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Successor Tax Liabilities:

Understanding the potential risks in M&A transactions

Introduction

In an acquisition of a company, regardless of the legal form (i.e., equity purchase or asset purchase), an important consideration is what pre-transaction liabilities of the seller will be assumed by the buyer. Generally, the buyer may have visibility to what liabilities exist from (i) being reported in the company's financial statements, (ii) described in the representations and warranties of the purchase agreement, and / or (iii) separately disclosed by the seller. However, there may also be unknown pre-closing liabilities that become a significant area of focus for buyers and sellers in pre-transaction due diligence.

An important category of liabilities that may be known or unknown (or both) are successor tax liabilities. Successor tax liabilities, broadly, are any pre-closing income or non-income (e.g., sales/use, gross receipts, withholding, etc.) tax liabilities, debts, or obligations of a company. Whether the buyer or seller bears the successor tax liability risk generally depends on the tax form of the transaction and is also highly dependent on what jurisdictional legal and tax rules are applicable. For these reasons, it is important to perform tax due diligence in both stock and asset transactions to understand which successor tax liabilities may be inherited by a buyer or otherwise retained by a seller. Following is a general overview of US federal and state successor tax liability considerations in the context of M&A transactions. Note that additional and different considerations may apply in cross-border transactions. Often the ultimate responsibility for successor liabilities is based on legal analysis and advice from legal counsel should be sought to understand successor liability implications of a transaction.

Purchase of Assets (or "Deemed" Purchase of Assets)

In the context of a legal asset acquisition, a buyer purchases certain assets from a seller, and the seller retains the ownership of the legal entity(ies) that held the assets pre-transaction. Generally, liabilities not specifically assumed by the buyer are retained by the seller. Further, a purchase of an entity that is disregarded for US federal income tax purposes (e.g., single member limited liability company (LLC)) is generally treated as an asset acquisition for US federal income tax purposes (thus a "deemed" purchase of assets and assumption of liabilities).

There are a variety of reasons to structure a purchase as an asset acquisition; some are driven by the necessities of the deal (e.g., a seller only wishes to divest certain assets or a segment of their overall business), some are driven by tax benefits (i.e., a buyer receives a step-up in tax basis in the acquired assets in connection with an asset acquisition), and some are driven by the ability to limit liability (i.e., broadly speaking, an asset sale may limit a buyer's successor liabilities because only certain assets and identified liabilities are assumed from a seller). With respect to successor tax liabilities, generally historical US federal and certain state income tax liabilities are retained by the seller in an asset acquisition and deemed asset acquisition. However, a purchase of substantially all of the assets that constitute a trade or business may result in the buyer succeeding to non-income tax liabilities (e.g., sales tax, use tax, personal and real property taxes, payroll tax, and other transaction level taxes) and certain state income and franchise tax liabilities. Almost all states have statutory authority to impose successor liability for non-income tax liabilities in an asset acquisition, including transfer taxes, arising in the transaction. However, some states do have procedures that allow for relief from successor tax liabilities in an asset acquisition. A common procedure is a bulk-sale exemption and / or clearance certificate where a buyer reports the purchase of the assets to a state (following the respective state's statutory requirements) to relieve itself of any successor state tax liabilities. It is important for buyers and sellers to consider the applicability of the successor tax liabilities in all applicable jurisdictions and assess the tax implications related to any state specific procedures that may be available.

Purchase of Stock

Conversely, in a stock acquisition, a buyer purchases the stock of a corporate entity from a seller, and the acquired entity generally retains all its assets subject to liabilities, whether known or unknown. As such, the purchase of stock generally is at risk of inheriting more successor tax liabilities as compared to in an asset acquisition, putting more importance on purchase agreement terms and protections (e.g., indemnities). A stock acquisition can generally be effectuated through a merger transaction or a purchase of the shares directly from the existing shareholders. Broadly, there are three common types of stock acquisitions that each treat successor tax liabilities differently:

Purchase of a C corporation

- With transactions involving the purchase of a corporate entity, whether a stand-alone entity or the parent of a consolidated tax group, pre-closing US federal, state, and local income and non-income tax liabilities carryover and become an indirect liability of the buyer. As such, tax due diligence is key to understanding what pre-closing tax liabilities may exist that a buyer could inherit or for a seller to prepare for any potential pre-closing tax liabilities that may become a focus in negotiations.

