ACCOUNTING BRIEF

Taxable vs Nontaxable Transactions in Business Combinations

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Summary

The tax structure of a business combination does not merely impact the income tax line(s) within the financial statements. It may also influence the values recorded for certain assets acquired and liabilities assumed. The purpose of this article is to discuss the accounting, tax and valuation considerations relating to the tax structure of a business combination (i.e., where the assets or entity acquired meets the definition of business as defined in ASC 805, *Business Combinations*).

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1. GENERAL

1.1 Types of Tax Structures

1.1.1 Taxable business combinations

A taxable business combination typically involves the transfer or the sale of assets and liabilities that constitute a business. The seller is responsible for any income taxes to be paid on the transaction, and the buyer's tax basis in the assets acquired and liabilities assumed are adjusted, generally to fair value, with certain exceptions. Taxable business combinations are often referred to by tax professionals as asset purchases.

In a taxable business combination, both the book and tax basis of the acquired assets and liabilities assumed will generally be adjusted to fair value, with certain exceptions. Therefore, there are often few temporary differences recognized in accordance with ASC 740, *Income Taxes*, in taxable business combinations.

Purchases of partnership interests or limited liability company (LLC) interests also usually result in taxable business combinations. Additionally, under certain circumstances, the U.S. Internal Revenue Code allows companies to elect to treat certain transactions that are structured as sales of entities (e.g., the sale of stock in an entity) as a purchase of assets by the buyer. One such election is a section 338 election (either a section 338(h)(10) election, which is a joint election between a buyer and seller, or a section 338(g) election, which is a unilateral election by a buyer). Consequently, the purchase of the stock of C Corporations or S Corporations, when combined with certain tax elections, could also result in a taxable business combination.

1.1.2 Nontaxable business combinations

A nontaxable business combination typically involves the sale or transfer of ownership interests (e.g., C corporation shares), rather than just certain assets and liabilities that constitute a business. Because the ownership interests are transferred to the buyer, the acquired assets and assumed liabilities continue to be carried at the acquired entity's tax basis for income tax purposes.

Nontaxable business combinations often result in many temporary differences between the book and tax basis of acquired assets and assumed liabilities, because the tax basis of the acquired assets and assumed liabilities is not affected by the business combination (i.e., the acquired entity's carryover tax basis is used for tax purposes), while the book basis of the acquired assets and assumed liabilities is based predominantly on the acquisition-date fair values of the assets and liabilities of the acquired entity, as required by ASC 805. Nontaxable business combinations are often referred to by tax professionals as stock purchases.

1.1.3 Partially taxable business combinations

Transactions may also be a combination of a taxable (i.e. tax basis changes) and a nontaxable (i.e. carryover tax basis) business combination. Partially nontaxable business combinations are common in otherwise taxable business combinations when the seller receives a "roll-over" interest in an acquiring company, which is structured as a tax-deferred rollover. In such transactions, there is a combination of carryover tax basis for the rollover interest and a tax basis change for the remainder of the business combination. Further complications may result from cross-border transactions, as different tax authorities around the world have a variety of rules about basis

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adjustments, deductibility of amortization expenses and other factors that can make the same business combination taxable in some jurisdictions and nontaxable in others.

For further discussion of taxable and nontaxable business combinations, please see our guide to accounting for business combinations.

1.2 Pass-through entities

Partnerships, LLCs taxed as partnerships and entities that have elected S Corp status (collectively referred to as pass-through entities) do not pay U.S. federal income taxes, but rather pass the tax liability to the owners. The term “taxable” in the context of business combinations does not refer to the taxpaying status of the buyer but rather the tax structure of the business combination.

Furthermore, when financial statements are prepared in conformity with U.S. GAAP, a pass-through entity must report income taxes related to any subsidiary included in its consolidated financial statements that is not a pass-through entity. Thus, deferred taxes may be recorded at the pass-through entity level as a result of basis differences existing at their consolidated subsidiaries after a business combination. Therefore, it is important to consider the full consolidated tax structure of both the buyer and the acquired entity when considering the impact of income taxes on the business combination.

