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Tax implications and opportunities of M&A in a COVID world

In the midst of a rapidly changing US market, many companies are assessing how to monetize losses, considering raising or restructuring debt, or planning for a divestiture or acquisition of underperforming assets. That's why it's more important than ever for organizations to have timely tax planning to capture value and manage risks.

Host: **Ian Solomon, Senior Manager, Deloitte**

Guests: **Lindsay Wietfeld**

David Hoffman

Ian: Lindsay, David, great to have you on the podcast. Thanks for coming on to talk about M&A activity in this really interesting environment.

David: Glad to be here. Thank you.

Lindsay: Yeah, thank you for having us.

Ian: So, Lindsay, let's start with you. COVID-19 and the related economic environment has obviously had a huge impact on companies. But specifically, how has this landscape impacted M&A activity? And what have you seen in the market and with your clients?

Lindsay: Yeah, sure. So, M&A activity was slower than it has historically been as the uncertainty in the world really began. A lot of the deal activity went on pause. I think deals were down approximately 30 percent year-over-year in the first quarter alone.

But I will say we have seen M&A activity significantly increase. This doesn't come as a complete surprise. In April, Deloitte conducted a study of almost 3,000 clients, and 70 percent of those clients indicated that they plan to continue M&A activity, and in some cases, they even planned to accelerate their deal activities.

Some of this is related to the fact that a lot of companies have record levels of cash reserves right now. The S&P 1200 companies have nearly $3.8 trillion of cash reserves. And then the private equity sector also has nearly $2.5 trillion worth of dry powder that still needs to be deployed. So, we do expect, given that and the fact that M&A is kind of still a critical part of companies' overall growth strategies, we do expect M&A to continue an uptick here.

We expect that some M&A activity will really be defensive for some companies. Some companies might look at M&A for things like gaining liquidity or exiting a piece of the business that hasn't been performing. On the flip side, there's also companies who are planning to use M&A in an opportunistic way. So those companies might be looking at entering into new markets, investing in technology or the distressed assets out there.

Ian: And David, let's switch over to the sell side a little bit. What are some of the trends that you think we'll be seeing more of given the current environment?

David: Lindsay certainly framed what the buyer landscape is, the cash and the opportunistic nature of the buyers. What is the corollary to that, of course, is that you have some very anxious sellers, maybe because they want to take advantage of what are low capital gains rates right now in light of an uncertain political environment and the prospect of rates going up. It may be that they view that we're at the end of a strong M&A cycle, at least in terms of valuations, and they want to capitalize on what might still be—if you can somehow "COVID adjust" valuations—what still might be healthy pricing.

And some situations where you simply have to raise cash and so companies could be selling off pieces—and then even private equity—selling off pieces of a business or even businesses that are underwater and are forced to go through some sort of liquidation event to give creditors an opportunity to collect as much as they can. There's always going to be a buyer and seller, of course, but we may see a lot more seller-driven activity.

We're seeing other types of transactions also become more common. Spinoffs are certainly very popular. Any way that companies can identify ways to capture untapped value through the equity markets. Spinoffs become attractive opportunities. You also see transactions that are going to happen, a reference to creditor situations. But we'll inevitably continue to see more bankruptcies in light of the economic environment. And that generates opportunities to get bidders looking at pieces of businesses, whether in the whole or in a breakup scenario. It creates transaction opportunities.

Ian: Lindsay, when it comes to either a divestiture or an opportunistic M&A, what are some of the ways that companies can effectively tax plan?

Lindsay: I mentioned previously that we are seeing an uptick in M&A transactions, and one trend I will say I've personally noticed in the deals I've been involved in, and what our team is seeing, is that deals are very complex right now. I think there's a lot of economic factors and non-tax factors that companies and dealmakers are using in order to get deals done in this environment. For example, there is always a gap between what value a buyer wants and a seller wants. But that gap is a little bit bigger right now. So, a lot of times companies are looking at things like earn-out structures, things like that.

