



# Navigating Tax Issues and Terms in Healthcare M&A

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Houston, TX

**Presented by:**

Benjamin Sparks  
September 15, 2022



# Your Presenter



**Benjamin Sparks,  
JD, LLM**

**Partner-in-Charge,  
Transaction Tax  
Advisory Services**

- ▶ Ben has more than 20 years of industry experience as a tax attorney. He has worked extensively with federal and international tax matters, including cross-border transactions; tax planning; and tax structuring for investment funds, public and private clients.
- ▶ Ben has assisted many investment partnerships, such as hedge funds, private equity funds and venture capital partnerships, in addressing the economic and tax implications related to the investments and allocations relevant to their situations. Ben has driven the tax analysis for clients across many different industries, such as health care (including physician-owned practices, home health, urgent care, dental, and implementation of the MSO structure and SPAC acquisitions), financial services (including mortgage servicing, title insurance, broker-dealers), manufacturing and distribution, construction, energy and telecom. Ben has assisted private equity clients assess the tax risks on such deals, and work through the structuring considerations. He also assists founder-owned businesses complete the sale process by minimizing the tax risk and the potential tax costs on a transaction.
- ▶ Ben holds a Bachelor of Business Administration from the University of Texas at Arlington, a Juris Doctor (JD) from the Fordham University School of Law, and a Master of Laws (LLM) from the New York University School of Law.



# Audience Poll

- ▶ Have you been involved in a <\$1B M&A transaction in the last 24 months?
- ▶ Have you been involved in at least five M&A transactions in the last 24 months?
- ▶ Have you been involved in the exploratory process of a potential M&A deal in the past 24 months?

# Agenda

- ▶ Overview of the M&A Process
- ▶ What Does “Tax” Mean?
- ▶ Understanding the Transaction – When do Taxes Matter?
- ▶ Understanding the Terms
- ▶ The Tax Basis Step-Up
- ▶ The Busted “S”
- ▶ Tax Impact of the MSO Structure
- ▶ Tax Deferral
- ▶ Healthcare and the 1202 Benefit
- ▶ Sourcing and Non-resident Withholding Taxes
- ▶ “What Is Wayfair?”

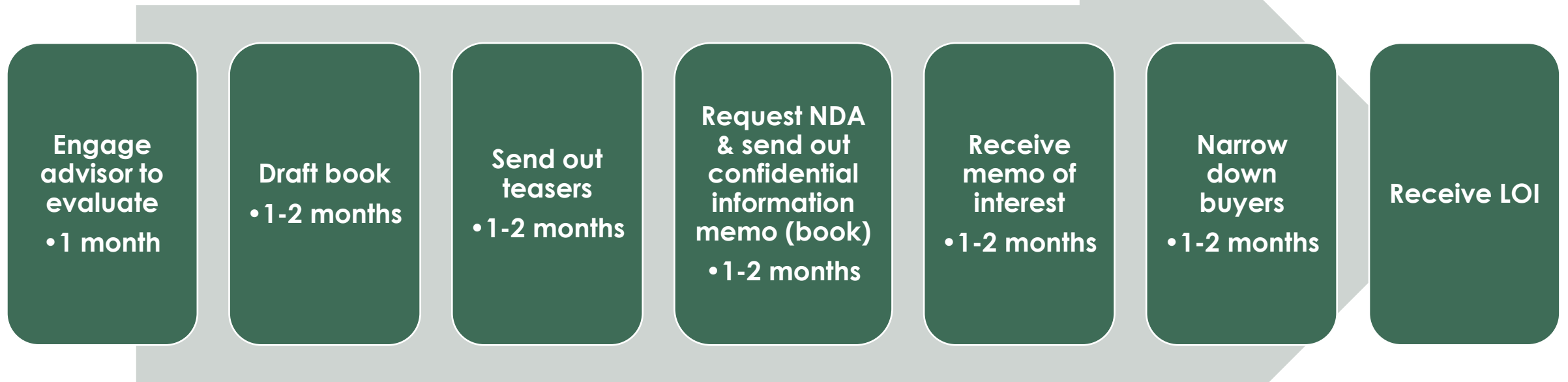




# Overview of the M&A Process



# Overview of the M&A Process (Seller's Perspective)



**Six to Ten Months**

# What Comes Next?



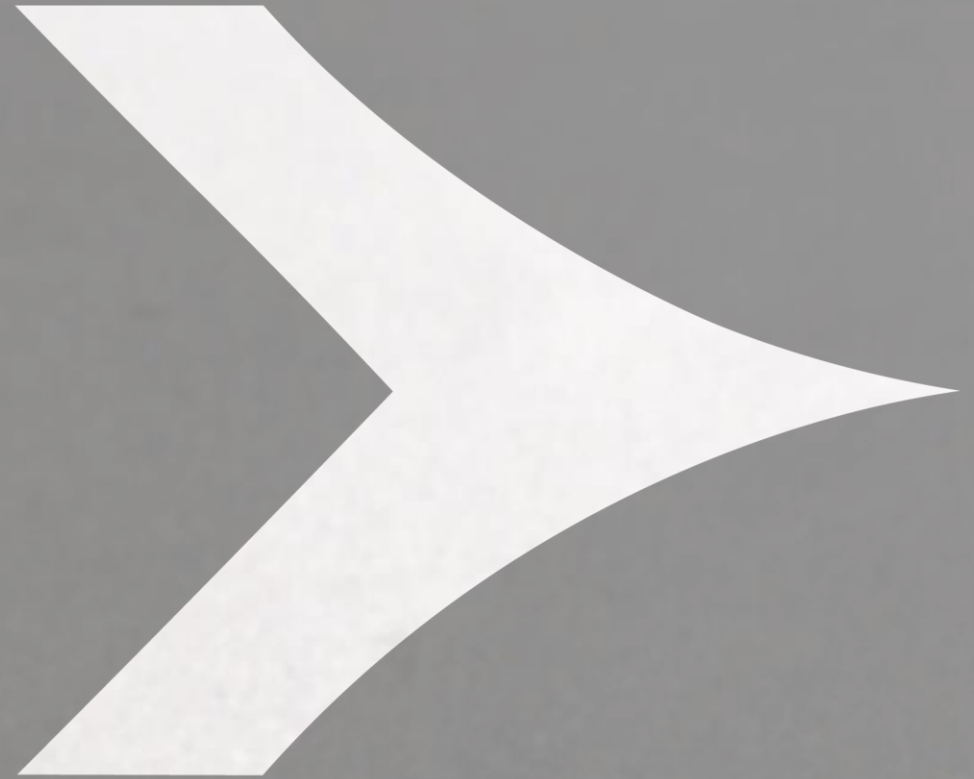
## What comes after “Receive LOI”