In summary, the term “taxable” in business combinations involving pass-through entities relates to the tax implications of the transaction itself rather than the tax status of the buyer and the acquired entities, because transactions involving consolidated subsidiaries must be considered.

2. IMPACT OF TAX STRUCTURE ON CASH FLOW INPUTS

The tax structure of a transaction also affects the cash flow inputs used to value the business combination under ASC 805. In a taxable business combination, the tax amortization benefit (TAB) is one of the cash flow inputs used to estimate the underlying transaction’s internal rate of return (IRR). The income approach is one methodology used to estimate the IRR by comparing the total purchase consideration to the stream of cash flows, which in a taxable business combination includes the TAB and solving for the IRR.

The TAB refers to the net present value of income tax savings resulting from the amortization of intangible assets under the respective jurisdiction’s tax law. For U.S. federal income tax purposes, amortization expense is tax deductible. Intangible assets are amortized over a 15-year period, pursuant to Section 197 of the Internal Revenue Code (IRC). Additionally, amortization expense may be deductible in some foreign jurisdictions.

The transaction’s IRR is one of the inputs considered when determining the discount rate applied in a valuation using the income approach of certain acquired assets (generally intangible assets) and assumed liabilities.

In a nontaxable business combination, the tax basis of any acquired intangible asset is not adjusted to fair value. As a result, the buyer does not gain an additional TAB from the adjusted book basis of the intangible assets. However, the buyer does obtain the

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existing tax attributes of the acquired entity and therefore, the impact of any pre-existing tax attributes of the acquired business should be considered within the cash flow inputs to the IRR calculation. For example, net operating loss or tax credit carryforwards, which result in future tax benefits to the buyer, should be considered as a cash flow input when calculating the IRR on a nontaxable business combination.

3. ACCOUNTING CONSIDERATIONS

3.1 Background

Failure to appropriately consider the tax structure of the transaction, the tax structure of the acquired entity, the tax structure of the buyer or a combination of the three may result in errors impacting the accounting for the business combination under ASC 805. Such errors may impact the income tax-related accounts recorded as a result of the business combination as well as the overall purchase price allocation and related IRR, which may lead to further errors in the valuation of the recorded amounts for the assets acquired, liabilities assumed and residual goodwill.

Common pitfalls related to the tax structure of a transaction that have the potential to cause errors in the accounting for business combinations under ASC 805 include:

- Taxable business combination incorrectly treated as a nontaxable business combination
- Nontaxable business combination incorrectly treated as a taxable business combination
- Partially taxable business combination incorrectly treated as fully taxable
- Buyer or acquired entity tax structure not properly considered

These four pitfalls, and their potential impacts on accounting for the business combination, are discussed in detail in the following section.

3.2 Illustrative Scenarios

3.2.1 Taxable business combination incorrectly treated as a nontaxable business combination

Buyer acquires membership interests in a limited liability corporation (a pass-through entity) in exchange for cash and inappropriately accounts for the business combination as nontaxable. The Buyer incorrectly assumed that the purchased membership interests should be treated the same as acquired stock in a C Corporation.

3.2.1.1 Potential impact on valuation

Buyer prepares the IRR calculation without including a TAB. By excluding the TAB, Buyer incorrectly calculates the IRR, which is generally reconciled to the weighted average cost of capital (WACC) and weighted average return on assets (WARA) as part of the valuation of the acquired assets and assumed liabilities.

Discount rates used in the valuation of intangible assets are generally derived from the WACC. Thus, if the IRR is not accurately calculated, it may lead to incorrect discount rates, impacting the valuation of acquired intangible assets, assumed liabilities and residual goodwill.

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3.2.1.2 Potential impact on tax accounts

Buyer prepares its opening balance sheet tax calculations by comparing the historical tax basis of the assets acquired and liabilities assumed to their book basis, which includes fair value adjustments, thus generating deferred tax assets and deferred tax liabilities.

