

M&A – Key Issues for Israeli Acquirers May 13, 2008

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Agenda/Contents

Initial Set-Up of U.S. Presence

- Issues to Consider Prior to Investment
- Forms of Doing Business
- Transfer Pricing

Selected Topics in Acquisition of U.S. Company

- Stock Acquisition v. Asset Acquisition
- Sec. 338(h)(10) Election
- Utilization of Tax Attributes (Goodwill, NOLs)
- Basic Tax-Free Acquisition Structure
- Partial Disposition of Assets
 - Leveraged Partnership Transaction
 - Parallel HoldCo Structure
- Other considerations
 - Golden Parachute Payment (Sec. 280G)
 - Transaction Cost Analysis
 - Purchase Price Allocation

Issues in Structuring U.S. Inbound Operations

- Global tax optimization and effective tax rate management.
- Form of doing business.
- U.S. trade or business or PE and tax exposure.
- Tax implications of creating entities or transferring assets into and out of the U.S.
- Planning for repatriation of profits.
- Regulatory issues.
- Local country tax issues.

Criteria for Selection of Entity

- Entity choice often the result of a "growth process".
- Key factors:
 - Projection of operating results.
 - Expected repatriation demands.
 - Type of income to be earned.
 - Availability of treaty benefits.

Available Forms

- Import only.
- Licensing agreement (indirect operation).
- Branch.
- Partnership.
- Domestic subsidiary.
- Foreign Subsidiary with U.S. branch.
- Hybrids (e.g., LLC, LLP, “Check-the-Box” entities).

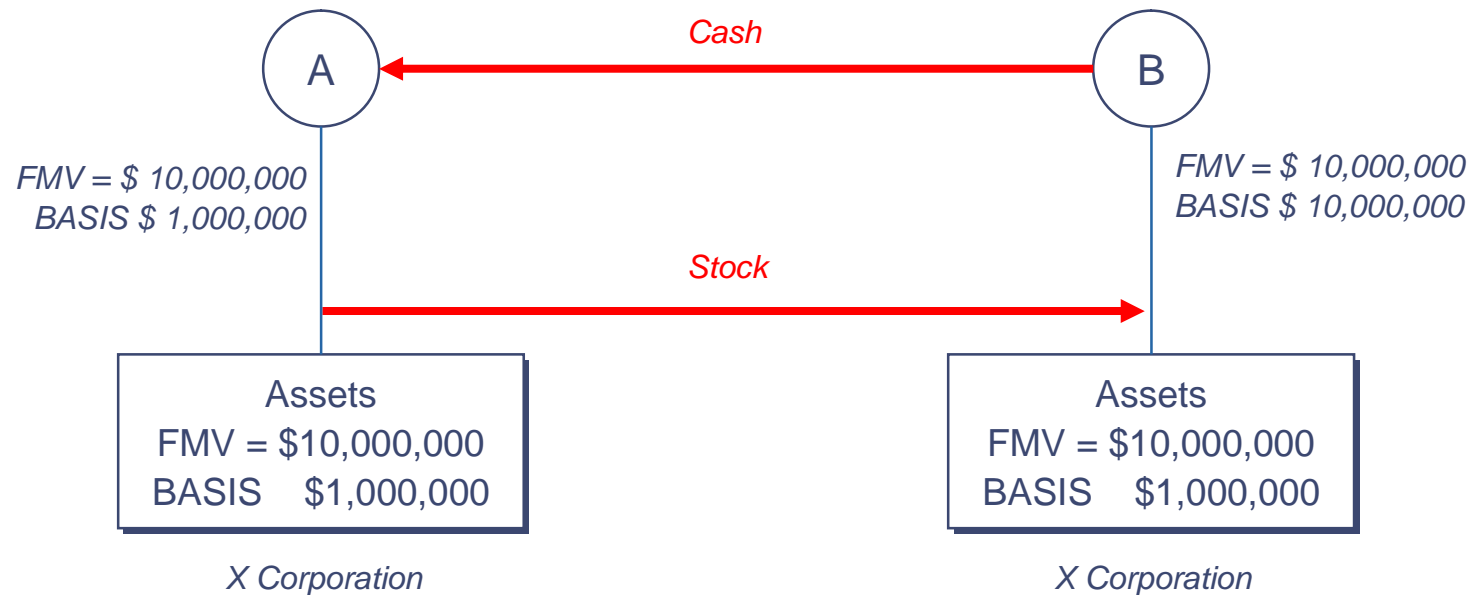
Taxable Acquisitions – Tax Objectives of Seller