- ▶ Evaluate LOI offers and negotiate LOI terms.
- ▶ Initial round of financial diligence (quantitative analytics) by potential buyer(s).
- ▶ Negotiation of deal terms (purchase agreement).
- ▶ Determination of NWC PEG.
- ▶ Full scope diligence – legal, financial, tax, environmental, employment, IT, etc.
- ▶ Valuation of target assets (if needed).
- ▶ Structuring and modeling of alternatives.
- ▶ Evaluation/negotiation of transition services agreements.
- ▶ Negotiate post-close employment agreements.

## Six to Eighteen Months

A person wearing a blue suit jacket and dark pants is walking, carrying a brown leather briefcase. The person is wearing a watch on their left wrist. The background is a plain, light-colored surface.

# What Does “Tax” Mean?





# What Does “Tax” Mean?

The following is the definition used by three different law firms:

“Tax” or “Taxes” means (a) any federal, state, local or foreign taxes, charges, fees, imposts, levies or other assessments, including all income, gross receipts, capital, sales, use, ad valorem value added, transfer, franchise, profits, inventory, capital stock, license, withholding, payroll, employment social security, unemployment, excise, severance, stamp, occupation, property, escheat and estimated taxes, customs duties, fees, assessments and charges of any kind whatsoever; and (b) any interest, penalties, fines, additions to tax or additional amounts imposed by any Taxing Authority in connection with any item described in clause (a).

“Tax” or “Taxes” means (i) all federal, state, territorial, local, and foreign taxes, including income, capital, capital gains, gross receipts, windfall profits, fuel, gas import, customs, duties, alternative or add on minimum, escheat, ad valorem, value added, severance, property, production, sales, transfer, capital stock, registration, stamp, recording, premium, goods and services, harmonized sales, use, excise, franchise, margin, employment, unemployment, withholding or similar taxes, together with any interest, additions or penalties with respect thereto and (ii) any liability for amounts described in clause (i) of another Person under Treasury Regulation 1.1502-6 (or similar provisions of federal, state, local, or foreign Law), as a result of transferee liability, by Law, Contract or otherwise.

“Tax” or “Taxes” means (a) any national, federal, state, local, municipal, foreign or other tax, charge, fee, duty (including customs duty), levy or assessment, including any income, gross receipts, net proceeds, alternative or add-on minimum, corporation, ad valorem, turnover, real property, personal property (tangible or intangible), sales, use, franchise, excise, value added, stamp, leasing, lease, user, transfer, fuel, excess profits, profits, occupational, premium, interest equalization, windfall profits, severance, license, registration, payroll, environmental, escheat, unclaimed property, capital stock, capital duty, disability, estimated, gains, wealth, welfare, employee’s income withholding, other withholding, unemployment or social security, tax imposed under Sections 951A or 965 of the Code or any other tax of whatever kind (including any duty fee, assessment, impost or other charges in the nature of or in lieu of any tax) that is imposed by any Governmental Authority, including any interest, fines, penalties or additions resulting from, attributable to, or incurred in connection with any such items, (b) any Liability for payment of amounts described in clause (a) whether as a result of transferee liability, joint and several liability, or by reason of being a member of an affiliated, consolidated, combined, unitary or other group for any period, or payable by reason of Contract assumption, operation of law, or otherwise, and (c) any Liability for the payment of amounts described in clause (a) or (b) as a result of any Tax Sharing Agreement, Tax indemnity agreement or any other express or implied agreement to pay or indemnify any other Person whether by Contract or otherwise.

# Tax in a Transaction

Sale  
Transaction



## Pre-Close Issues:

1. Historical tax exposures
2. Tax Acquired exposures (prior M&A Activity of Target)
3. Tax Accounting method
4. Tax Ongoing audits

