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**Tax Due Diligence for M&A Transactions**

***Presented by:***

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# Introduction

## *Tax Due Diligence for M&A Transactions:*

1. Structural Considerations
2. Federal Income Tax Compliance
3. State and Local Tax (SALT)
4. Employment Tax & Payroll Compliance
5. Indirect Taxes & Specialized Taxes
6. Transaction-Specific Considerations
7. Employment & Benefit Plan Tax Issues
8. Transaction Taxes
9. International Tax (if applicable)
10. Legal Agreements and Support Documents
11. Unreported or Contingent Liabilities
12. Typical Deliverables in a Tax Due Diligence Review

# 1. STRUCTURAL CONSIDERATIONS

## Entity Classification & Structure

- Confirm the entity type for target
  - C corporation, S corporation, partnership, disregarded entity, LLC
  - Request corporate formation documents filed with the applicable Department of State
- Evaluate S corporation status
  - Including potential eligibility and inadvertence termination issues
    - **Ineligible shareholders** (nonresident aliens, corporations, partnerships, certain trusts)
    - **Second class of stock** issues (disproportionate distribution or liquidation rights)
    - **QSST/ESBT failures** or late elections
  - Request IRS Form 2553, *Election by a Small Business Corporation*
  - Request IRS S corporation acceptance letter (CP261 Notice)
  - If CP261 Notice is unavailable, request Buyer to obtain S Corporation Verification Letter 385C
    - Have an officer of target entity call the IRS Business and Specialty Tax Line to verify the S corporation election date and current S corporation status
- Identify any changes in entity classification
  - Have there been any prior Form 8832, *Entity Classification Elections* for FIT purposes
  - Change in entity classification can only be made once every 60 months

## Entity Classification & Structure

- Review ownership structure for issues that may affect tax attributes or liabilities
  - Net Operating Losses & Credits
    - IRC §§ 382 and 383
    - Significant equity transfers may trigger an ownership change
    - Prior financing rounds, redemptions, option exercises, or equity compensation issuances matter
  
  - Impact:
    - Annual limitation on NOL usage
    - Credits may be severely limited or unusable post-closing

## Transaction Structure Implications

- Stock vs. asset sale impact on tax liabilities and tax attributes
  - **Stock (Equity) Sale**
    - Buyer acquires the entity “as is”
    - All historic tax liabilities, attributes, elections, and exposures remain with the entity
    - No step-up in asset basis (unless special election)
    - Buyer inherits – historic income tax exposure, payroll and sales tax liabilities, nexus risk, pending audits (successor tax liability exposure)
    - Tax attributes (NOLs, credits) remain with the target company but may be limited by § 382
  - Seller perspective
    - Often preferred by selling shareholders as it results in a single level of tax at the shareholder level (gain is typically treated as capital gain)
    - No entity-level tax is imposed on the target company (unlike an asset sale)
  - Buyer perspective
    - Strong tax reps & warranties
    - Escrow/holdback
    - Indemnities and survival period

## Transaction Structure Implications

- Stock vs. asset sale impact on tax liabilities and tax attributes
  - **Asset Sale**
    - Buyer selects assets and often excludes liabilities
    - Seller retains historic entity-level tax exposure
    - Buyer receives **step-up in asset basis** (which significantly increases Buyer ROI)
    - Purchase price allocated under § 1060
    - Future depreciation/amortization benefits
    - NOLs remain with seller (Buyer gets none)
  - Seller perspective
    - C-corp sellers face **double taxation** – at the entity level and at the shareholder level when the proceeds are distributed to shareholders
    - Pass-through sellers – gain flows through to owners but may include ordinary income components (*e.g.*, depreciation recapture, inventory and receivables, etc.)
  - Buyer perspective
    - Reduced successor liability
    - Ability to avoid legacy tax issues

- Deemed Asset Sales (Hybrid Structures)
  - **§ 338(h)(10) Election**
    - Available for S-corps and consolidated subsidiaries
    - Transaction is legally a stock sale
    - Treated as an asset sale for tax purposes
    - Buyer gets **step-up in asset basis**
    - Seller recognizes asset-level gain
    - S-corp BIG tax may apply
  
    - **Key Diligence**
      - Eligibility confirmation
      - State conformity analysis – states that decouple from federal law entirely may or may not recognize the election or classify the gain differently
      - Allocation of asset disputes
  
  - **§ 336(e) Election**
    - Similar to § 338(h)(10) but:
      - Seller-initiated
      - More flexible ownership thresholds
      - State conformity varies widely

- Tax Representations and Warranties
  - Are assurances by the seller that specific statements about the target's tax matters are true and accurate as of a specified date (often signing and/or closing). If any statement proves to be untrue, the buyer may have contractual remedies such as indemnification, purchase price adjustment, or escrow recovery.
  