Because this was actually a taxable business combination, the Buyer should not have used the acquired entity's historical tax basis of assets acquired and liabilities assumed. Had the Buyer properly adjusted the tax basis as required in a taxable business combination, the resulting opening balance sheet tax calculations would have minimal deferred tax assets and deferred tax liabilities, as both the tax basis and book basis, in most cases, would reflect the fair value adjustment of assets acquired and liabilities assumed.

3.2.2 Nontaxable business combination incorrectly treated as a taxable business combination

Buyer acquires the stock of a C Corporation in exchange for cash. The transaction agreement provides the option for Buyer and Seller to make an election pursuant to Section 338(h)(10) to treat the transaction as a taxable business combination. Buyer and Seller, however, do not make the election and thus the business combination remains nontaxable.

3.2.2.1 Potential impact on valuation

The Buyer prepares the IRR calculation, including the TAB while excluding the future tax benefits of the acquired entity's existing net operating loss (NOL) and tax credit carryforwards. By incorrectly including the TAB and excluding the NOLs and tax credit carryforwards, Buyer incorrectly calculates the IRR, which is generally reconciled to the WACC and WARA as part of the valuation of the acquired assets and assumed liabilities.

Discount rates used in the valuation of intangible assets are generally derived from the WACC. Thus, if the IRR is not correctly calculated, it may lead to incorrect discount rates, impacting the valuation of acquired intangible assets, assumed liabilities and residual goodwill.

3.2.2.2 Potential impact on tax accounts

Buyer prepares its opening balance sheet tax calculations by comparing the book and tax basis of the assets acquired and liabilities assumed, which were both adjusted to fair value, resulting in minimal deferred tax assets or deferred tax liabilities.

Because this transaction was actually a nontaxable business combination, Buyer should have used the acquired entity's historical tax basis when preparing its opening balance sheet. Had Buyer used the historical tax basis, the resulting opening balance sheet would likely have reflected significant deferred assets and deferred tax liabilities resulting from the fair value adjustment of assets acquired and liabilities assumed for book purposes.

3.2.3 Partially taxable business combination incorrectly treated as fully taxable

Buyer acquires the membership interest in a limited liability corporation (a pass-through entity) in exchange for both cash and rollover equity. Buyer inappropriately accounts for the transaction as a fully taxable business combination without appropriately considering that the rollover equity portion retains the acquired entity's

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historical tax basis (similar to a nontaxable business combination) while the portion paid in cash receives a step-up in basis because it was a taxable cash purchase of an interest in a pass-through entity.

3.2.3.1 Potential impact on valuation

Buyer prepares the IRR calculation including a full TAB while not considering the potential reduction of the TAB due to the nontaxable portion of the business combination. The Buyer also does not consider any future tax benefits attributable to the acquired entity's existing NOL and tax credit carryforwards that are attributable to the nontaxable portion of the business combination. By incorrectly including the full TAB, rather than a partial TAB, and excluding any NOLs and tax credit carryforwards attributable to the nontaxable portion of the business combination, Buyer incorrectly calculates the IRR, which is generally reconciled to the WACC and WARA as part of the valuation of the acquired assets and assumed liabilities.

Discount rates used in the valuation of intangible assets are derived from the WACC. Thus, if the IRR is not accurately calculated, it may lead to incorrect discount rates, impacting the valuation of acquired intangible assets, assumed liabilities and residual goodwill.

3.2.3.2 Potential impact on tax accounts

Buyer prepares its opening balance sheet assuming that both the book and tax basis of the assets acquired and liabilities assumed are adjusted to fair value without considering that a portion of the business combination retains the historical tax basis.

Because this transaction was actually a partially taxable business combination, Buyer should have considered that the rollover portion of the business combination retained the acquired entity's historical tax basis. Had Buyer used the historical tax basis appropriately for the nontaxable portion of the business combination, the resulting opening balance sheet would have reflected higher deferred tax assets and deferred tax liabilities resulting from the fair value adjustments to the nontaxable portion of the business combination (i.e., the portion allocated to the rollover equity).

