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Check Your Timing: Tax Traps for the Unwary in Acquisition Agreements

Certain tax covenants in M&A agreements sometimes get less attention than they should. And the coordination among tax and other financial accounting methodologies in key economic provisions in M&A agreements can often be overlooked. Preparation of tax returns, payment of taxes, control and participation in tax controversies, tax treatment, and purchase price allocation often (and understandably) garner the most attention. Straddle period tax allocations typically receive somewhat less attention and are often perceived as boilerplate.

The straddle period tax allocation provisions across M&A agreements generally say the same thing, just using different words depending on the form or the firm drafting them. In general, most provide that, for purposes of determining tax liabilities for any "straddle" period (typically defined as any taxable period that includes but does not end on the closing date), (1) income, sales, payroll, and other similar taxes are measured using an "interim closing of the books" approach; and (2) all other taxes, such as property or other taxes imposed on a periodic basis, are measured using a "proration" approach. The interim closing of the books approach assumes a hypothetical closing of the books at the end of the pre-closing period, typically as of a specified date and time. The proration approach applies the tax against a fraction, the numerator the number of days in the pre-closing period and the denominator the number of days in the entire taxable period. This allocation provision is critical in dividing the responsibility for pre-closing taxes to the seller in the case of any straddle period when accrued and unpaid pre-closing taxes are factored into the purchase price adjustments, whether that be in the net working capital or indebtedness calculations.

In most transactions, the end of the closing date is the natural endpoint for the pre-closing portion of the straddle period, as that is when in many cases a target's tax year terminates. Quite often an M&A closing occurs in the morning on the closing date. Sometimes, even if the parties close later in the day, the purchase agreement will specify that the "effective time" for the transaction occurs at 12:01 am on the closing date.

When the parties adopt this approach (effectively handing over the keys at the beginning of the day on the closing date), the seller will often prepare the relevant financial accruals for ordinary course items in net working capital and debt (such as target debt, receivables, cash, payables, etc.) through the end of the day on the day before the closing date – the last full day before the company changes hands. When these accruals factor in pre-closing taxes using an end of the closing date cutoff for straddle periods, this approach will create a one-day disparity between the approach for allocating straddle period taxes and the approach for allocating all other financial items run through the purchase price adjustments, which can create headaches for buyers and sellers.

Sellers can avoid this pitfall and conform the tax accrual to the general financial accrual by specifying that the endpoint for the pre-closing portion of the straddle period is the day before the closing date. However, both buyers and sellers should be mindful to specify that any tax items triggered by the transaction itself (such as deductions that crystallize at the closing and any taxes of the target incurred as a result of the transaction) will be deemed to accrue on the pre-closing side of the ledger. Sellers will want the benefit of deductions resulting from the transaction in offsetting any tax liabilities accounted for in the tax accrual, and buyers will want any transaction-related taxes (such as transfer or sales taxes) to be accounted for in the purchase price adjustments. Furthermore, the parties should be mindful of the effect the straddle approach has on *unknown* tax liabilities accounted for through indemnification or otherwise because the tax accrual is only an estimate of the *known* tax liabilities of the target at closing.

<u>Example</u>: A C corporation (Seller) sells all of its stock in a wholly owned C corporation subsidiary (Target) to another C corporation (Buyer) for cash. The purchase agreement specifies that the closing date is July 1, 2021. The agreement contains typical adjustments to purchase price, including for net working capital as estimated at closing and then adjusted after closing once better information is available. The agreement further specifies that these purchase price adjustment items are calculated as of the "effective time," which is defined as 12:01 am EDT on the closing date. The parties agreed that net working capital includes Target's unpaid and accrued income and sales taxes for the pre-closing period. If Target's accountants prepare all accruals for the net working capital calculation, including taxes, through the end of the day on June 30, 2021, given that Seller will dispose of all of Target's equity at the beginning of the day on July 1, 2021, Seller should draft the straddle period tax covenant to specify that all unpaid and accrued pre-closing income and sales taxes of Target for any 2021 straddle period are calculated as of the end of the day on the day before the closing date (using an interim closing of the books approach). However, if Target has any employee bonuses or severance payments triggered upon a change of control, Seller should specify that those amounts, which create deductions for Target's income taxes and crystallize at the closing, are nevertheless appropriately captured in net working capital as offsetting any accrued pre-closing taxes. By the same token, Buyer should also specify that taxes incurred as a result of the transaction are accounted for in the accrual; otherwise, Buyer would economically bear such transaction-related tax liabilities if the contract does not include a bright-line pre-closing tax indemnity or other pre-closing tax-related payment covenants.

