CHAPTER 6

Tax Matters

The following discussion of tax matters relating to acquisition review procedures focuses primarily on the purchaser's counsel's concerns regarding the target company's compliance with applicable tax obligations to federal, state, local, and foreign governments and the propriety of the target company's tax accounting and tax return preparation practices, including its exposure to assessment of taxes for prior periods. Purchaser's counsel also frequently is called upon to advise the purchaser about (1) the immediate and prospective tax consequences of alternative structures of the acquisition transaction, and (2) probable changes in the tax treatment of the target company's operations that would result from application of the purchaser's tax-reporting practices. Those issues, which relate essentially to the value of the target company and the price the purchaser will be willing to pay, frequently must be addressed earlier in the transaction, before the purchaser's counsel generally has access to the scope of information contemplated in the following outline. The outline may be helpful to counsel even at the earlier stages of the transaction, however, because it identifies many issues that should be taken into account in structuring the transaction and negotiating its terms.

The acquisition review with respect to tax matters should include, but is not limited to, income tax, sales or use tax, franchise tax, worker's compensation, unemployment tax, FICA withholding, and customs procedures. A number of other issues in the acquisition review have tax consequences, such as compliance with federal laws respecting retirement benefits, which are dealt with in other chapters of this volume.

The federal income tax aspects of corporate acquisitions are highly complex. Although the issues identified in the outline will probably be familiar to practitioners who have some experience in acquisition transactions, the resolution of those issues ordinarily will require the advice of specialists in corporate taxation. It is particularly important also to have good coordination and communication among the lawyers and accountants on the acquisition team as well as with the purchaser's financial personnel to assess properly the information obtained.

As used in this outline, "Company" refers to the target company and, as appropriate, each of its subsidiaries.

A. Documents Customarily Reviewed

The documents listed below should be obtained and reviewed and the indicated procedures should be followed:

___ 1. All filings, including tax returns, applications for extensions of time to file tax returns, and correspondence of the Company, for the statute of limitations period (generally three years for federal income tax purposes, but possibly six years in the event of substantial omission by the filer* and for any prior years for which the Company has agreed to

extend the statute of limitations, with:
___ a. the Internal Revenue Service (the IRS)
___ b. any state taxing authority
___ c. any local taxing authority
___ d. any foreign taxing authority
___ 2. Evidence of payment of taxes.
___ 3. Current good standing certificates from each state in which the Company conducts business operations in order to verify that all state taxes have been paid. (Note: Counsel should exercise care in the interpretation of good standing certificates from other jurisdictions; in certain states the certificate may not include corporate franchise taxes or other taxes, such as income tax.)
___ 4. All documents relating to any audit by any taxing authority and any assessments, deficiencies, or settlements of tax liability, proposed or assessed, against the Company during the preceding five years, including any revenue agent reports and any waivers of statute of limitations on assessment or collection of any tax.
___ 5. All tax elections filed by the Company.
Purpose:
There are a number of matters for which taxpayers may elect to utilize a particular method or approach to tax treatment (e.g., an election to use LIFO for inventory on Form 970, an election under Code Section 461(h) with respect to economic performance and accrual, or an election under Code Section 341(f) with respect to collapsible corporations). The Company's elections should be analyzed to determine (i) whether the Company is following the required election, and (ii) the potential impact of any binding elections that may affect the Company's future tax reporting.
___ 6. All correspondence between the Company, as taxpayer, and the IRS with respect to any pending tax case.
___ 7. All revenue ruling requests and any rulings received, or any correspondence received denying rulings requested by the Company relating to the tax consequences of its operations (past, present, or proposed).
___ 8. Any tax-sharing or tax-allocation agreements involving the Company and other members of an affiliated group, including any joint venture agreements having the effect of tax allocation agreements, and a statement setting forth how any such agreement was carried out for the last five tax years and any liabilities under such agreements.
___ 9. All documents relating to tax-exempt obligations with respect to which the Company is the obligor, including indentures, loan or lease agreements, and guaranties. These should be reviewed to determine whether the proposed transaction will cause interest payable on such obligations to become taxable for federal or state income tax purposes.
___ 10. All legal or accounting tax opinions relating to the Company's tax reporting received by the Company from outside advisers during the last five calendar years.
___ 11. All agreements and undertakings, including indemnification

agreements, between the Company and any third party relating to tax matters, including undertakings or agreements in connection with an acquisition or disposition. ___ ___ 12. All documents, including option agreements, employment agreements, and/or deferred compensation agreements, that reflect compensation arrangements with employees of the Company that would be deemed to be "golden parachutes" under Section 280G of the Code to consider proper tax treatment and effect of any severance or termination arrangements with the Company's management.
___ 13. If the Company is an S Corporation, the S Corporation election and all documents, including correspondence with the IRS, relating to the Company's status as an S Corporation.
___ a. Verify that all shareholders are eligible to be shareholders of an S Corporation.
___ b. Review the capital structure of the Company to see if it meets the one-class-of-stock requirement.
___ 14. Independent auditor's accrual work papers and "cushion" analysis.
___ 15. Tax preparer's tax review memorandum.
___ 16. Agreements under which the Company has made or is obligated to make payments with respect to environmental cleanup expenses; review timing of such payments in relation to date of cleanup to assess propriety of deductions in period taken and to evaluate whether such expenses must be capitalized.

B. Procedures to Be Followed
The following checklist outlines the procedures to be followed, and issues to be raised or resolved, during a pre-acquisition review of tax matters.