Purchase of a subsidiary out of a US consolidated tax group

- Similar to the C corporation discussion above, successor tax liabilities (US federal and state income and non-income) generally carryover and become the buyer's indirect responsibility in a purchase of a corporate subsidiary from a US consolidated tax group. Further, it is possible for the subsidiary member to be liable for any historical tax liabilities (both income and non-income) and tax audit assessments for the seller's consolidated US tax group (as governed by Treasury Regulation § 1.1502-6) for the time the subsidiary was a member of the group. Outside of the traditional tax protections related successor tax liabilities, it is also common, for a buyer to seek specific contractual protection (e.g., an indemnity) from sellers against these liabilities.

Purchase of an S corporation

- Many closely held businesses elect to be treated as S corporations for US income tax purposes. S corporations are generally not subject to an entity-level US federal income tax; rather, taxable income, gain, loss, deduction, credit, and other tax attributes "pass through" and are taxed at the shareholder level. Any historical US federal, and certain state, income tax liabilities are expected to remain with seller. However, non-income tax liabilities, certain entity-level state income tax liabilities, and non-resident state withholding tax liabilities may carryover with purchased S corporation (i.e., become buyer's indirect responsibility post-closing).
- Further, in order to be classified as an S corporation for US federal income tax purposes, an entity must meet certain requirements outlined by the IRS. If an entity classified as an S corporation fails to meet the requirements at any point in time since the election was effective, its status as an S corporation may be invalid or terminated and it would be classified as a C corporation. A buyer that acquired an S corporation would also indirectly inherit historical corporate level US federal and state entity-level income tax liabilities imposed on a company if an entity's S corporation status was invalid or terminated.
- It is not uncommon for the purchase of a S corporation to be structured in a manner to deliver a tax basis step up to the buyer, for example with a section 338(h)(10), section 336(e) election, or type "F" reorganization. These types of transactions are expected to be treated as deemed asset purchases for tax purposes, and sellers are often compensated for any additional tax leakage that may result from a section 338(h)(10), section 336(e) election, or type "F" reorganization. However, if the target was not a valid S corporation, any federal and state income tax exposure would generally carryover in the transaction. Similarly, non-income tax exposures generally remain with the legal entity and carryover in the transaction. Full scope S corporation due diligence can help the buyer understand potential inheritable tax risks relate to the target's S corporation status even if the transaction is structured as an asset purchase for US tax purposes.

Purchase of a Partnership Interest

Partnerships are generally not subject to US federal income tax; rather, taxable income passes through the entity and is taxed at the ownership level. Generally, in the acquisition of a partnership interest, historical US federal income tax liabilities will remain with the seller. However, for tax years beginning after 2017, as a result of the enacted partnership audit regime under the Bipartisan Budget Act of 2015 ("BBA"), it is possible the acquired entity will be liable for entity level US federal income tax liabilities absent an election to "push-out" such liabilities to its historical partners upon audit. Agreement in the purchase agreement between a buyer and seller on "push-out" elections is a common negotiation point between parties. Note that alternative BBA rules may apply that automatically result in liabilities at the partner level in situations where 100% of partnership interests are acquired (e.g., the "cease to exist" rule when the transaction results in the termination of the partnership, such as in the context of a Rev. Rul. 99-6 transaction, among others where the partnership terminates). Further, liabilities for non-income taxes, non-resident withholding, and, in several states, income and franchise taxes, remain with the acquired entity and become buyer's indirect responsibility, post-closing. As a result of the BBA, the potential for historical entity level taxes underscores the need for the tax due diligence in partnership acquisition transactions.