Another transaction requiring this "effective time" accrual approach involves an acquisition of an S corporation that causes an "S termination year" (e.g., an acquisition by a C corporation of stock in an S corporation, causing the target's S corporation status to terminate). Section 1362(e)(1)(A) mandates an "S short year" ending the day before the termination takes effect. The period beginning the day the termination takes effect is treated as a separate short taxable year and referred to as the "C short year." Generally, items of income, loss, deduction, and credit are allocated between the S short year and the C short year using a daily proration approach, except in the case of the S corporation joining a consolidated return or if the S corporation elects to use an interim closing of the books approach. Section 1362(e)(6) also mandates an interim closing of the books approach when there has been a 50% or greater change in the ownership of the S corporation during the termination year. In any transaction that triggers an S corporation termination and thus an S short year and a C short year, the straddle period and other tax covenants in the purchase agreement should be carefully drafted to take account of the appropriate allocations permitted or required under the Code, and appropriate consideration should be given to other taxes (such as state or local sales or property taxes or transfer taxes) determined outside this special framework for federal income taxes.

These tax considerations should generally affect only one day of tax accruals, but even one day of unanticipated tax liabilities can have meaningful consequences. In addition, conforming the purchase agreement financial accounting for tax and other ordinary course items will be a welcome clarification for sellers and buyers as they sharpen their pencils and put numbers to the heavily negotiated legal text.

For more information, please contact John Baron at 704.444.1434, Danny Reach at 704.444.1272, or Eli McCrain at 704.444.1329.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Federal Tax Group

John F. Baron
Chair
704.444.1434
john.baron@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

Seth M. Buchwald
404.881.7836
seth.buchwald@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Laura L. Gavioli
212.210.9432
214.922.3580
laura.gavioli@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

Stefanie Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Sam K. Kaywood, Jr.
404.881.7481
sam.kaywood@alston.com

Clay A. Littlefield
704.444.144
clay.littlefield@alston.com

April McLeod
212.210.9487
april.mcleod@alston.com

Eli Patrick McCrain
704.444.1329
eli.mccrain@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Richard L. Slowinski
202.239.3231
richard.slowinski@alston.com

Edward Tanenbaum
212.210.9425
edward.tanenbaum@alston.com

Shawna Tunnell
202.239.3040
shawna.tunnell@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghua Road ■ Chaoyang District ■ Beijing, 100004 CN ■ +86.10.85927500
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: One South at The Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: Chase Tower ■ 2200 Ross Avenue ■ Suite 2300 ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
FORT WORTH: 3700 Hulen Street ■ Building 3 ■ Suite 150 ■ Fort Worth, Texas, USA, 76107 ■ 214.922.3400 ■ Fax: 214.922.3899
LONDON: 5th Floor ■ Octagon Point, St. Paul's ■ 5 Cheapside ■ London, EC2V 6AA, UK ■ +44.0.20.3823.2225
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ■ Suite 600 ■ Raleigh, North Carolina, USA, 27601-3034 ■ 919.862.2200 ■ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ■ Suite 2100 ■ San Francisco, California, USA, 94105-0912 ■ 415.243.1000 ■ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ■ Suite 430 ■ East Palo Alto, California, USA 94303 ■ 650.838.2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333