Three Mini Seminars

Tax Covenants in Merger Agreements – Gray Areas and the Illegality Defense

Tax Characterization of Earnout Provisions in Corporate Acquisitions – What if the Earnout Is Subject to Vesting Conditions?

A Suggested Tax Structure for Converting LLC Employee Options When an LLC Incorporates

AUGUST 2007
EAST BAY TAX CLUB
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I. Tax Covenants in Merger Agreements – Gray Areas and the Illegality Defense.

A. Tax Covenants.

1. Coordinate parties' tax filing positions.

2. Reorganization vs. fully taxable transaction – parties may have conflict about preferred characterization.

3. Section 1060 (Form 8594) filing required in asset sales and some stock sales.

B. Contractual Agreement to Report Consistently.

1. Acknowledgment of reasonableness of reporting position.

2. What standard of certainty?

   a. More likely than not?

   b. Substantial authority?

   c. No tax fraud?

C. The Illegality Defense.

1. Illegal contracts.

2. California Civil Code.

   a. Section 1598. Where a contract has but a single object, and such object is unlawful, whether in whole or in part, or wholly impossible of performance, or so vaguely expressed as to be wholly unascertainable, the entire contract is void.

   b. Section 1599. Where a contract has several distinct objects, of which one at least is lawful, and one at least is unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest.

   3. Common Law – Transfair International, Inc. v. United States (54 Fed. Cl. 78, 80 (2002)):

From the dawn of the common law tradition in England, courts generally have refused to implement contractual undertakings that, when measured against prevailing mores, contravene public policy. See 1 Edward Coke, Institutes of the Laws of England: A Commentary upon Littleton 19 (Thomas ed. 1827) ("nihil quod est inconveniens est licitum"); Percy H. Winfield, "Public Policy in the English Common Law," 42 Harv. L. Rev. 76, 79 (1928). For its part, the Supreme Court has often applied this concept, describing it recently in the following terms: "a promise is unenforceable if the interest in its enforcement is outweighed in the circumstances by a public policy harmed by enforcement of the agreement." Town of Newton v. Rumery, 480 U.S. 386, 392 (1987).

… This doctrine is potentially applicable both where a bargain is illegal in its formation or its performance. See Restatement (Second) of Contracts Section 512 (1979).

D. Representations and Legal Opinions on Enforceability.

E. Damages for Breach of Tax Covenant.

1. Audit defense costs?
2. Principal amount of tax assessment?
3. Offset for basis step-up?
4. Penalties and interest only?

II. Tax Characterization of Earnout Provisions in Corporate Acquisitions – What if the Earnout Is Subject to Vesting Conditions?

A. Earnouts.

1. All or a portion of the deal consideration is deferred.
2. Often, payment is tied to target corporation's achievement of post-acquisition performance targets.
3. Tax characterization questions arise if payment is also conditioned on continued employment (or consulting services) by target corporation personnel following closing.

B. Tax and Financial Accounting Stakes.

1. Tax.
   a. If it's compensation:
      i. Ordinary income for recipients (withholding? employment taxes? Section 409A compliance? Section 280G parachute payment issues?)
      ii. Current deduction for acquiring corporation.
   b. If it's payment for shares:
      i. Capital gain (boot) for recipients.
      ii. Basis in target shares for acquiring corporation.
2. GAAP.

a. If it’s compensation, immediate hit to P&L for acquiring corporate group.

b. If it’s payment for shares, “purchase accounting” will apply – acquiring corporate group takes an amortizable basis in target corporation’s assets.

C. Factors to Consider.

1. What happens to unvested amounts? Forfeit or redistribute among other shareholders?

2. Is earnout distributed to all target shareholders in proportion to their stock ownership?

3. Are personnel subject to vesting also receiving stated salaries and benefits comparable to their historic salaries and benefits?

4. Are personnel subject to vesting also receiving stated salaries and benefits comparable to similarly situated personnel of the acquiring corporate group?

5. How stringent is the vesting restriction standard? Perform to specified metrics or simply avoid termination for cause?

6. Is the vesting term calculated to facilitate transfer of capital value of intellectual property or customer relationships of target corporation?

D. Consider a Tax Covenant.

III. A Suggested Tax Structure for Converting LLC Employee Options When an LLC Incorporates.

A. The Problem – Incorporating an LLC with Outstanding In-the-Money Compensatory Options.

1. No direct mechanism in IRC Section 351 to permit successor corporation to “assume” outstanding LLC compensatory options when an LLC incorporates.

2. Prior practice:

   a. Permit exercise prior to incorporation, distribute corporate shares in a Section 351 transaction.

   b. Substitute “in-the-money” NQOs for LLC options.

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3. Section 25102(o) of the California Corporations Code had limited in-the-money option grants for rank-and-file personnel. And Section 409A now creates barriers for any in-the-money option grant.

B. The Solution – In-the-Money NQOs with 409A-Compliant Exercise Provisions.

1. New corporation issues replacement corporate NQOs.
2. LLC options become worthless following incorporation and dissolution of LLC.
3. NQOs can now be issued at less than 85 percent of FMV and still comply with California securities exemption under California Corporations Code Section 25102(o).
4. NQOs will represent nonqualified deferred compensation under IRC Section 409A. So exercise can occur only upon one of the events described in Section 409A(a)(2)(A).
    a. Separation from service.
    b. Disability.
    c. Death.
    d. Change in control of issuing corporation.
    e. Specified time/fixed schedule.
        i. Section 1.409A-3(d) of the Treasury Regulations generally permits exercise to occur at any time during a single specified calendar year.
        ii. Consider setting exercise year of new NQO to match final year of the term of the prior LLC option.
5. Some lingering concern about optionee recognition of gain on a deemed “swap” of old LLC option for new corporate NQO. But some favorable prior precedent associated with option repricing and with rules governing ISO “modifications.”

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