1. Procedures related to accounting matters with tax consequences:
___ a. Identify accounting procedures and methods used by the Company that will be affected by the acquisition or by application of the purchaser's accounting procedures.
___ b. Identify whether investment tax credits are being amortized or flowed-through in reported earnings. If flowed-through, earnings are being inflated because entire credit is used to offset taxes in one year.
___ c. Determine the post-acquisition tax effect of any "loss carry-forwards," "built-in loss assets," and "built-in gain assets" of the Company. Such items are not fully deductible after change in ownership of the Company pursuant to Section 382 of the Code.
___ d. Identify any prior deduction of expenses incurred in connection with a bid by a third party to acquire the Company, a prior acquisition by the Company, or this acquisition. These costs must be capitalized rather than deducted as current expenses.
___ e. Determine the propriety of the Company's tax treatment of any deductions or related income to noncompete clauses, confidentiality, standstill agreements, and the like.
___ f. Identify all leased property on which depreciation is taken by the

Company to assess whether depreciation allowance was properly available to the Company.
___ g. If purchaser intends to file an election under Section 338 of the Code (or if the transaction involves a purchase of assets), identify all tangible assets and all intangible assets of the Company that have a limited life (e.g., patents, copyrights, trademarks) and with respect to each:
___ (1) confirm that valuation of such assets, including intangibles, is reflected in the acquisition documents; and
___ (2) review valuation analyses and "lifeing" studies.

Purpose:
To determine those assets to which the purchase price may be allocated in a transaction accounted for as a purchase and to evaluate, based on the difference between the total purchase price and the amount allocable to such assets, the goodwill of the Company (goodwill is excluded from purchaser's basis in acquired depreciable assets).
___ h. Identify what changes to retained earnings and the deferred tax liability account will be necessary as a result of termination of a tax-sharing or tax-allocation agreement.
___ i. Review the deductibility of payments by the Company to its principal stockholders if the Company is a closely held corporation to determine susceptibility of such payments to reclassification by the IRS as dividend distributions rather than compensation, thereby affecting deductibility of expense and increasing taxable income.
___ j. Review the Company's accounting policies, and independent auditor's and tax preparer's work papers relating to the method of accounting for inventory, including the expensing of inventory and any book/tax differences, to assess the Company's treatment of inventory for consistency and compliance with applicable tax elections. The inventory accounting practices of privately held corporations often are designed to minimize income taxes. The acquisition of such a corporation, particularly by a publicly held corporation, frequently results in a change in accounting for inventory that may expose the prior returns of the Company to audit.
___ k. Review the Company's dividend policies to evaluate whether substantial earnings have been accumulated (particularly if the Company is a closely held corporation) to identify potential liability for accumulated earnings tax, and, if there has been a substantial accumulation, to determine whether there has been adequate business justification for such accumulation.
___ l. Identify present and prior practices concerning political or commercial payments to obtain business, domestic or foreign, including the manner in which such payments were controlled or recorded.
___ m. Identify any income realized as a result of any prior change in the Company's accounting method that the Company has elected to recognize over multiple tax years (e.g., change from cash to accrual required under the

Tax Reform Act of 1986) to evaluate whether the recognition of such income will be accelerated as a result of the transaction for federal (and, possibly, state) tax purposes.

2. Procedures related to state and local taxing authorities:
___ a. Identify any disputes concerning income, sales or use, property, or franchise or other local taxes.
___ b. Identify and quantify any state and local taxes (e.g., sales or use tax) that may arise as a result of the proposed transaction, and identify the party potentially liable for such tax. Sales and use taxes generally are not applicable to acquisitions of stock, but real estate transfer taxes occasionally are triggered by a stock acquisition.
___ c. Analyze taxing structure of the states and local jurisdictions in which the Company conducts business operations, and consider their application to the acquired business to determine whether structure of transaction should be modified to reduce potential local taxes.
___ d. Review the Company's determination of business and nonbusiness income and application of multistate apportionments to evaluate the potential impact on future business operations.
___ e. Review the Company's practices on sales tax collection and remittance, particularly if the Company's business is involved in multistate or mail-order retail operations, to evaluate potential liability for state sales tax.
___ f. Identify all foreign shareholders of the Company and determine whether the Company is a Foreign Real Property Holding Company under Code Section 897; if so, a portion of the sales price must be withheld.

3. Procedures related to tax preparers:
___ a. Confer with the Company's tax preparers and tax counsel.
___ b. Obtain an explanation for any change in tax preparer within the preceding five years.
___ c. Review any correspondence to or from the Company's tax preparers concerning any disagreements between the Company and the preparer relating to tax matters or concerning the proper treatment of any tax item.
___ d. Identify issues on which formal advice (from IRS or from tax counsel) was sought and with respect to which an audit or challenge may be likely.

4. Procedures related to employees and affiliates:
___ a. Determine whether the Company makes significant use of the services of independent contractors. If so, review the extent and circumstances of such arrangements, including the filing of forms 1099. Purpose:
To evaluate potential exposure for underwithholding of employee taxes in the event IRS reclassifies "independent contractors" as "employees," for underwithholding of employee taxes, social security tax liability, and possible disallowance of deductions because of improper withholding.

___ b. Determine whether the Company has properly withheld, or received payment for, tax due as a result of exercise of nonqualified options; counsel should assess potential for disallowance of deductions for compensation expense because of improper withholding.
___ c. Determine whether the Company has properly filed employment tax returns for employees and that all employment-related taxes (federal, state, and local) have been paid.
___ d. Identify any transaction occurring in the preceding five years between the Company and certain affiliated persons pursuant to which services or products have been purchased, sold, or leased. Purpose: To evaluate the propriety of allocation of value for goods and services transferred among parties for Code Section 482 purposes (as well as for foreign and local tax purposes), and to determine the Company's possible exposure to any "disguised dividend" issues.