- Maximize after-tax proceeds.
- Avoid recognition of gain at more than one level.
- Pay tax on capital gains rather than ordinary income.
- Minimize state taxes.
- Defer tax to another year.

Taxable Acquisitions – Tax Objectives of Buyer

- Minimization of post-acquisition taxes.
- Step-up in tax basis equal to purchase price.
 - Increased basis may be depreciated or amortized.
 - Reduction in gain on disposition of unwanted assets.
- Alternatively, acquire Target's tax attributes:
 - NOLs
 - Capital losses
 - Credits
 - Built-in losses/deductions

Typical Stock Purchase (with No Section 338 Election)



Typical Stock Purchase (with No Section 338 Election)

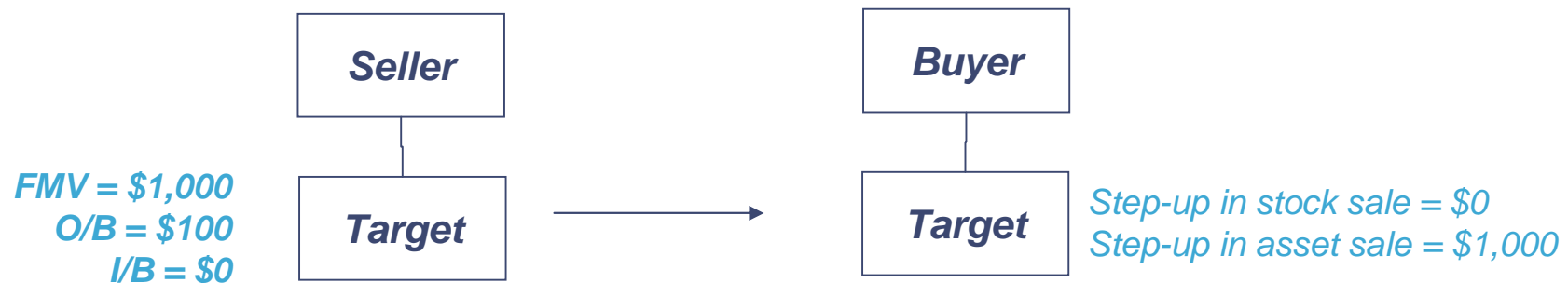
- Seller's gain based on tax basis in stock (i.e., "outside basis").
- Buyer does not obtain a step-up in tax basis (absent a Section 338 election).
- Under purchase accounting, book basis step-up recorded with no corresponding tax step-up. The book/tax disparities on depreciation and amortization can negatively impact earnings.
- Buyer inherits all of Target tax attributes (may be subject to limitation).
- Disposition of unwanted assets may result in tax cost.

Section 338(h) (10) Election

- What is it?
- Joint election by buyer and seller.
 - Treats seller of stock as having sold assets in a taxable transaction.
 - Seller therefore recognizes gain or loss on deemed asset sale.
 - Buyer gets “stepped-up” basis in assets and therefore additional future tax deductions.
- When is it available?
 - Must be a Qualified Stock Purchase – at least 80% of Target’s stock must be purchased by another corporation during a 12-month period in a taxable transaction.
 - Target may be an S or C corporation.
 - C corporation must be a subsidiary with at least 80% of its stock owned by another domestic corporation.

Section 338(h) (10) Election – Example

Where the seller's outside basis (basis in the stock) equals inside basis (target corporation's basis in the assets), the seller is generally no better or worse off by entering into a Sec. 338(h)(10) transaction. On the other hand, if the outside basis is higher than inside basis, the seller's tax cost would be greater in a Sec. 338(h)(10) transaction, thus would prefer a stock sale or seek compensation for the increased tax cost of 338(h)(10). There are circumstances in which the buyer's benefit of the Sec. 338(h)(10) election exceeds the seller's detriment. See the following example.



