FTCs	• Not subject to tax assuming 12-month holding period satisfied on distributions

International M&A: Case Studies

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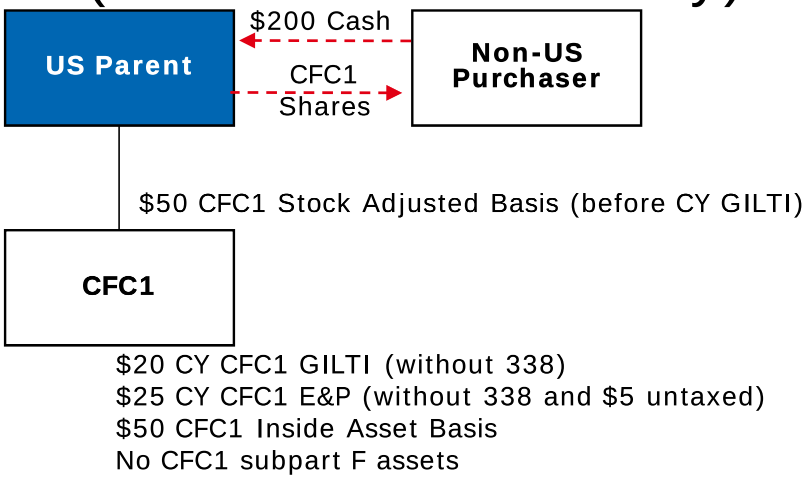
Situation 1

– July 1 sale of CFC by a US shareholder <u>with no 338 election</u> to non-US purchaser (without US subsidiary)



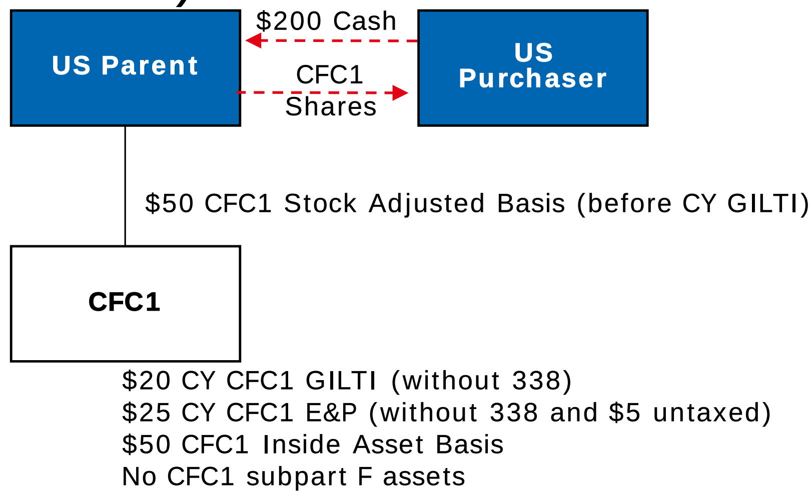
Description	Income	US Tax Rate	US Tax*
GILTI inclusion	$10 (6/12 * $20)	10.5%	$1.05
Gain on stock sale	$140 ($200 cash - ($50 CFC1 original basis + $10 GILTI basis)	-	-
1248 dividend	$2.5 (6/12 * $5)	0%	$0
Capital gain recognized	$137.5 ($140 (stock gain) - $2.5 (1248 dividend))	21%	$28.88
Total			$29.93

* Before FTCs

International M&A: Case Studies (continued)

Situation 2

– July 1 sale of CFC by a US shareholder <u>with no 338 election</u> to US purchaser (or CFC)



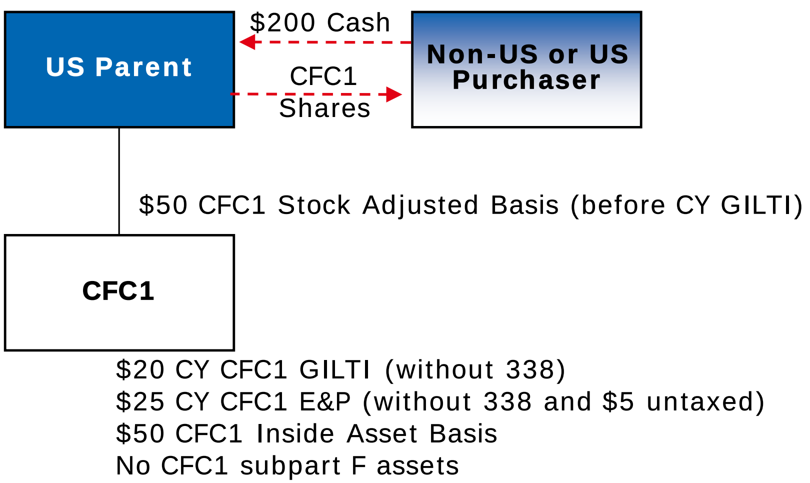
Description	Income	US Tax Rate	US Tax*
GILTI inclusion	$0	10.5%	$0
Gain on stock sale	$150 ($200 cash - $50 CFC1 original basis)	-	-
1248 dividend	$12.5 (6/12 * $25 CY CFC1 E&P)	0%	$0
Capital gain recognized	$137.50 ($150 (stock gain) - $12.5 (1248 dividend))	21%	$28.88
Total			$28.88

* Before FTCs

International M&A: Case Studies (continued)

Situation 3

– July 1 sale of CFC by a US shareholder <u>with 338 Election</u>



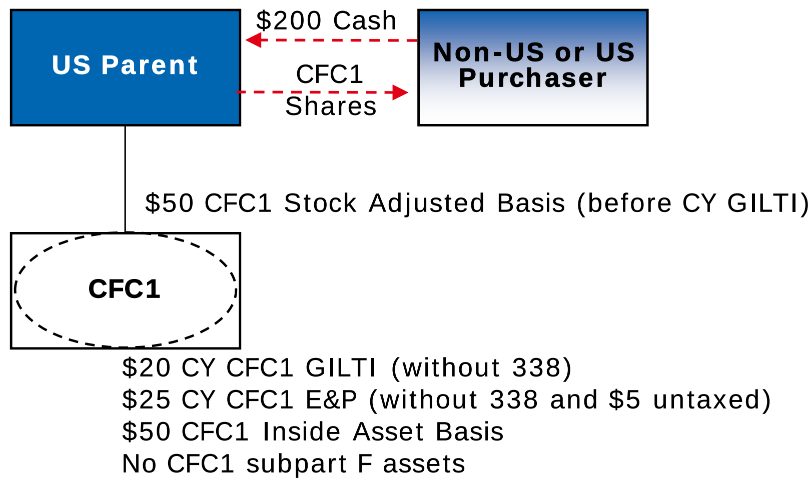
Description	Income	US Tax Rate	US Tax*
Operating GILTI	$10 (6/12 * $20)	10.5%	$1.05
Deemed sale GILTI	$150 ($200 cash - $50 Inside Asset Basis)	10.5%	$15.75
Capital loss recognized	$(10) ($200 (stock gain) - $50 (original basis) - $160 (GILTI basis))	21%	$(2.10)
Total			$14.70

* Before FTCs

International M&A: Case Studies (continued)

Situation 4

– July 1 Sale of CFC by a US shareholder <u>after check-the-box election</u>



Description	Income	US Tax Rate	US Tax*
GILTI inclusion	$10 (6/12 * $20)	10.5%	$2.10
All E&P Amount	$2.5 (6/12 * $5)	0%	$0
Asset gain	$150 ($200 cash - $50 Inside Asset Basis)	21%	$31.50
Total			$33.60

* Before FTCs

Questions?

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