## Transaction Issues:

1. Tax deferral vs. gain recognition
2. Transfer taxes
3. Tax basis
4. Tax clearance letters

## Post-Close Issues:

1. Tax amortization
2. Tax on ongoing operations
3. Tax impact of business combinations
4. New jurisdiction filings

# Business Types



Physician Practices



Ambulatory Surgery



Diagnostic Imaging



Urgent Care Centers



Cancer Centers

Radiation Therapy  
Medical Oncology




Home Health / Hospice



Dialysis Services



Physical Therapy



Cath Labs



Hospitals

General  
Long-Term Acute  
Inpatient Rehab  
Specialty



Diagnostic Labs



Infusion Clinics



Sleep Centers



Pharmacies



Medical Technology

Device Equipment



Emergency Centers



Telehealth



Biomedical Devices



Life Sciences

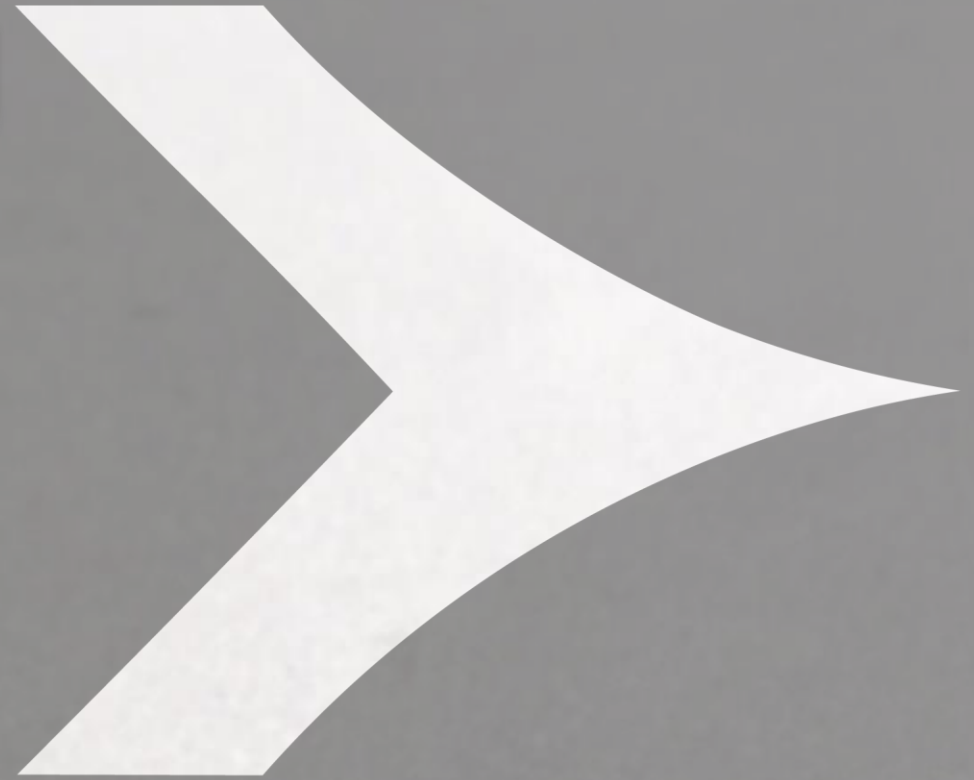


Distributors



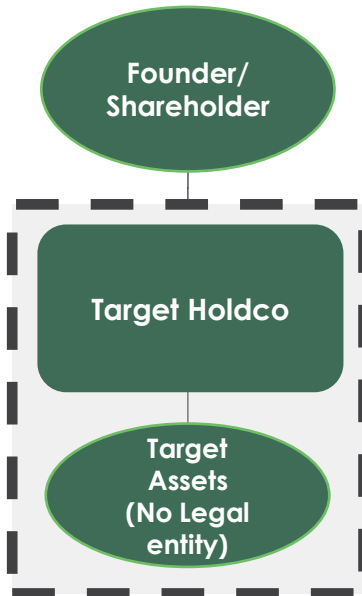
A person wearing a blue suit jacket and dark trousers is walking, carrying a brown leather briefcase. The person's left hand is on the handle of the briefcase, and a watch is visible on their left wrist. The background is a plain, light-colored wall.

# Understanding the Transaction – When Do Taxes Matter?



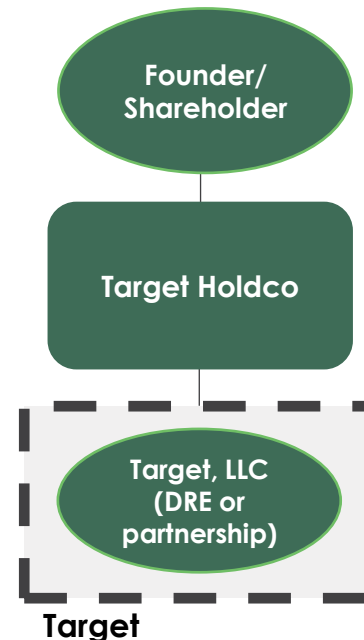
# Equity Deal vs. Asset Deal (For Legal) vs. Asset Deal (For Tax)

## Equity Deal – both tax and legal

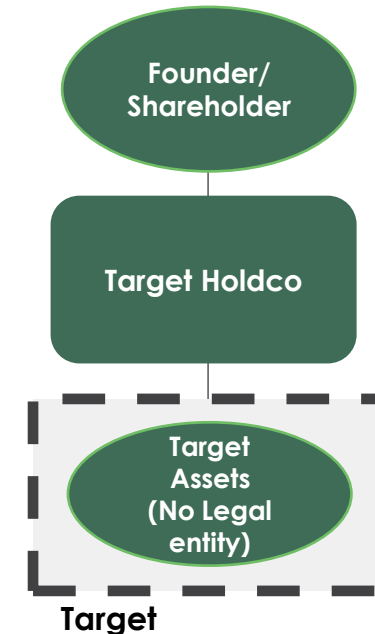


Example: Seller will (or will cause to) sell and transfer to [Buyer], and [Buyer] will purchase and acquire from Seller, **all of the Interests**

## Equity Deal – legal Asset Deal - Tax



## Asset Deal – both tax and legal



Example: Seller wishes to sell and assign to Purchaser, and Purchaser wishes to purchase and assume from Seller, substantially **all the assets and liabilities** of the Business

# When Do Taxes Matter?

- ▶ Historical tax exposures can, generally, be assumed by the buyer in the acquisition of a business in an:
  - ▶ Equity Deal for tax – all instances
  - ▶ Asset Deal for tax:
    - State income tax, in specific instances (e.g., Michigan)
    - State sales taxes
    - Payroll taxes
- ▶ What is **successor liability**?
  - Legal concept that allows a creditor to seek recovery from the purchaser of assets for liabilities that were not assumed as part of an acquisition
  - Buyer is, effectively, viewed as a continuation of the seller





# When Do Taxes Matter – Other Issues



- ▶ Cross-Border Transactions
- ▶ Structuring and Post-Transaction Impact
  - Achieving tax deferral
  - Purchase price allocation – book vs. tax
  - Value of a the tax basis step-up on value of the target

- ▶ **Understand What Is Important to the Buyer – Coordination with Deal Attorneys**
- ▶ **Role of Reps & Warranties Insurance**
  - R&W will require a specific diligence threshold be met.
  - Example of Christmas, 2020.
- ▶ **What about the Indemnities and the Reps in the Purchase Agreement?**
  - What is the scope of the indemnity?
  - What is the relationship of the parties post-close?
  - What does the recoverability process look like?





# Understanding the Terms



# Common Terms in Transaction Documents

## ALLOCATION OF PURCHASE PRICE

- Allocation of Purchase Price. The Purchase Price and the Assumed Liabilities shall be allocated among the Purchased Assets for all purposes **(including Tax and financial accounting)** as shown on the allocation schedule set forth on [Attachment] (the “**Allocation Schedule**”). The Allocation Schedule shall be prepared in accordance with Section 1060 of the Internal Revenue Code of 1986, as amended. Purchaser and Seller shall file all Tax Returns in a manner consistent with the Allocation Schedule.