  - Designed to:
    - Allocate **pre-closing tax risk** to the seller
    - Supplement and backstop **tax due diligence**
    - Support **indemnification and escrow provisions**
    - Provide a basis for **closing conditions**
    - Encourage full disclosure of known tax issues through schedules
  
  - Are a critical tool for identifying, disclosing, and allocating tax risk in an M&A transaction as they bridge tax due diligence and post-closing protection by converting factual tax assumptions into enforceable contractual obligations.

- How Tax Reps and Warranties Are Used in the Agreement
  - **Disclosure Schedules:** Sellers qualify tax reps by disclosing exceptions
  - **Indemnification:** Breaches typically trigger seller indemnification for pre-closing taxes
  - **Survival Periods:** Tax reps often survive longer than general reps (sometimes through the statute of limitations)
  - **Escrows / Holdbacks:** Buyers may require a specific tax escrow
  - **Closing Conditions:** Accuracy of tax reps may be a condition to closing

- Common Tax Representations and Warranties
  1. Tax Returns and Payments
    - All required tax returns have been **timely filed**
    - All taxes shown as due have been **timely paid**
    - Returns are **true, complete, and correct** in all material respects
  2. No Undisclosed Tax Liabilities
    - The target has no unpaid or unaccrued tax liabilities other than those reflected on the balance sheet or incurred in the ordinary course of business
  3. Tax Audits and Controversies
    - No ongoing, pending, or threatened audits, examinations, or disputes with taxing authorities
    - All audits have been resolved and properly paid
  4. Withholding and Employment Taxes
    - Proper withholding and remittance of payroll, employment, and backup withholding taxes
    - Proper classification of employees vs. independent contractors

- Common Tax Representations and Warranties – Cont'd
  5. Sales, Use, and Other Indirect Taxes
    - Proper collection and remittance of sales, use, VAT, or similar taxes
    - Disclosure of nexus in applicable jurisdictions
  6. Tax Liens
    - No tax liens or encumbrances on the target's assets (other than permitted liens)
  7. Tax Elections and Accounting Methods
    - Disclosure of material tax elections
    - Consistent and compliant accounting methods for tax purposes
  8. Tax Attributes
    - Accuracy and availability of net operating losses, credits, and other tax attributes
    - No limitations or events that would impair such attributes (*e.g.*, IRC § 382)
  9. Related-Party and International Matters
    - Proper treatment and documentation of related-party transactions
    - Compliance with transfer pricing rules
    - No participation in listed or reportable transactions (or proper disclosure if applicable)

- Tax Covenants
  - Allocate responsibility for tax-related actions and cooperation surrounding the transaction and post-closing periods. They are enforceable obligations and often survive closing independently of indemnification limits applicable to representations and warranties.
  - Designed to:
    - Protect the buyer from actions that could create **pre-closing tax liabilities**
    - Ensure **proper filing, payment, and cooperation** after closing
    - Preserve valuable **tax attributes**
    - Define **control of tax audits and controversies**
    - Support the intended **tax structure** of the transaction
  - Are a critical component of M&A agreements because they actively manage tax risk across the signing-to-closing period and beyond. They ensure continuity, protect negotiated tax outcomes, and provide clear rules for handling tax matters after the transaction closes.