*Gain in stock sale = \$900
Gain in asset sale = \$1,000
Assuming 40% tax rate,
Seller is \$40 worse off.*

Assuming the entire step-up is for goodwill (amortized straight line over 15 years), a 40 % tax rate and 10% discount rate, NPV of Buyer's benefit is approximately \$200.

Section 197 Amortization of Goodwill & Other Intangibles

- Permits the amortization of the cost of certain intangibles over a 15 year period.
- Generally, the intangible must have been acquired in connection with the acquisition of a trade or business (generally) through an asset acquisition.
- Intangibles included under Section 197 include:
 - Goodwill and going concern value
 - Core deposits
 - Workforce in place
 - Customer lists
 - Patents, copyrights, formulas, etc.
 - Covenants not to compete

Net Operating Losses (“NOLs”)

- NOL results when allowable tax deductions exceed gross income.
- No regular tax, but may incur Alternative Minimum Tax (“AMT”).
- General carryback and carryforward rules.
 - 2 years back
 - 20 years forward

Net Operating Losses (“NOLs”)

- NOLs limited on changes of more than 50 percent in ownership of corporation (Section 382).
- Limitation based on value of company times long-term tax-exempt rate.
 - Limitation computed only once, not annually.
 - Unused limitation can carry over from year to year.
 - States may impose additional limitations on use of NOLs.
 - Special rules for companies emerging from bankruptcy.
- Other limitations can impact NOL utilization (e.g., SRLY).

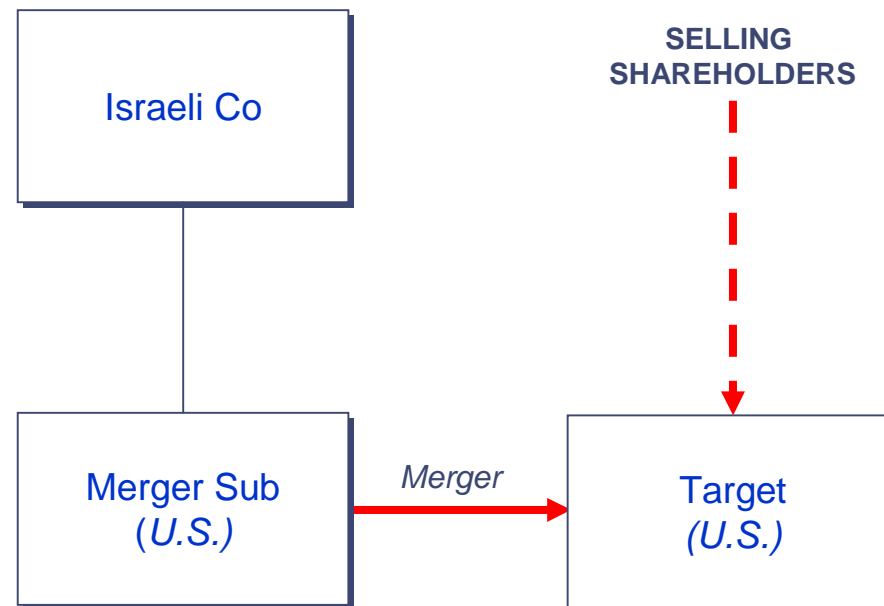
Net Operating Losses – Section 382 Limitation

- X corporation has \$50 million of NOLs and its stock is acquired for \$100 million.

The long term tax exempt rate is 5% when the stock is acquired.