Asset Class	Allocation Methodology
Class I (Cash and deposit accounts)	The actual amount.
Class II (Actively traded personal property)	The actual amount used to determine the Net Working Capital Amount.
Class III (Accounts receivable)	The actual amount used to determine the Net Working Capital Amount.
Class IV (Inventory)	The actual amount used to determine the Net Working Capital Amount.
Class V (Fixed Assets)	Amount equal to the net book value as of the Closing Date.
Class VI/VII (Intangibles & Goodwill)	Remainder; provided, however that \$1,000 shall be allocated to the restrictive covenants / non-compete agreements set forth in the Agreement (which amount shall not be used as a measure of damages in the event of breach of any restrictive covenants / non-compete agreements).

## TRANSFER TAXES

- ▶ The Parties currently do not anticipate that any transfer, sales, use, documentary, stamp or other similar Taxes will arise as a result of the consummation of the Transactions (collectively, "Transfer Taxes"). Notwithstanding the foregoing, **if any Transfer Taxes arise as a result of the consummation of the Transactions, the payment of such Transfer Taxes shall be made 50% by Seller and 50% by Buyer.** The Parties agree to cooperate with each other to minimize any such liability for Transfer Taxes to the extent legally permissible, and the Parties shall cooperate in the preparation, execution, and filing of all Tax returns regarding any Transfer Taxes that become payable in connection with the Transactions and use commercially reasonable efforts to obtain any certificate or other document from any Tax authority or any other Person as may be necessary to mitigate, reduce or eliminate any Transfer Tax.
- ▶ In this agreement, the parties agreed to a 50/50 sharing of any transfer taxes.

## INTENDED TAX TREATMENT

- ▶ The parties acknowledge and agree that the purchase of Interests by [Buyer] from Seller pursuant to this Agreement will be treated for U.S. federal and applicable state and local Tax purposes as though ***Seller sold, and [Buyer] purchased, the assets of Company directly from Seller (the "Intended Tax Treatment")***. Seller and [Buyer] agree not to report or take any Tax position (on a Tax Return or otherwise) for United States federal, state and local income Tax purposes that is inconsistent with the Intended Tax Treatment.
- ▶ This section will vary depending on the negotiated structuring of the Transaction.

A person wearing a blue suit jacket and dark pants is walking, carrying a brown leather briefcase. The person is wearing a watch on their left wrist. The background is a plain, light-colored surface.

# The Tax Basis Step-Up





# What Is the Tax Basis Step-Up?



## Illustrative Purchase Price Allocation Methodology

Asset Class	Allocation Methodology
Class I (Cash and deposit accounts)	The actual amount.
Class II (Actively traded personal property)	The actual amount used to determine the Net Working Capital Amount.
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## Allocation of \$100M Purchase Price to Sample Company

Amounts in '000s \* Includes liabilities in NWC

<b>Enterprise Value</b>	100,000
<b>Entity Liabilities</b> *	5,000
<b>Equity Roll (as a percentage)</b>	0.0%
<b>Anticipated Holding Period</b>	15
<b>Buyer's Effective Tax Rate</b>	25%
<b>Discount Rate</b>	10%
<b>Cash Purchase Price</b>	<b>105,000</b>

Amounts reflected less equity roll percentage	Tax Basis	Allocated Value	Gain to Seller
Class I (Cash)	1,000	1,000	1,000
Class II (e.g., Securities)			-
Class III (Accounts Receivable)	5,000	5,000	-
Class IV (inventory)			-
Class V (PPE)	-	5,000	5,000
Class V (Other)			-
Class VI/VII		94,000	94,000
<b>Total</b>	<b>6,000</b>	<b>105,000</b>	<b>100,000</b>

This example produces a first year cash tax reduction of **\$2.8M**; and annual cash tax savings of **\$1.6M**.

# Potential Issues on the Tax Basis Step Up

## “Kill the deal”

### ► Valuation of the Target:

Buyer submitted an LOI including the value of the step-up, seller wants to renegotiate the deal to reflect the value of the step-up.

**Solution:** Make sure the Bid Process Letter clearly identifies that the tax basis step-up should be taken into consideration in the bid price.

## “Create angst, but manageable”

### ► Tax leakage to sellers.

Buyers will often calculate the tax benefit, request a calculation from sellers of the tax leakage, and provide a gross-up to cover the tax resulting from the asset sale treatment.

### ► Allocation methodology:

Tax basis vs. NBV vs. FMV.

As long as the parties agree on a methodology and allocation, both parties have minimal tax risk with the allocation. In effect, the methodology becomes a business point. (Technically, the IRS could challenge this; in practice, this is rarely, if ever, done in a true M&A deal).





# The Busted “S”



# The Busted “S” – What Is It?

- ▶ An S-Corp is a corporation for tax purposes, that:
  - Is a domestic corporation;
  - **Has only US resident individuals as shareholders (and certain trusts);**
  - Fewer than 100 shareholders;
  - **Has only one class of stock;**
  - Is not an ineligible corporation (e.g., certain financial institutions, etc.).
- ▶ This results in flow-through tax treatment of the entity (i.e., no entity level tax for federal purposes).
- ▶ The IRS does not verify/certify an election unless this was addressed on audit.
- ▶ If the entity has a busted “S,” then it is **treated as a C-Corporation at the time of the disqualification up to the present.**