- Common Tax Covenants

1. Pre-Closing Tax Conduct Covenants – require the seller (and target) to:

- Operate in the **ordinary course** consistent with past tax practices
- Refrain from making or changing tax elections
- Avoid amending tax returns
- Avoid settling or initiating tax audits without buyer consent
- Avoid actions that would jeopardize tax attributes (*e.g.*, NOLs)

2. Post-Closing Tax Filing Covenants

- Allocate responsibility for preparing and filing tax returns for:
  - Pre-closing periods
  - Straddle periods (tax periods that include the closing date)
- These covenants often specify:
  - Which party prepares the return
  - Review and approval rights
  - Allocation methodologies (*e.g.*, interim closing vs. proration)

- Common Tax Covenants – Cont’d
  3. Tax Payment and Indemnity Covenants – provide that:
    - Seller is responsible for **pre-closing taxes**
    - Buyer is responsible for **post-closing taxes**
    - Mechanics for payment, reimbursement, or indemnification
  4. Tax Audit and Controversy Covenants – establish procedures for:
    - Notice of tax audits or inquiries
    - Control of audit defense
    - Cooperation between buyer and seller
    - Settlement authority and consent rights
  5. Transfer and Transaction Tax Covenants – address:
    - Responsibility for **transfer taxes**, stamp duties, or similar taxes
    - Allocation of payment between buyer and seller
    - Filing of related returns or forms

- Common Tax Covenants – Cont'd

- 6. Tax Elections and Structural Covenants – commit parties to:

- Make or refrain from making specific tax elections (*e.g.*, IRC §§ 338(h)(10), 336(e))
    - File consistent tax returns reflecting the agreed transaction structure
    - Cooperate in purchase price allocation filings (*e.g.*, Form 8594)

- 7. Information and Cooperation Covenants – require ongoing cooperation, including:

- Access to books and records
    - Sharing tax information
    - Assistance with audits, filings, and claims for refunds

## 2. FEDERAL INCOME TAX COMPLIANCE

## Historical Return Review

- Review at least 3 – 5 years of federal income tax returns
  - Have returns been prepared consistent with entity structure
  - Any significant reported or unreported tax positions
  - Have returns been timely filed
  - Private letter rulings
- Identify:
  - Audit history
  - Pending examinations
  - Extension of statute of limitations
  - Unresolved issues

## Key Areas to Scrutinize

- Revenue recognition and accounting methods (IRC § 451, UNICAP)
- Deductions with risk (repairs vs. capital improvements, IRC § 162 expenses)
- R&D credits, wage-based credits, or other incentives
- NOLs, credit carryforwards, and expiration schedules
- Transfer pricing if cross-border (intercompany arrangements, documentation)
- Ascertain deferred tax assets/liabilities and uncertain tax positions (ASC 740)

### 3. STATE AND LOCAL TAX (SALT)

## Nexus Exposure

- Evaluate sales tax, income tax, payroll tax nexus across states
  - **Nexus** is the connection that allows a state to tax a business.
- Review economic nexus thresholds (Wayfair-type exposure)
  - South Dakota v. Wayfair, Inc., U.S. Supreme Court, June 2018
  - Before the Wayfair decision, states could generally require a business to collect sales tax only if the business had a physical connection to the state.
  - The Wayfair ruling eliminated the requirement that a seller have physical presence in the taxing state and now allows states to tax businesses with no physical presence in the state (remote business), in addition to in-state businesses.
  - By January 1, 2020, nearly every state with a general sales tax has implemented an economic nexus law requiring remote retailers to register for and collect sales tax if their sales in the state exceed a certain threshold.
  - **Economic nexus** is the kind of connection that's economic in nature, such as having \$100,000 in sales in the state or 200 separate sales transactions during the previous calendar year.
  - Exempt sales of goods and services may count toward your economic nexus threshold. Each state has its own economic nexus requirements so it critical to understand the nuances.
  - Taxpayers need to register (with the Secretary of State to do business and with Revenue for tax purposes) in states where they have economic nexus.

- **Claimed Exemptions**
  - Buyer will request Seller's sales by state for the past 3 to 5 years to determine compliance.
  
- **Uncollected Tax Risks**
  - Buyer will require Seller to enter Voluntary Disclosure Agreements (VDAs) with noncompliant states and will require sales proceeds be placed into escrow to pay tax and interest (penalties typically waived).
  - VDA lookback period varies per state (*e.g.*, three, four or five years).
  