There's also challenges in the debt markets right now. So, companies might be turning toward additional solutions to financing a transaction. All of those things together create a lot of complexity from a tax perspective. And so it's even more important now than it has been in the past to make sure that tax is plugged in early in a transaction and that some of these economic factors and the non-tax decisions that are being made are modeled from a tax perspective so that companies and taxpayers understand what the implications of the various alternatives that they're looking at will actually lead to from a tax perspective.

Another kind of key focus area from the tax lens is monitoring tax attributes. Tax attributes have always been a key focus from an M&A perspective. But now there's a focus on understanding the value in tax attributes, planning around whether you can monetize losses that have been generated, particularly in this time, if there's a way to preserve those attributes, things like that are very important. So, again, I think the critical thing that a company can do to really plan for either a divestiture or opportunistic M&A is getting tax involved early and really modeling out the different scenarios that companies are looking at.

Ian: So, David, let's talk a little bit about due diligence. What are some of the things that tax should be on the lookout for during that part of the deal?

David: It really builds on some of what Lindsay referred to, and that is understanding what you are acquiring in the business from a tax profile. If you've got companies that are sitting on attributes in the form of net operating losses, credits of high basis, how much confidence do we have that those attributes exist and the amount at which they exist, and perhaps even more important, what's the value of those attributes in our hands?

So maybe we're buying a company with a lot of losses, but are the Section 382 ownership change rules, which are in some degree of flux because of proposed regulations last fall, are those ownership change rules really going to impair the buyer's use of those attributes in a way that means that they don't have so much value? Or how should we anticipate potential tax law changes and corporate tax rate changes as impacting the value of those attributes? So, it's really about getting your arms around what exists.

A couple other things we're seeing, and I referred to it earlier with respect to distressed transactions and the fact that you may have companies that can't even satisfy their debt obligations. But what's happening in a lot of deals is that debt is being modified in connection with the transaction itself.

And when we've got debt being modified, even in ways that may be subtle, you have the potential for cancellation of debt income and the corresponding tax implications of that, which could impact the possibility of creating taxable income that would create a cash tax or soak up some of those attributes before the buyer can even avail itself of them. Or are there implications on basis? Are there basis reductions or attribute reductions that otherwise could impair the value of those assets in the hands of the buyer?

So it does come down to understanding the full scope of the transaction, including all the changes to the capital structure, and ultimately comes down to modeling the future for this business—all the tax attributes, how those tax attributes fit into a buyer's profile, and trying to assess what the mass really looks like.

Ian: So, last question, and this is for both of you. And, Lindsay, why don't we start with you. What's the importance or the value of getting tax involved early on in either a divestiture or a carve-out?

Lindsay: Yeah, so as companies think about divesting a piece of their portfolio or carving out their business, it is important to start to think about tax matters early. Some of it comes to the structure points that I raised earlier, so making sure that you understand any tax leakage or maybe if there's a more efficient way to do the breakup of a company, that's an important piece that should get started early in a divestiture scenario.

And additionally, it's important to think about just standard tax sell-side due diligence. We're seeing a much more significant trend in this area. It's very helpful for our clients if they are prepared and understand things like what the value of their attributes are, so that they can appropriately plan or monetize those attributes on an exit.

And then also thinking about avoiding surprises. So, understanding if there are any potential areas of concern or things that need to be addressed or changed in advance of a transaction can be very powerful.

David: I would just add, Ian, that it is part of the holistic role of an organization's tax function, inclusive of tax advisers, to have as much foresight around transactional events, whether it's certain aspects of the CARES Act and other pending legislation that could have material and sometimes adverse implications on a deal, on a divestiture, and that otherwise might impact the non-transaction planning that an organization might do. Having as much runway to get ahead of those issues and make better, more well-informed decisions is valuable and hopefully avoids some of the surprises in deal negotiations.

Ian: Lindsay, David, absolutely great information. Thanks again for coming on the podcast to talk about M&A activity.

David: You're welcome.

Lindsay: Thank you.