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Income Tax Due Diligence – A Critical Piece of Acquisition Due Diligence

DUE DILIGENCE , PRIVATE EQUITY , TAX
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In addition to a comprehensive sales and use tax review, a thorough income tax review is critical in the overall tax diligence process that a buyer must undertake in considering an acquisition. This is particularly true with equity transactions, due to the complexity of tax law at both the federal and state level and the hidden risks that may be inherited.

We previously covered the importance of the sales and use tax review as part of the overall tax due diligence process (see Our Thoughts On https://www.schneiderdowns.com/our-thoughts-on/salt/sales-tax-due-diligence-deep-dive and https://www.schneiderdowns.com/our-thoughts-on/salt/what-you-should-know-about-sales-tax-due-diligence). Now we consider the income tax review.

Income Tax Due Diligence

The structure of the acquisition will often govern the level of income tax diligence that is necessary. Under an asset purchase, the buyer will generally not inherit any historical *income* tax risk of the seller (note that the same cannot be said for certain other taxes, including sales and use tax). However, it is still prudent to perform some level of income tax diligence so that the buyer understands any tax complexities that are associated with the business being acquired (such as multiple state filing requirements or the existence of a foreign permanent establishment). Additionally, a review of payroll tax filings and tax remittances should be performed in an asset purchase, because successor liability could attach.

The potential acquisition of equity (stock, LLC interests, etc.) gives rise to the need for a more thorough diligence review. The acquisition of equity comes with it all known and unknown historical tax risk, so it is important to have a tax diligence team that is knowledgeable in the areas of federal, state and international taxation. Since the buyer will inherit the tax history of the target company in a stock purchase, it is important to understand, among other things:

- Tax elections made
- Accounting methods used
- Historical tax reporting
- State income tax nexus and required filings
- Foreign activity
- Carryforward of net operating losses and tax credits

This said, the level of diligence may also vary depending upon the type of entity being acquired, i.e., a C corporation or a pass-through entity (S corporation or partnership). In an acquisition of a C corporation, any increase in income taxes resulting from tax examination adjustments will be borne by the buyer. In contrast, since pass-through entities are generally not tax-paying entities (income reported by, and tax paid by, the owners), any adjustments to historical taxable income will be reported by the owners, and the entity itself should not bear a significant burden (note that this could change somewhat given recently finalized partnership tax examination rules).

This is not to suggest that there is not risk in acquiring an S corporation. A very common tax structure involving the acquisition of S corporation stock involves the Internal Revenue Code (IRC) Section 338(h)(10) election, which treats a stock acquisition as an asset purchase for income tax purposes, affording the buyer a step-up in basis. An IRC Section 338(h)(10) election is limited in its application primarily to acquisitions of S corporations or C corporation subsidiaries of a consolidated group by a corporate entity.

A buyer's diligence team must ensure the validity of the S corporation being acquired to protect the buyer from a couple adverse consequences. First, the S corporation that the buyer thought they acquired might be considered a C corporation, and, for all open tax years under statute, tax, penalty and interest could be assessed, all to be borne by the buyer. Second, the Section 338(h)(10) election filed would be invalid, and the basis step-up that the buyer thought they achieved would be void.

A good tax diligence team may also provide the buyer with analysis of whether the outcome of the transaction will meet the desired effect, or whether there are hurdles to be cleared before consummation of the acquisition. Additionally, a well-informed diligence team may identify opportunities to treat certain stock acquisitions as asset acquisitions for income tax purposes. With this typically comes an analysis of the estimated tax consequences to the seller under both scenarios to provide the buyer with the requisite information to successfully negotiate a potential change in deal structure.

As you can see, tax due diligence is not to be taken lightly and should be an essential component of the acquisition process so that the buyer is educated and informed about the risks they are acquiring.

If you have questions related to M&A tax diligence, whether buy-side or sell-side, we welcome the opportunity to assist and help protect your investment.

You've heard our thoughts... We'd like to hear yours

investment, tax, or legal advice. Please note that individual situations can vary. Therefore, this information should be relied upon when coordinated with individual professional advice.