- **Marketplace Requirements**
  - Effective April 1, 2018, PA implemented its marketplace facilitator law (Revenue added subsequent Sales and Use Tax Bulletin 2019-01) in response to Wayfair.
    - Requires marketplace facilitators (think Amazon, Etsy, etc.) with \$100,000 of gross sales into PA to collect and remit tax on third-party sales as well as on its own taxable sales.
    - Amazon started collecting and remitting tax for its third-party sellers in PA on April 1, 2018.
    - Significant uptick in sales tax litigation as a result of the PA's marketplace facilitator law.

- **Franchise Taxes**
  - State-imposed taxes or fees for the privilege of doing business in a state
  - Tax base - Net worth or capital (*e.g.*, Delaware, Tennessee), Gross receipts (*e.g.*, Texas), authorized shares or assumed capital, flat annual fees (common for LLCs)
  - Owed regardless of profitability, often assessed annually and automatically, penalties accrue quietly if filings lapse
  - **DD Focus** - confirm all required franchise tax returns filed, verify entity “good standing”, identify accrued but unpaid franchise taxes, check whether exemptions were properly claimed
- **Gross Receipts Taxes**
  - Taxes imposed on gross revenue, not profit, with little or no deduction for expenses
  - Apply even if the business operates at a loss, nexus thresholds are often lower than income tax, apportionment rules differ from income tax rules
  - **DD Focus** - correct sourcing of receipts, proper classification of revenue streams, verification of filings in all applicable jurisdictions
- **Annual Reports**
  - Mandatory annual or periodic filings with state authorities to maintain legal standing
  - Annual reports or statements of information, franchise tax or annual fee payment
  - **DD Focus** - good standing certificates, identification of dormant or dissolved entities, review of penalties accrued due to late filings

## 4. EMPLOYMENT TAX & PAYROLL COMPLIANCE

## Employment Tax & Payroll Compliance

- Refers to a company's adherence to federal, state, and local tax laws governing the withholding, reporting, and payment of taxes arising from compensation paid to employees and certain service providers. In an M&A context, deficiencies in this area present elevated risk due to successor liability, trust-fund tax rules, and the potential for penalties and personal liability.
- Payroll Tax Filings and Reporting – review of:
  - Form 941 (quarterly payroll tax returns)
  - Form 940 (federal unemployment tax return)
  - Forms W-2 and W-3
  - Withholding and Remittance of Payroll Taxes
  - Timely Filing of Payroll Tax Returns
  - **DD Focus** – failures in this area can result in significant penalties and trust fund recovery liability
- Worker Classification – evaluation of:
  - Classification of workers as employees versus independent contractors
  - Exempt versus non-exempt status for wage and hour purposes
  - **DD Focus** – misclassification can lead to liability for unpaid employment taxes, penalties, wage and hour claims, and benefit plan exposure

## Employment Tax & Payroll Compliance – Cont'd

- Compensation and Benefit Tax Treatment – review of tax treatment and withholding for:
  - Bonuses, commissions and incentive compensation
  - Equity-based compensation and severance payments
  - Deferred compensation issues (*e.g.*, § 409A compliance)
  - Taxable fringe benefits (*e.g.*, car allowances, meals, relocation, imputed income)
  - **DD Focus** – improper treatment can result in underwithholding and reporting failures
- Audits, Assessments, and Voluntary Disclosures – identification of:
  - Pending or historical employment tax audits
  - Open assessments or installment agreements
  - Participation in voluntary disclosure or amnesty programs
  - **DD Focus** – these matters often drive indemnity, escrow, or purchase price negotiations
- Other Considerations
  - Employee retention credits (ERC) – a major diligence area due to improper claims
  - Review of payroll processes and use of third-party payroll providers
  - Reconciliation of payroll records to general ledger and tax filings
  - **DD Focus** – weak internal controls increase the likelihood of unreported liabilities

