

Bloomberg Tax

Prevent Employee Retention Credits From Scuttling a Merger Deal

- Maslon's Walt Cosby explains risks of Covid-era tax credits
- Due diligence protects buyers, sellers from ERC surprises

The IRS has featured employee retention credits on its “Dirty Dozen” list of notable tax scams since 2023 and simultaneously extended the statute of limitations for seeking ERC repayment to five years under specific circumstances.

Disputes over the ERC have delayed closing of mergers and acquisitions by months, and some insurers have even added ERC risks to their standard policy exclusions. There is some crucial information that both sides of an M&A transaction should know.

Sellers must hire reputable tax advisers to perform comprehensive due diligence to mitigate or eliminate any risks associated with ERCs. A sell-side adviser can proactively address any qualification issues and prepare necessary documentation to validate the credit refund. They also can assist in preparing amended returns if there are inaccuracies in refunded amounts.

Sellers who fail to take these precautionary measures run the risk of the buyer uncovering ERC issues, leading to increased holdbacks as well as escrows and indemnities, or even prompting the buyer to withdraw from the deal. Precautionary measures by the seller can prevent closing delays and affect the seller's bottom line positively.

Buyers should conduct their own tax due diligence to verify the legitimacy of any ERC claims before finalizing the deal. Buyers ultimately may be responsible for any tax liabilities arising from erroneous ERCs claimed by the target company.

Buyers also must ensure that target companies are legitimately entitled to ERC refunds. This can protect them from future tax adjustments and potential litigation that may arise from a disallowance of ERCs during an IRS audit.

The risk for buyers isn't limited simply to returning the credit that the target erroneously received; they also may be subject to interest and penalties, which vary in amount based on taxpayer culpability. Both sellers and buyers can use a checklist to ensure a smooth and successful business transaction.

Due Diligence

Ensure all ERC claims are thoroughly documented and comply with IRS guidelines. Review the calculations and supporting documentation to confirm eligibility and accuracy. Using a certified public accountant to prepare such calculations is ideal, as is ensuring the claim was approved.

Evaluate the potential financial and tax liabilities associated with ERC delays. Determine the impact on the target company's valuation and financial health.

Transaction Impact

Address ERC-related issues in purchase agreements. Include representations, warranties, and indemnities related to ERC claims and potential delays.

Consider setting up escrow accounts to hold funds until ERC issues are resolved. This can protect both buyers and sellers from unexpected liabilities.

Stakeholder Communication

Maintain open communication with clients, buyers, and sellers about the status of ERC claims and any potential delays. Ensure all parties are aware of the implications for the transaction.

Be prepared to negotiate adjustments to deal terms, such as purchase price modifications or earn-outs, based on the resolution of ERC claims.

Planning and Strategy

Advise clients on the timing of recognizing ERCs in financial statements. Delays may affect tax planning and cash flow projections.

Explore other available tax benefits or incentives that might offset the impact of ERC delays. This can help mitigate potential cash flow issues.

Regulatory Updates

Keep up to date with IRS announcements and regulatory changes related to the ERC. Promptly communicate any new guidance or changes to clients and stakeholders.

If appropriate, assist clients in communicating with the IRS to expedite the processing of delayed ERC claims. This might involve submitting additional documentation or following up on the status of claims.

Compliance Considerations

Have legal counsel review any ERC-related issues that may affect the transaction. This includes compliance with relevant laws and potential exposure to penalties or interest.

Prepare for potential IRS audits related to ERC claims. Ensure documentation is complete and accurate to support the claims if challenged.

Client Education

Educate clients about the potential impact of ERC delays on their business operations and M&A transactions. Provide guidance on managing cash flow and financial planning during the delay.

Encourage clients to take proactive measures, such as maintaining detailed records and staying compliant with ERC requirements, to minimize the risk of delays and complications.

Advisers to both sellers and buyers should exercise due care in performing ERC-related due diligence. This will ensure a smooth and successful business transaction and limit exposure to their clients.

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