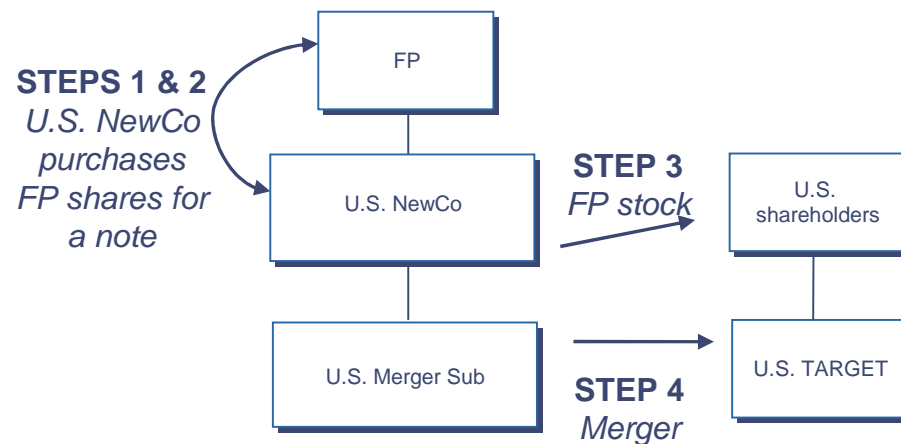
- $\$100\text{m} \times 5\% = \$5,000,000$: No more than \$5,000,000 of NOLs can be used annually.
- If not used, the limitation carries over to the next year increasing the amount of NOLs that can be utilized.
- Exception for built-in items (e.g., increase in limitation from amortization of Net Unrealized Built-In Gains (“NUBIG”)).
- Reduction of equity value for additional debt.

Typical Israeli Acquisition of U.S. Target – Reverse Triangular Merger

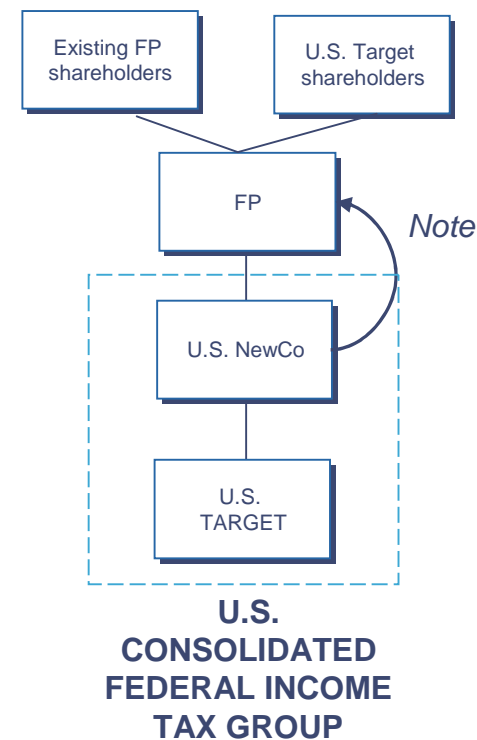


Basic Tax-Free Acquisition of U.S. Target With Debt Insertion

ACQUISITION STRUCTURE



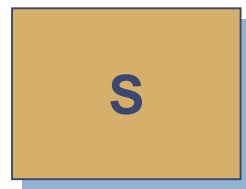
RESULTING STRUCTURE



Leveraged Partnership Transaction

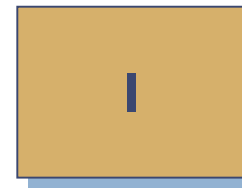
Objectives

- Facilitate the transfer of certain business assets on a tax-deferred basis
- Allow Seller Corp (“S”) to receive cash immediately
- Investor (“I”) usually receives step-up when Seller exits partnership