## 5. INDIRECT TAXES & SPECIALITY TAXES

## Indirect Taxes & Specialty Taxes

- Encompass non-income taxes imposed on transactions, property, or specific activities rather than on net income. In an M&A context, these taxes frequently present heightened risk because they are often assessed on a gross basis, are subject to strict liability regimes, are commonly under-reserved or overlooked in financial statements and may result in successor liability.
- Indirect Taxes – sales and use taxes, value added tax, goods and services tax (consumption tax used in many countries), if applicable.
- Excise and Transaction-Based Taxes – assessment of compliance with taxes imposed on specific goods or activities, such as:
  - Fuel, alcohol, tobacco, or environmental excise taxes
  - Communications, utility, or insurance premium taxes
  - **DD Focus** – these taxes are often industry-specific and heavily regulated
- Specialty Taxes such as Property Taxes – review includes:
  - Accuracy of property tax assessments
  - Timely filing of renditions and returns
  - Appeals history and pending reassessments
  - Exposure from omitted or undervalued property
  - **DD Focus** – property tax liabilities often attach to the asset itself, creating successor risk in asset acquisitions

## Indirect Taxes & Specialty Taxes – Cont'd

- Industry-Specific or Regulatory Taxes – review may include:
  - Severance or production taxes
  - Environmental fees
  - Licensing or regulatory assessments
  - **DD Focus** – these taxes can materially affect transaction costs if not planned for in advance
- Gross Receipts and Franchise Tax – review of:
  - Compliance with state or local gross receipts or margin-based taxes
  - Proper sourcing and apportionment of receipts
  - Registration and filing obligations in each jurisdiction
  - **DD Focus** – these taxes can apply even in the absence of profitability
- Unclaimed Property (Escheat) – assessment of:
  - Compliance with unclaimed property laws for items such as customer credits, gift cards, and payroll checks
  - Dormancy tracking and reporting procedures
  - Exposure from prior noncompliance
  - **DD Focus** – unclaimed property is often a significant diligence finding due to long look-back periods and aggressive state enforcement

## 6. TRANSACTION-SPECIFIC CONSIDERATIONS

## Transaction-Specific Considerations

- Address tax issues that arise directly from the structure, timing, and mechanics of the contemplated M&A transaction. These considerations are distinct from historical compliance matters and focus on how the transaction itself may create tax liabilities, affect tax attributes, or influence post-closing tax outcomes for the buyer and seller.
- Purchase Price Allocation – analysis of:
  - Allocation of consideration among assets or equity
  - Treatment of goodwill and intangible assets
  - Consistency requirements across tax filings (*e.g.*, Form 8594)
  - **DD Focus** – improper allocation can result in disputes with tax authorities and adverse amortization outcomes
- Change in Control Issues – assessment of:
  - Golden parachute payments and IRC § 280G exposure
  - IRC § 382 limitations on NOLs and credits after ownership change
  - Acceleration of equity awards or deferred compensation
  - **DD Focus** – these costs can be material and often arise only upon closing

## Transaction-Specific Considerations – Cont'd

- Tax Elections Related to the Transaction – consideration of:
  - Availability and advisability of elections such as IRC §§ 338(h)(10), 336(e), or 754
  - Timing, filing requirements, and consistency obligations
  - Impact on basis, depreciation, and future taxable income
  - **DD Focus** – failure to coordinate elections can negate intended tax benefits
- Transaction Costs and Deductibility – review of:
  - Deductibility or capitalization of transaction expenses
  - Allocation of costs between buyer and seller
  - Treatment of success-based fees and facilitative costs
  - **DD Focus** – mischaracterization can lead to disallowed deductions or penalties
- Deferred Revenue and Liabilities – assessment of:
  - Treatment of prepaid income under § 451
  - Whether the buyer will inherit liabilities (cost of performance/service) associated with these amounts
  - **DD Focus** – represent real post-closing obligations that affect the true value and purchase price especially for subscription-based businesses like SaaS companies

# 7. EMPLOYMENT & BENEFIT PLAN TAX ISSUES

## Employment & Benefit Plan Tax Issues

- Arise from the design, administration, and tax treatment of compensation and employee benefit arrangements. In an M&A transaction, these issues can create significant tax exposure, accelerate liabilities at closing, and trigger excise taxes or penalties if not properly identified and addressed.
- Qualified Retirement Plans – evaluation of:
  - Compliance of 401(k), pension, and profit-sharing plans with IRS qualification requirements
  - Timely filing of Forms 5500 and related schedules
  - Favorable determination or opinion letters
  - Operational compliance (*e.g.*, nondiscrimination testing, contribution limits)
  - **DD Focus** – failures may result in plan disqualification, retroactive tax liabilities, and correction costs
- Health and Welfare Plans – review of:
  - Compliance with tax-favored treatment of employer-provided benefits
  - Cafeteria plans (IRC § 125) and FSA/HSA arrangements
  - Employer mandate compliance and reporting, ACA penalties
  - **DD Focus** – failures may result in loss of tax-favored status or excise taxes