3.2.4 Buyer entity/acquired entity tax structure not properly considered

Buyer (a pass-through entity) acquired 100% of the membership interests of another pass-through entity in a cash transaction. Buyer correctly identifies this acquisition of the membership interests as a taxable business combination but does not fully consider the tax structure of the acquired entity, which has a consolidated subsidiary that is a C Corporation (i.e., the consolidated subsidiary is not a pass-through entity). The subsidiary's tax basis is unchanged as a result of the acquisition of its parent and therefore this portion of the business combination would be considered nontaxable.

3.2.4.1 Potential impact on valuation

Buyer prepares the IRR calculation including a full TAB while not considering the potential reduction of the TAB due to the impact of the corporate subsidiary (i.e., the nontaxable portion of the business combination). Buyer also does not consider any future tax benefits attributable to the acquired corporate subsidiary's existing NOLs and tax credit carryforwards.

Excluding the corporate subsidiary's existing NOLs and tax credit carryforwards, and not reducing the potential TAB, impacts the calculated IRR, which is generally reconciled to the WACC and WARA as part of the valuation of the acquired assets and assumed liabilities.

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Discount rates used in the valuation of intangible assets are derived from the WACC. Thus, if the IRR is not accurately calculated, it may lead to incorrect discount rates, impacting the valuation of acquired intangible assets, assumed liabilities and residual goodwill.

3.2.4.2 Potential impact on tax accounts

Buyer prepares its opening balance sheet assuming that it is a pass-through entity for income tax purposes and thus there are no deferred tax assets or deferred tax liabilities recorded.

Because the acquired entity included a C Corporation subsidiary, the opening balance sheet was incorrect. Because the subsidiary's tax basis in its assets and liabilities was not impacted as a result of the business combination, Buyer should consider whether there are additional deferred taxes to be recorded as a result of differences between the book and tax basis of the C-Corporation subsidiary.

3.2.5 Summary

The above scenarios are illustrative and do not address every possible scenario. Their purpose is to highlight the potential impact on an entity's opening balance sheet under ASC 805 when management fails to appropriately consider the tax structure of a business combination.

4. AUDIT CONSIDERATIONS

To avoid scenarios like the ones illustrated above, we recommend early and frequent communication between the audit engagement team (including the engagement leader) and the senior members of the tax and valuation teams.

We also recommend that during the planning stage of the audit, the audit engagement team, core tax team and client meet and conclude on whether the business combination is considered taxable, nontaxable or partially taxable. This agreement should occur after all participants have reviewed the purchase agreement, buyer and seller organization charts, due diligence reports and any other information necessary to make this determination. These conclusions should also be communicated to any third-party valuation providers engaged by the client and to our internal valuation specialists that are assisting in the audit.

If information becomes available that changes the initial conclusion, it should be communicated to all parties so that any necessary changes to valuation assumptions and the opening balance sheet may be recorded timely.

We recognize that these conversations may not always occur timely and audit engagement teams may receive a draft valuation report from the client's valuation provider prior to the above-mentioned meetings taking place. In these instances, we recommend that audit engagement teams review the valuation report to determine whether the valuation provider has considered the business combination to be taxable, nontaxable or partially taxable. The audit engagement team should review the IRR calculation within the valuation report and related explanations included with the calculation, as that is the easiest place to identify the characterization of the business combination. Generally, if there is a TAB being added within the IRR calculation, and there are no adjustments to reduce the taxable portion by any nontaxable attributes, it is likely being treated as a fully taxable business combination. Conversely, if there is a supporting schedule computing the roll-over tax attributes, it is likely being treated as a fully nontaxable business combination. The audit engagement team should then follow

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the recommendations above and ensure that all members of the engagement team, including valuation and tax specialists as appropriate, concur with the evaluation of the tax structure of the business combination.

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