Business Assets

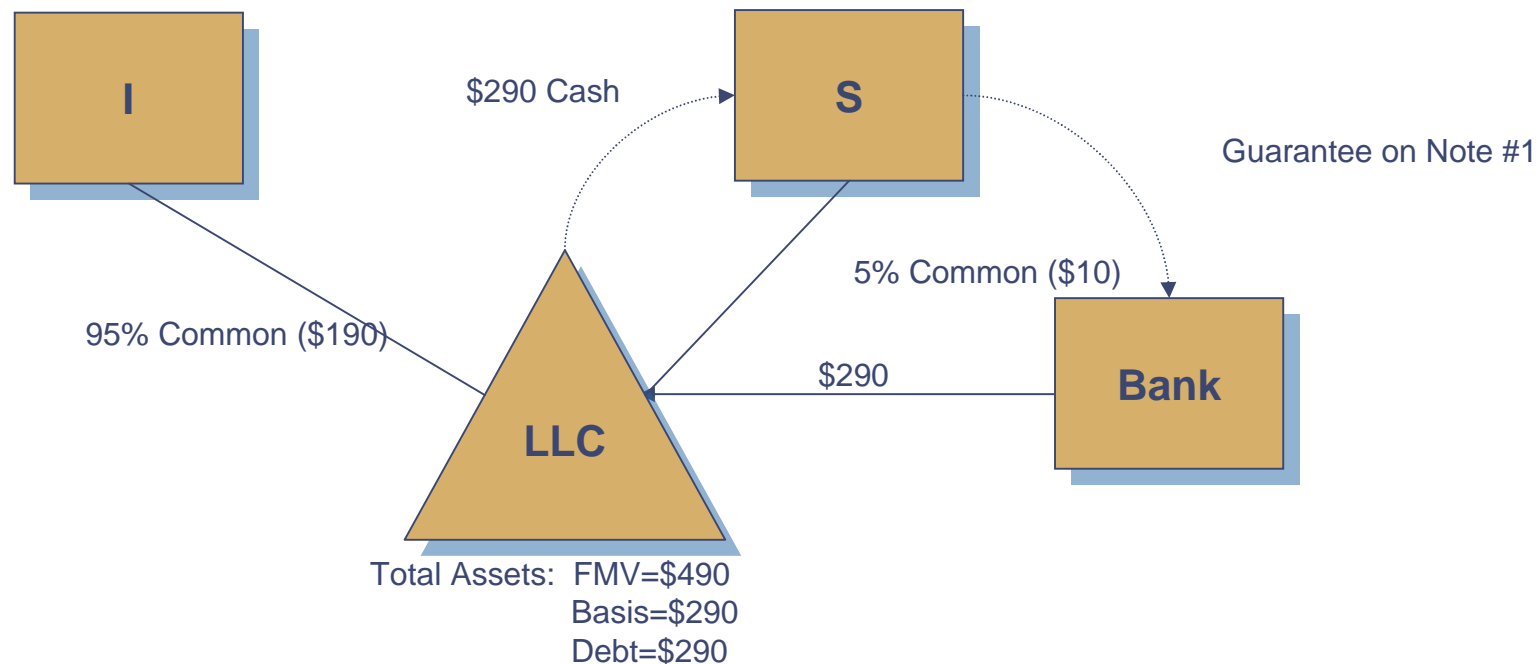
FMV = \$300 M
ATB = \$100 M



Cash and/or Working Capital

FMV = \$190 M
ATB = \$190 M

Leveraged Partnership Transaction



- Step 1: S contributes Business assets with FMV \$300, Basis \$100 and I contributes Strategic Assets (and/or working capital) to LLC with FMV \$190, Basis \$190.
- Step 2: LLC borrows \$290 from Bank (Lender #1), secured by LLC's assets.
- Step 3: LLC distributes \$290 cash to S reducing its Common interest to 5%.
- To avoid disguised sale implications, S guarantees the full \$290 debt to Lender #1.

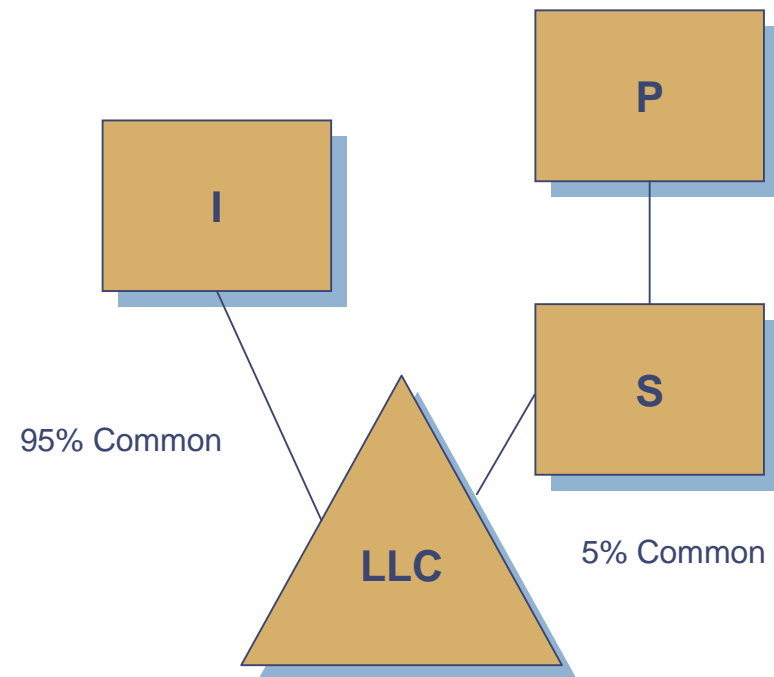
Leveraged Partnership Transaction Use of Guarantee