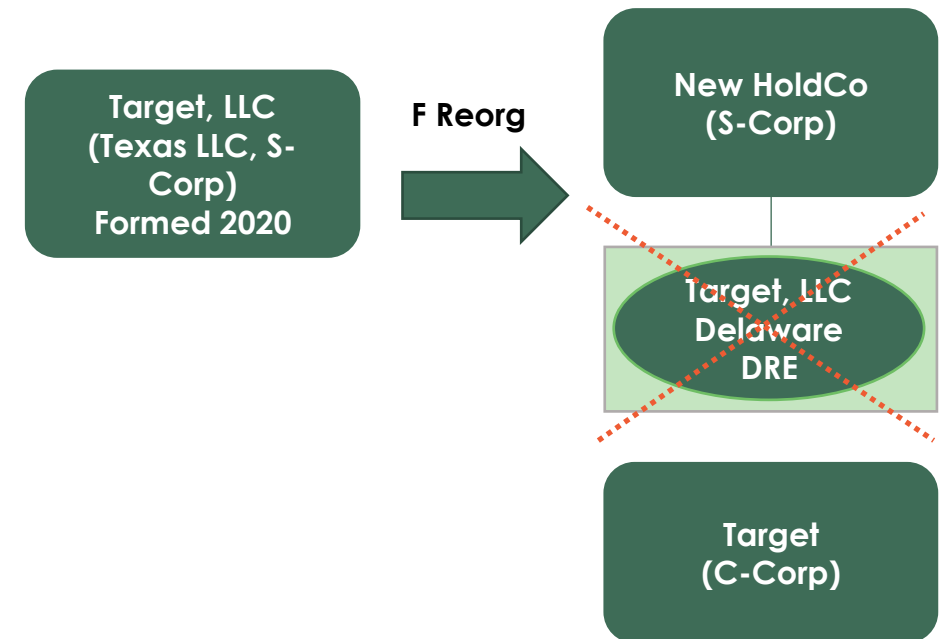
# The Busted “S” - Example

## Overview:

- ▶ Check-the-box regulations: An LLC can make an election to be either a corporation or a partnership/DRE. This can only be made once every five years (generally) without IRS approval.
- ▶ Once an election is made, it stays in place until a subsequent election is made.

**Example:** Target attempted to purge a prior election by migrating a Texas LLC, which had elected to be a corporation, to Delaware.

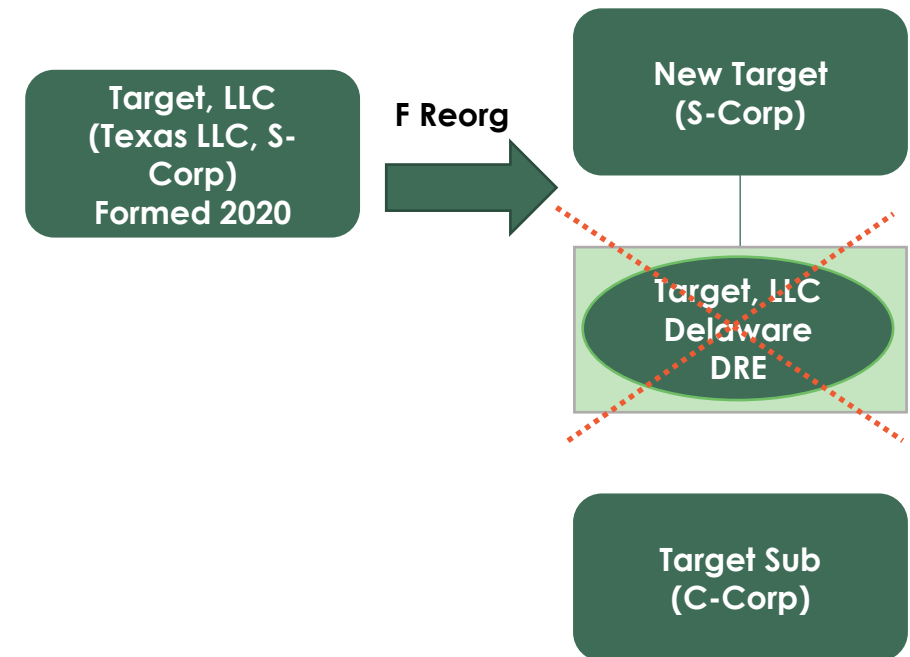
Unfortunately, this does not “purge” the prior election – instead, Target, LLC was no longer a qualifying S-Corp, and became a C-Corp.



# The Busted “S” - Example

## Deal Implications:

1. Historical tax liability due to C-Corp treatment (with tax refund to shareholders)
  2. Post-close tax liability with C-Corp in the buyer's structure
  3. Buyer is valuing the New Target inclusive of tax basis step-up. A C-Corp in the structure negates the step-up
- ▶ Buyer evaluated special policy to cover the tax risk
  - ▶ Ultimately, buyers decided doing this as an asset deal (legal and tax) was the best option to addressing the busted S in this scenario





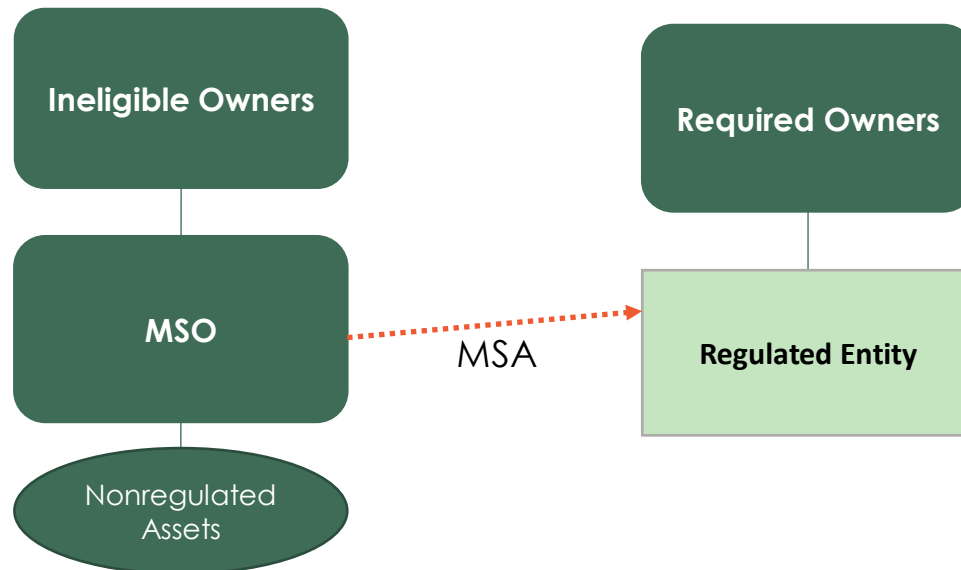
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# Tax Impact of the MSO structure