## Employment & Benefit Plan Tax Issues – Cont'd

- Golden Parachute and Change-in-Control Payments (IRC § 280G) – analysis of:
  - Whether transaction-related payments exceed § 280G thresholds
  - Exposure to 20% excise tax on excess parachute payments
  - Loss of deduction for the employer
  - **DD Focus** – these costs are transaction-specific and often material
  
- Severance and Retention Arrangements – evaluation of:
  - Tax treatment of severance, retention, and transaction bonuses
  - Withholding obligations
  - Interaction with IRC §§ 409A and 280G
  - **DD Focus** – improper structuring can create unexpected tax liabilities at closing
  
- Multi-State and Cross-Border Benefits – review of:
  - Benefit plan coverage for employees in multiple jurisdictions
  - Withholding and reporting requirements for mobile or expatriate employees
  - Foreign pension or benefit plan obligations
  - **DD Focus** – cross-border benefits raise complex compliance and reporting issues

## 8. TRANSACTION TAXES

## Transaction Taxes

- Are taxes imposed directly as a result of executing an M&A transaction, rather than from the target's ongoing operations. These taxes are highly jurisdiction-specific and can materially affect deal economics if not identified and allocated properly in advance of closing.
- Transfer Taxes – analysis of:
  - Real estate transfer taxes
  - Personal property transfer taxes
  - Allocation of responsibility between buyer and seller – customarily split 50/50 between parties
  - Bulk sales or similar transfer taxes - Notice requirements – 10 days prior to the transfer of 50% or more of assets
  - **DD Focus** – these taxes may apply even in stock transactions if underlying assets are deemed transferred
- Stamp and Documentary Taxes – assessment of:
  - Taxes on executed agreements, share transfers, or debt instruments
  - Jurisdictional filing and stamping requirements
  - Penalties for late or improper stamping
  - **DD Focus** – stamp taxes are common in non-U.S. jurisdictions and certain U.S. States

## 9. INTERNATIONAL TAX (IF APPLICABLE)

## International Tax (if applicable)

- Arise when a target company has operations, customers, employees, or transactions outside the United States. In an M&A context, cross-border tax issues can materially affect historical compliance, transaction structuring, and post-closing tax efficiency, and often involve heightened complexity, documentation requirements, and penalty exposure.
- Foreign Operations and Permanent Establishment – review whether the target:
  - Has foreign subsidiaries, branches, or disregarded entities
  - Conducts activities that may create a **permanent establishment (PE)** in foreign jurisdiction
  - Has properly registered, filed, and paid taxes in all applicable countries
  - **DD Focus** – undisclosed PEs can result in retroactive income tax, penalties and interest
- Transfer Pricing - evaluation of intercompany transactions, including:
  - Pricing of goods, services, royalties, and cost-sharing arrangements
  - Existence and adequacy of transfer pricing documentation
  - Consistency with OECD guidelines and local country requirements
  - **DD Focus** – transfer pricing adjustments can lead to double taxation and significant penalties

## International Tax (if applicable) – Cont'd

- Withholding Taxes – assessment of:
  - Proper withholding on cross-border payments (*e.g.*, dividends, interest, royalties, services)
  - Application of tax treaties and reduced withholding rates
  - Availability and documentation of treaty benefits
  - **DD Focus** – failure to withhold properly typically results in liability for the payer
- Controlled Foreign Corporations (CFCs) and Anti-Deferral Regimes – analysis of:
  - Whether foreign subsidiaries are CFCs
  - Compliance with U.S. anti-deferral regimes, including Subpart F and GILTI
  - Earnings and profits (E&P) calculations and tracking
  - **DD Focus** – these rules directly affect ongoing U.S. tax liability
- Inbound and Outbound Structuring – consideration of:
  - Tax efficiency of existing holding and operating structures
  - Impact of the transaction on treaty eligibility and withholding taxes
  - Potential exit, migration, or step-up tax exposure
  - **DD Focus** – structural issues often present planning opportunities post-closing

# 10. LEGAL AGREEMENTS AND SUPPORT DOCUMENTS

## Legal Agreements and Support Documents

- Are reviewed in tax due diligence to identify contractual provisions that create, allocate, or shift tax liabilities, affect the tax characterization of transactions, or impose ongoing tax obligations that may survive closing. These documents often reveal tax risks, compliance gaps, or planning opportunities that are not evident from tax returns or financial statements alone.
  