Issues

- P or S can provide guarantee.
- “Bottom Dollar ” guarantee
- How much other assets must guarantor have?
 - § 1.752-2(j)(4).
- Does S have sufficient common interest?

IRS Challenges (CCA 200246014)

- Disregard S as a partner
 - § 1.701-2(a)
- Disregard guarantee
 - § 1.752-2(i)
- LLC is a sham
- Substance over form

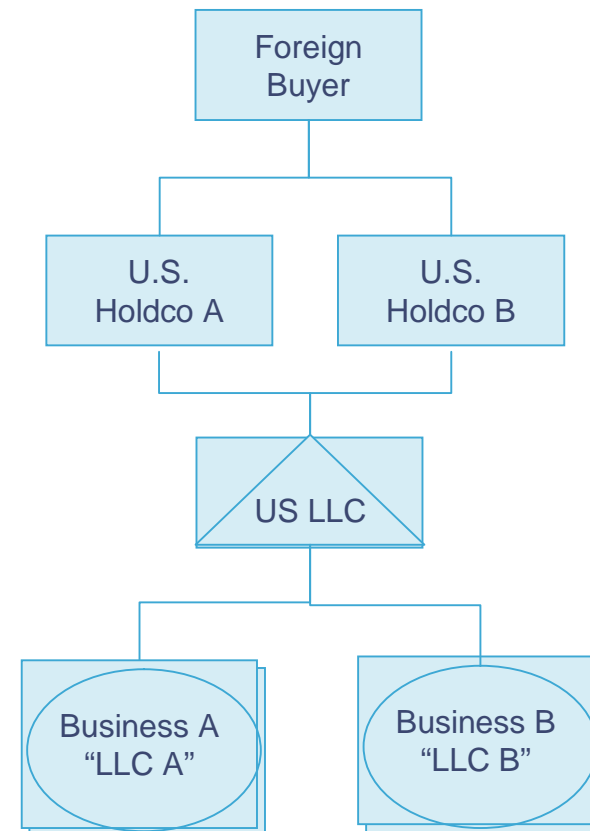


TAM 200436011- Preferred Interest

Break-up Transactions

Overview

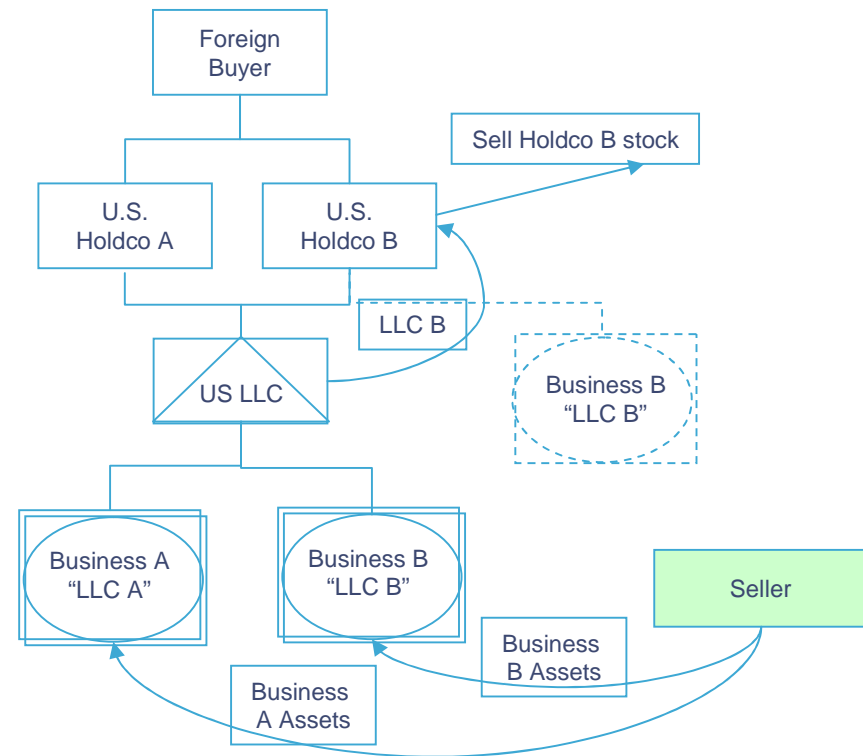
- In situations where a foreign buyer acquires multiple business units in an asset acquisition and the buyer contemplates a subsequent disposition of one of the units, the following structure may allow the buyer to enjoy the benefit of tax consolidation and minimize the tax upon the disposition.