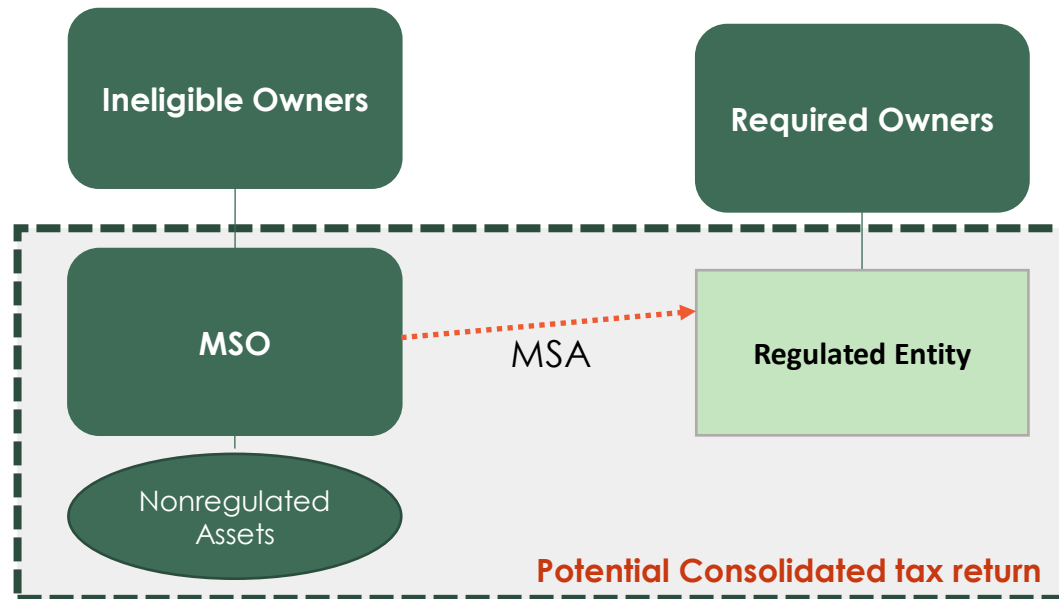
# MSO structure – What Is It?

- ▶ An organizational structure that allows for certain owners to receive the economic benefit of certain activities while meeting certain regulatory ownership requirements.



# MSO structure – Consolidation

- ▶ Because of the MSA between the Regulated Entity and the MSO, the tax filing positions of the companies to be evaluated carefully.
- ▶ Depending on the extent of the economics sent to the MSO, the Regulated Entity may be considered a consolidating entity of the MSO.







# Tax Deferral



# Equity Roll and Tax Deferral

- ▶ **Equity roll** – Often a financial buyer (e.g., private equity) will require the sellers to continue to receive a portion of the Enterprise Value (total sales price) in the form of buyer equity, typically between 10-30%. Depending on the structure of the entities involved, the receipt of buyer equity may be taxable proceeds.
- ▶ Both parties will typically look to try to structure the deal such that sellers do not incur a tax liability on the equity proceeds, but instead, defer recognition of gain until a subsequent sale.

# Impact of Corporate Buyer

## Partnership Target

- ▶ Receipt of buyer stock will be taxable proceeds unless the transaction qualifies as a 351 (>80% contribution).
- ▶ Alternative – consider installment sale (e.g., convertible note).
- ▶ Check-and-Merge: may be an option, but need to make sure there is plenty of blue sky before LOI.

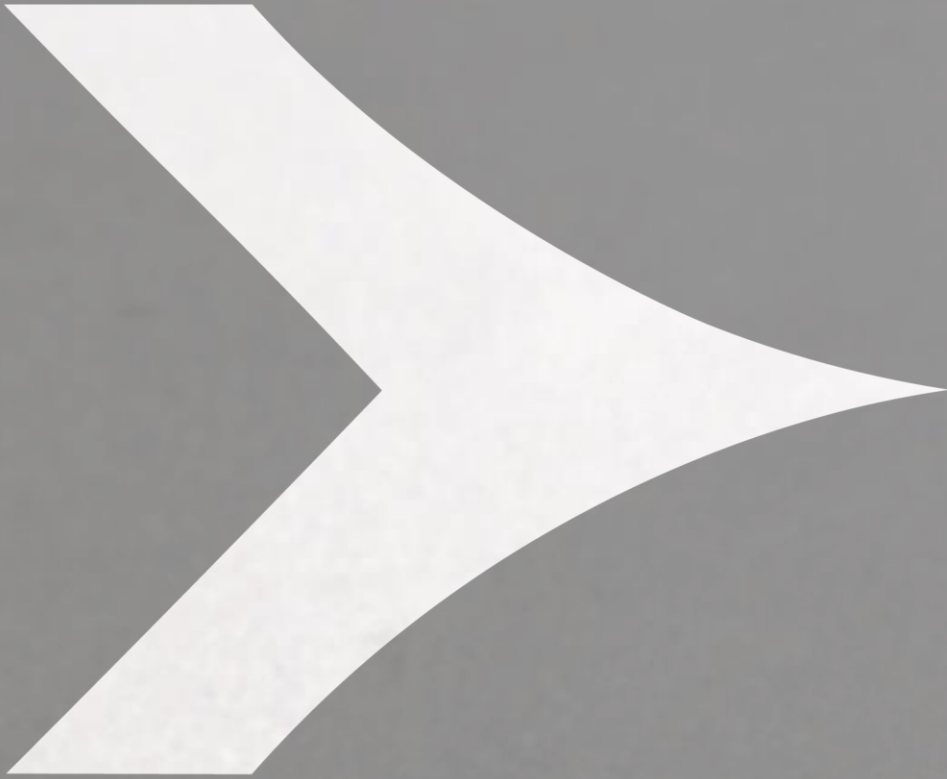
## Corporate Target

- ▶ Reorg provisions may help, but need at least 40% equity roll to qualify.
- ▶ Alternative – consider installment sale (e.g., convertible note).
- ▶ Use of an Aggregator Partnership.