- Review of Existing Agreements – review of:
  - Operating agreements, partnership agreements – tax allocations (§ 704(b))
  - Tax-sharing agreements, indemnities, historic M&A activity and escrow agreements
  - Prior tax opinions and memoranda
  - Review for contingent liabilities (*e.g.*, earn-outs and their tax treatment)
  - **DD Focus** – these documents may affect tax classification, income and loss allocations, eligibility for tax elections, and continuity of tax attributes
  
- Customer, Vendor, and Commercial Contracts – consideration of:
  - Vendor, customer and franchise agreements with embedded tax responsibility provisions
  - Sales and purchase agreements addressing sales, use, VAT, or similar taxes
  - Indemnities related to tax treatment of transactions
  - **DD Focus** – ambiguous or unfavorable tax clauses may shift indirect tax liability to the target

## Legal Agreements and Support Documents – Cont'd

- Government Agreements and Rulings – examination of:
  - Closing agreements with taxing authorities
  - Private letter rulings or advance pricing agreements
  - Settlement agreements and audit resolutions
  - **DD Focus** – such agreements may restrict future tax positions or impose continuing obligations post-closing
  
- Real Estate and Lease Agreements – assessment of:
  - Responsibility for property, sales, and use taxes
  - Lease classification for tax purposes
  - Transfer tax exposure upon assignment or change in control
  - **DD Focus** – property-related taxes often follow the asset and can survive closing

# 11. UNREPORTED OR CONTINGENT LIABILITIES

## Unreported or Contingent Liabilities

- Are potential tax obligations that are not fully reflected—or reflected at all—on the target company's balance sheet or tax provisions but may arise from historical activities, uncertain tax positions, or future events.
- Statute of Limitations Exposure – exposure arising from:
  - Failure to file required tax returns
  - Substantial omissions of income
  - Misclassification or misreporting issues
  - **DD Focus** – in such cases, tax years may remain open indefinitely
- Uncertain Tax Positions – positions that:
  - Rely on aggressive interpretations of law
  - Lack adequate technical or documentary support
  - Have not been adequately reserved under ASC 740
  - **DD Focus** – these may result in additional tax, penalties, and interest if challenged
- Other Considerations – evaluation of:
  - Nexus studies, reverse audits
  - IRS correspondence, notices, penalties or payment plans
  - Pending or potential litigation with tax consequences
  - **DD Focus** – essential to identify, quantify, and allocate these risks appropriately

## 12. TYPICAL DELIVERABLES IN A TAX DUE DILIGENCE REVIEW

## Typical Deliverables in a Tax Due Diligence Review

A Buyer or Seller may expect:

- **Tax Due Diligence Report** – issues list, red/yellow/green flags
- **Quality of Earnings (QoE)** – not tax specific but often integrates with tax findings
- **Working Capital Adjustment** considerations
- **Tax Indemnity Escrow Recommendations** for uncovered risks
- **Representation & Warranty Support** for the purchase agreement

# FINAL THOUGHTS

## Tax Due Diligence in M&A Transactions

- **NO ONE SIZE FITS ALL** – the scope varies depending on whether the deal is a stock sale, asset sale, or equity purchase, the industry, and the size of the transaction.
- Can materially affect tax attributes or create hidden tax liabilities in an M&A transaction.
- Directly affects deal pricing, risk allocation, deal economics, and post-closing disputes.
- Unlike financial diligence, tax liabilities can be hidden, cumulative, and transferable, especially in equity transactions.
- A transaction without proper tax diligence risks - unexpected liabilities, lost tax benefits, purchase price erosion, post-closing outcomes.