Break-up Transactions

Steps

- (1) LLC A and LLC B acquire A and B assets, respectively. As LLC A and LLC B are disregarded for U.S. tax purposes, they are treated as assets of US LLC (a partnership for tax U.S. purposes), and thus, the income and losses of LLC A and LLC B may offset each other.
- (2) When Foreign Buyer decides to dispose of Business B, US LLC distributes LLC B to US HoldCo B. The distribution is taxed to the extent the fair market value exceeds US LLC's basis in LLC B.
- (3) Foreign Buyer disposes of the stock of US HoldCo B. Generally, such sale would not be taxed in the U.S. to the extent (i) US HoldCo does not constitute a U.S. real property interest ("FIRPTA company"), and (ii) Foreign Buyer has no effectively connected income in the U.S.



Other Considerations – Typical Post-Signing To-Do's

- Upon signing of a transaction, an action plan (“100-Day Plan”) is often prepared to list various pre- and post-closing to-do's. Typical tax items in such plan include:
 - Ensure parachute payments will not be characterized as non-deductible.
 - Perform transaction cost analysis.
 - Allocate the purchase price among the acquired assets.

What is a "golden parachute"? – Generally

- Generally, a golden parachute is a clause in the contract of a CEO or other executive officer of a corporation, that if the corporation is acquired it pays them a certain amount of money, or stock options. This payment is designed to counter the perverse incentive that a CEO has to not pursue being acquired by another corporation (because although being acquired might be good for the company and for the shareholders, it could cause the CEO to be fired). This payment is supposed to make the CEO impartial.
- These payments often cause controversy for several reasons. One being that often a company is a target for being acquired because it is performing poorly and that poor performance causes the market capitalization, or cost to purchase the company, to be lower. If purchased, the CEO would receive a large sum of money even though he had arguably done a bad job of running the company previously.

What is a "golden parachute"? – Generally

- IRC §§ 280G and 4999 disallow certain employers' compensation expense deductions and impose a 20% excise tax on the recipient on certain payments that are deemed to be "excess parachute payments"
 - Generally, the deduction disallowance and the excise tax are triggered if a "disqualified individual" receives a payment in connection with a "change in ownership or control" that exceeds 3-times the individual's 5-year average compensation from the employer (the "base amount")
 - If the "golden parachute" provisions of §§280G and 4999 are triggered, the employer's deduction is disallowed for, and the 20% excise tax is assessed to the individual on, payments in excess of 1-times the individual's base amount

When is there a change in control?