# Healthcare and the 1202 Benefit

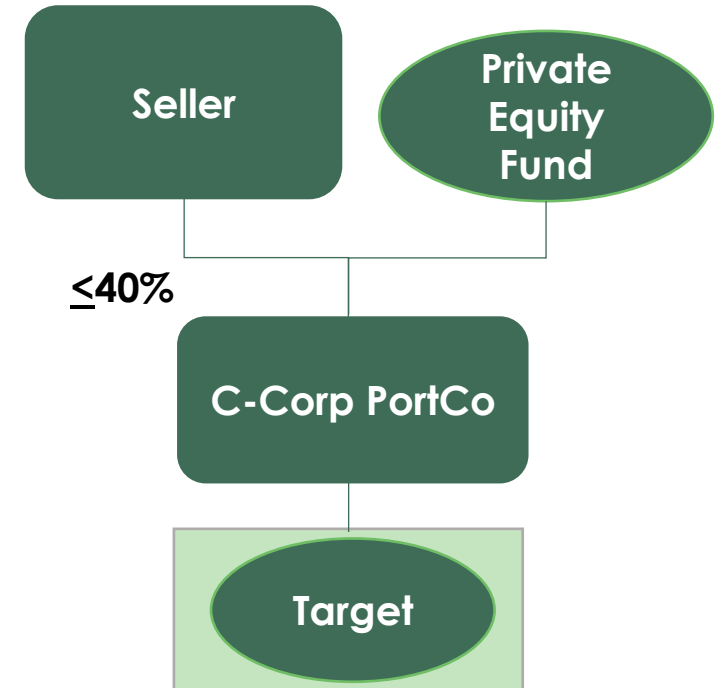


# Tax Deferral on a 1202 Structure

- ▶ Section 1202 – In certain situations, sale of C-Corp stock can be tax free up to \$10M or 10x tax basis.
- ▶ Some investment funds have C-Corp structures that may eventually take advantage of this rule.
- ▶ Achieving tax deferral for an add-on target can be challenging.

## Potential issues to consider:

- ▶ Impact of Target assets on 1202 eligibility
- ▶ Ability to transfer PortCo and retain 1202 benefit
- ▶ Five year hold requirement and holding period segmentation
- ▶ Fund investor restrictions (aggregator partnership)



# What are 1202 prohibited services?




- Certain “prohibited” businesses cannot qualify for § 1202 such as health services
- Reg. § 1.199A-5 (B)(2)(II) - Health services defined as “the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such.”

## Permitted Services:

- Laboratory services
- Pharmaceutical testing/ research
- Manufacturers health products
- Diagnostic services
- Distributors
- Surgery Centers
- Others?



A close-up photograph of a person's hand pointing at a document on a wooden table. The table is cluttered with various papers, including a circular diagram with numbers, and several colorful sticky notes (yellow, pink, green). The background is slightly blurred, showing other people's hands and a white mug. The overall scene suggests a collaborative work environment or a meeting.

# Sourcing and Non-resident Withholding Taxes



# State Income Tax Issues

## What's the risk?

- ▶ State income taxes vs. non-resident withholding taxes
- ▶ Impact of S election:
  - A few states do not allow for S-Corps
  - A few states require a separate election to be filed with the state
- ▶ Successor liability – if there is an exposure, each state needs to be considered under state law (if an asset deal)

## Sourcing & Nexus

- ▶ States vary on what is considered as state source income:
  - Debt Collector example
- ▶ P.L. 86-272 generally protects taxpayers if there is no physical presence – but this is an area under constant discussion.
- ▶ Industry impact – SaaS vs. Services vs. Manufacturer/Distributor, etc.