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Tax, Trusts and Estates

### BIOGRAPHY

Mike Herzog is a Member in the firm's Corporate Group. He concentrates his practice on a variety of tax matters and employee benefits counseling. His tax practice is informed by his experience as a CPA. Prior to practicing law, he served as a tax consultant for a Big Five accounting firm. He assists clients with the tax implications of business restructurings, mergers and acquisitions, international transactions, joint ventures, multistate tax matters, and federal, state, and local tax controversies. Mike advises clients on complex tax matters and represents them during audits, before the IRS Appeals Office, and in various state administrative appeals and courts including the U.S. Tax Court, the Commonwealth Court of Pennsylvania and the Supreme Court of Pennsylvania.

Mike also counsels clients on federal and state tax issues with respect to significant acquisitive and divisive business transactions, tax compliance, and tax return reviews. Mike's broad tax expertise with individual income tax, partnership tax, corporate tax, payroll tax, and state tax implications of interstate business activities informs his ability to serve as outside general counsel for several clients.

Within his employee benefits practice, Mike advises clients on tax-qualified retirement plans, executive compensation matters, IRC Section 409A tax compliance, and the tax implications of various employee benefit programs.

### EDUCATION

- 1999, JD, University of Pittsburgh School of Law
- 1994, B.S., Accounting, The Pennsylvania State University

### ADMISSIONS

- Pennsylvania
- Virginia
- U.S. Tax Court
- U.S. District Court for the Western District of Pennsylvania

### PROFESSIONAL AFFILIATIONS AND HONORS

- Allegheny County Bar Association Taxation Section, Council Member and Past President
- Association for Corporate Growth (ACG)
- Certified Public Accountant (Inactive)



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# Michael Herzog

## Member

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## REPRESENTATIVE MATTERS

- Successfully assisted multiple clients with making Pennsylvania Department of Revenue Tax Amnesty Program disclosures for sales/use tax, capital stock tax and gross receipts tax.
- Assisted client with the Massachusetts gross receipts taxation upon the distribution of electricity.
- Assists clients with the tax implications of business restructurings, international transactions, mergers and acquisitions, due diligence reviews, technical research and drafting of tax memoranda, tax and information return compliance, tax return reviews, and general tax advisory services.
- Advises clients on the many aspects of multistate tax matters for large organizations and international companies, including income and franchise tax, sales and use tax, and payroll tax matters.
- Advises individuals, business owners, and executives in various aspects of federal, state, and local taxation, including client representation before a variety of tax jurisdictions for audit defenses, settlement representation, tax credit litigation, administrative appeals, and refund claims.
- Successfully represented multiple clients regarding potential Internal Revenue Service trust fund recovery penalties for federal payroll taxes.
- Assists clients in securing federal and state tax incentives for the production and conservation of energy and natural resources, including oil and gas production from the Marcellus Shale.
- Advises clients with making IRS Offshore Voluntary Disclosure Initiative (OVDI) submissions and annual Reports of Foreign Bank and Financial Accounts (FBARs).



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## REPRESENTATIVE MATTERS

- Assists clients with tax return compliance matters, such as the preparation of black lung trust tax returns, individual income tax returns (resident and non-resident), and returns for private foundations.
- Represents clients in summons enforcement tax shelter matters and criminal tax investigations for alleged tax evasion and tax fraud allegations.
- Assists clients in the formation of nonprofit entities, advises nonprofit board of directors as to various tax matters, assists clients in fulfilling their tax compliance filing obligations, and resolves tax controversies for numerous nonprofit entities.
- Advises clients in the employee benefits area with an emphasis on tax-qualified retirement plans and executive compensation matters, particularly the treatment of employee benefits in merger and acquisitions, the various uses of employee stock ownership plans (ESOPs), qualified and nonqualified stock options and other equity-based compensation vehicles, and tax rules regarding deferred compensation.
- Reviews annual returns/reports of employee benefit plans, files voluntary compliance program submissions with the IRS and U.S. Department of Labor, assists clients with the termination of qualified retirement plans, and advises plan sponsors as to the tax consequences of day-to-day plan operations.
- Assist public sector clients in designing and maintaining compliance with employer-sponsored health and life insurance plans and disability benefits, as well as defined benefit pension plans and defined contribution plans, including profit-sharing, thrift savings and stock ownership plans.



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