Stock Acquisition

- A person or group acquires a total of 50% or more of the stock of a corporation
- Stock may be purchased by individuals, corporation or a group of individuals or corporation
- Stock ownership is determined in accordance with Section 318(a)

Asset Acquisition

- A person or group acquires assets of the corporation with a fair value that equals or exceeds 1/3 of the total fair value of the corporation's assets
- Based on a 12-month period (ending on the date of the last asset sale)
- Exceptions for a transfer of assets for assets transferred to a shareholder in exchange for stock and 50% owned company (directly or indirectly)

Disqualified Individuals & Exemptions

- **Disqualified Individuals: Highly compensated employees are the highest paid 1% of all employees of the company**
 - Annualized compensation during the disqualified individual determination period must be at least equal to the amount described in section 414(q)(1)(B)(i) (\$100,000)
 - Highly compensated employees are limited to 250 employees
- **Exemptions: What payments are excepted from the Golden Parachute Rules?**
 - Benefit enhancements under qualified retirement plans
 - Amounts that can be proven to be “reasonable compensation”
 - Amounts paid by certain small business corporations or non-publicly traded companies (with shareholder approval)

Transaction Costs

A taxpayer must capitalize amounts paid to facilitate the following transactions:

- Acquisition of assets that constitute a trade or business
- Acquisition where the two parties are related within the meaning of section 267(b) or 707(b)
- Acquisition of an ownership interest of the taxpayer (other than an acquisition by the taxpayer)
- Restructuring, recapitalization, or reorganization of the capital structure
- Transfers as described in section 351 or 721
- Formation or organization of a disregarded entity
- Acquisition of capital
- Stock Issuance
- Borrowing
- Writing an option

Transaction Costs

- Internal costs – generally deductible
 - Employee compensation
 - Severance costs
 - Some non-traditional employee compensation costs (e.g., payments to partners)
 - Special Board of Directors Payments
 - Affiliated member filing consolidated paying employees of another member
 - 3rd party clerical and administrative (except for shareholder approval)
 - May elect to capitalize these costs.
 - Comment: The election to capitalize is essentially for those taxpayer's that capitalize such amounts for financial reporting purposes.

Transaction Costs – Deductible Costs

- **Costs of asset sales**
 - Amounts paid to facilitate the sale of unwanted assets before a merger
- **Costs of dispositions required by law or court order**
 - For example: spin-offs, taxable sales
 - Comment: Rule could help, for example, in the case of the acquisition of a target where assets must be disposed of because of anti-trust concerns.
- **Integration costs following an acquisition**
- **Registrar agent fees for maintenance of capital stock records** – other than payments made for distributing proxy statements requesting shareholder approval of a capitalized transaction
- **Stock issuance costs of open-end regulated investment companies**
- **Borrowing costs**
- **Break-up fees** – deductible unless paid to facilitate another transaction: the mutually exclusive test

Purchase Price Allocation

- Generally, in an asset based transaction, the purchase price is allocated to the underlying assets of the business, including goodwill for tax purposes. The allocable purchase price is the amount paid, plus liabilities assumed and transaction costs required to be capitalized. The purchase price is allocated based on fair market value and how it is allocated amongst different types of assets impacts the tax benefit and/or treatment to the purchaser and seller.
- The applicable Treasury Regulations require that the purchase price be allocated to the acquired assets among six asset classes, Class I through Class VI, to the extent of the fair market value of the assets in each class. (Asset Classes I through V consists of tangible assets such as cash, accounts receivable, inventory and PP&E; Asset Class VI is intangible assets except for goodwill and going concern value; and Asset Class VII is goodwill and going concern value.) Any unallocated purchase price remaining after allocation among the first six asset classes is allocated to a residual Class VII, goodwill and going concern value.

Purchase Price Allocation

- The purchaser generally prefers to allocate a greater amount of the purchase price to assets with shorter recovery lives, such as inventory and machinery as opposed to assets with longer depreciable lives such as goodwill amortizable over 15 years.
- On the other hand, the seller would generally prefer to allocate more value to capital assets rather than to inventory or Plant, Property & Equipment (“PP&E”). For individual taxpayers, gain from the sale of inventory or PP&E may be taxed as ordinary income which is taxable at a higher tax rate than is a capital gain.
- While a purchaser and seller typically agree upon a purchase price allocation, there is no requirement to do so. If the purchaser’s and seller’s allocations are not consistent, however, the IRS requires a disclosure on Form 8594 (Asset Acquisition Statement Under Section 1060) which is an IRS Form that needs to be filed by both the purchaser and the seller in an asset acquisition.

Thank you

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