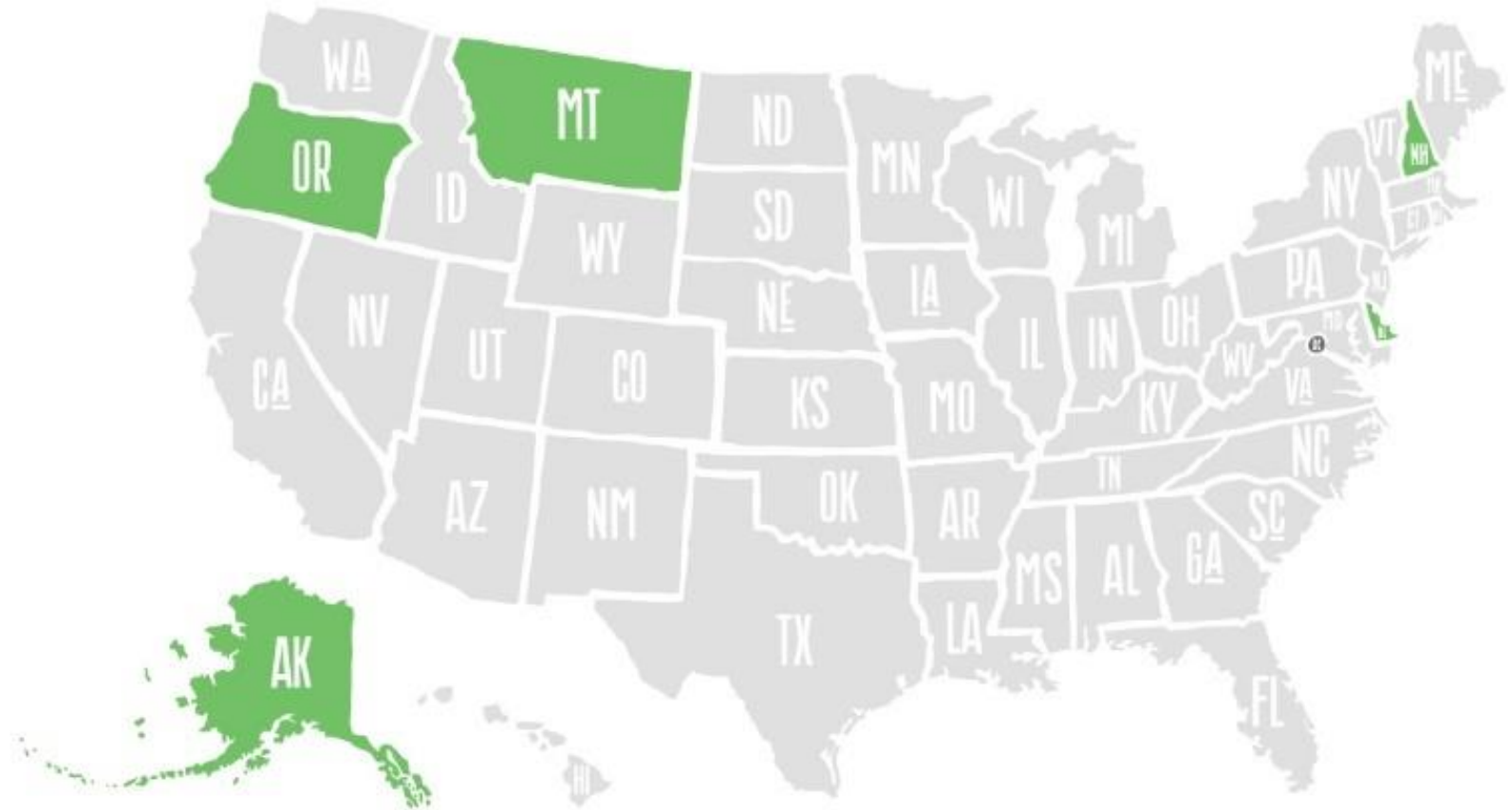


# “What is Wayfair?”

# Overview

## What states *do not* impose a state sales tax?

- ▶ New Hampshire
- ▶ Oregon
- ▶ Montana
- ▶ Alaska
- ▶ Delaware





## A Few Terms to Know...

### ▶ Sales Tax Nexus:

- Connection between a business and a state or local taxing jurisdiction.

### ▶ Substantial Nexus:

- Establishes a connection with a state due to physical presence or economic or virtual contacts.

### ▶ Economic Nexus:

- Establishes a connection with a state based upon economic activity.

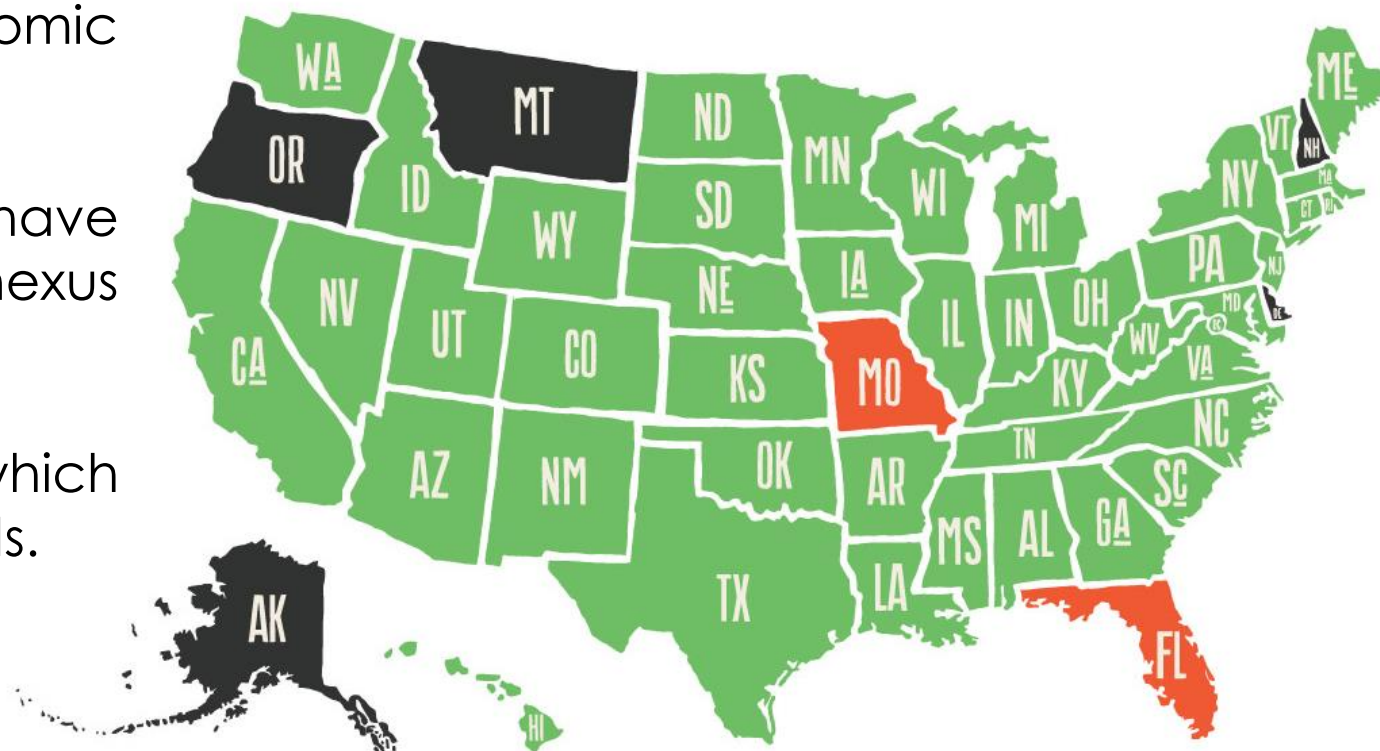
### ▶ Remote Seller:

- A business that sells products to customers in a state using the internet, mail order or telephone, without having a physical presence in that state.

# Economic Nexus Update

## Economic Nexus Legislation Status by State:

- ▶ MO and FL recently passed economic sales tax nexus legislation.
- ▶ All states that impose a sales tax have now passed economic nexus legislation.
- ▶ Alaska has local jurisdictions which impose economic nexus thresholds.



# Record Keeping

As a trustee of the state, you may be subject to a sales tax audit and you are expected to **keep accurate records**.

- ▶ Sales and purchase transactions that can be reconciled to your books and records.
- ▶ Invoice copies, contracts, exemption certificates.
- ▶ Failure to retain accurate and auditable records can result in estimated tax judgements against your business.
- ▶ Record retention
  - NY – three years
  - TX – four years
  - *In most states, unfiled returns will not toll the statute of limitations*





# Questions?





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