Mitigating risk of successor tax liabilities

Fortunately, there are ways to mitigate risk for successor tax liabilities, subject to the overall negotiations between a buyer and seller. One of the most effective protections for a buyer against successor tax liabilities is a dollar-for-dollar purchase price adjustment (e.g., an item included in net debt) for any known historical tax exposures. To protect against potential tax exposure, the parties may also negotiate a holdback/ escrow of the purchase price for a period of time post-closing. A direct purchase price reduction may be more favorable to a seller given it limits the potential exposure to a fixed amount and allows sellers to receive their expected cash consideration at closing (absent an earnout). Another protection a buyer may seek is an indemnity from the seller against pre-closing income and non-income tax liabilities through the applicable statute of limitations. However, this is usually a topic of negotiation during the sale process and a full tax indemnity is often difficult to achieve as most sellers do not want to be responsible for any liabilities arising after the transaction is closed. A third way to mitigate successor tax liability risks for a buyer is to purchase a representations and warranties insurance ("RWI") policy. RWI policies insure costs, up to an agreed upon amount, for any breach of a seller representation and / or warranty in the purchase agreement. Rather than seek remedies from the seller, the buyer would be able to make a claim under the RWI policy for costs associated with a breach of a representation and / or warranty, unless expressly excluded from the RWI policy. RWI policies allow a seller to generally relieve themselves from historical risks that may arise post-transaction. Note that a RWI policy coverage will typically exclude known exposures identified in due diligence. As such, in additional to RWI, a buyer and seller may negotiate a special indemnity to cover tax risks that are not covered by the RWI policy. Finally, depending on the specific facts of the transaction, transaction structuring alternatives may be available to reduce successor tax liabilities (e.g., structuring the deal as an asset transaction rather than acquiring legal entity shares). If upon completion of due diligence, it is known that there are historical income or non-income tax exposures, a buyer and seller may negotiate remediation measures that can be taken prior to the closing of the transaction in order to limit potential post-acquisition tax exposure. One commonly pursued avenue is federal or state voluntary disclosures. A voluntary disclosure may reduce or eliminate the amount of penalties and/or interest owed on back taxes and may reduce the lookback period for which the tax authorities could assess taxes. Buyers and sellers may negotiate the costs and burden for any filings to complete a voluntary disclosure, including applicable professional fees, which may be incorporated into the purchase price mechanics. Voluntary disclosures can be an effective way to mitigate historical risks for both buyers and sellers.

Statute of Limitations

An important factor that could impact purchase agreement negotiations is understanding the statute of limitations for successor tax liabilities. Generally, the statute of limitations for US federal income tax purposes remains open for three (3) years from the filing date of the US federal income tax return unless the taxpayer enters into an agreement with the IRS to extend the statute of limitations or in cases of fraud. Further, if a tax return contains a "substantial underpayment of income", which is generally determined as a taxpayer understating its income by 25%, the statute of limitations may be six (6) years. Many US states conform to the US federal statute of limitation; however, some states extend the statute to four (4) or five (5) years, depending on the state and the tax. Further, to the extent tax returns have not been historically filed, generally no statute of limitations will apply to limit the number of years open for assessment. To the extent a seller indemnity and/or holdback is obtained in a transaction, it is prudent to make the survival period on the relevant tax representations at a minimum the applicable statute of limitations.

Conclusion

As outlined above, depending on the structure of the transaction, different tax successor liabilities carryover to the buyer or be retained by a seller in an acquisition. Buyers and sellers should be aware of what taxes to focus on in due diligence to understand the successor liability risks when acquiring a target business and potential dollars at risk, whether through a legal asset acquisition or in the acquisition of a legal entity. Understanding and identifying the potential tax exposure, often times with the assistance of M&A tax advisors, can help prepare both buyers and sellers for purchase agreement negotiations and can help mitigate unexpected cash tax outlays post-acquisition.

Want to learn more?
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