Key Considerations in Cross-Border M&A involving US Targets

In spite of geopolitical tensions, roughly 40% of M&A deals in 2018 was cross-border. This number does not include countless cross-border M&A deals that failed to close for various reasons. This panel will address key legal, tax and business considerations for successful closing of a cross-border investment involving US targets.

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LEGAL ISSUES IN CROSS-BORDER M & A INVOLVING U.S. TARGET

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I. Businesses' Needs for Technology, Supply Chain, Money and Market

- It has become very hard for one country to have dominance and supremacy in all areas of business, especially in technology and service.
- Introducing one product often relies on many technologies and services from different sources – Growing need for efficient sourcing of components, supplies and services.
- Businesses' need for capital – the cheaper, the better
- Therefore, in spite of geopolitical tensions since last year and the growing focus on national security by various nations, cross-border transactions remain very strong.

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A. Tensions between Political and Regulatory Considerations and Business Need

II. Political and Regulatory Considerations

- Cyber Security; National Security& Espionage Prevention; National Interest in maintaining dominance in various business sectors- CFIUS review & Anti money laundering regulations
- Securities law compliance – investor protection
- antitrust regulations - Market protection
- Additional regulatory approvals in regulated industries: energy, public utilities, gaming, insurance, telecommunications and media, financial institutions, transportation and defense contracting.

III. More than ever, **sophisticated legal work is needed** to meet both the national security needs and business needs.

B. LEGAL ISSUES

1. DUE DILIGENCE

- Understand the investor/acquiror – affects acquisition currency and money transfer, among other things:
  - Is it sponsored or financed, directly or indirectly, by a foreign government or organized in a jurisdiction where government involvement in business is common?
    - Ex: Countries in Middle Eastk, Russia, China
  - Is it a publicly traded company? Can its funds arrive in the U.S. without local government's approval and other regulatory hurdles?
  - Many due diligence requests are best channeled through legal or financial intermediaries as opposed to being made directly to the target company by the acquiror/investor. This is because it can easily create friction between the parties.
- Understand the target – Make a list of regulatory hurdles.

2. CIFIUS, FIRRMA & ERCA

- Committee on Foreign Investment in the United States (**CFIUS**)—can block or cause parties to abandon or modify transactions on national security grounds. Foreign Investment Risk Review Modernization Act (**FIRRMA**) - 2018 - changed the CFIUS process and authority:
    - CFIUS's jurisdiction expanded to include 27 industries
    - Review of "non-controlling" investments in U.S. targets in critical technologies, critical infrastructure or sensitive personal data of U.S. citizens.
    - Mandatory filings for transactions involving a foreign investor in which a foreign government has a substantial interest and the U.S. target involves critical technology or infrastructure.
- The Export Control Reform Act (**ECRA**) provides sweeping statutory authority for regulation of commodities and technology, including in-country transfers and changes in an item's use in foreign countries.

2. CIFIUS, FIRRMA & ERCA

- The time frame for the review—the initial review phase extended from 30 to 45 days and the second-stage investigation phase from 45 to 60 days in “extraordinary circumstances”.
- establishes filing fees not to exceed the lesser of 1% of the transaction value or $300,000 – Parties must agree on how to share this fee.
- Critical for attorneys to factor into the CFIUS review.
  - Make a voluntary filing with CFIUS if an investigation is reasonably likely.
  - Devise methods of mitigation and any remedial measures.
  - Have a communications plan with government officials.
  - Consider reverse break fee.

2. CIFIUS, FIRRMA & ERCA

What Transactions Might Be Subject to the New Laws on Foreign-Related Transactions?

Examples:

- Acquisitions of U.S. companies in covered industry by non-U.S. acquirers – "control" - essentially mean "**influence.**"
- Minority investments by non-U.S. investors in U.S. companies holding "critical technology"
- Sales, licenses, or export of technology to non-U.S. companies
- Acquisition or lease of certain types of U.S. real estate by foreign entities

Under FIRRMA, covered transactions expressly include investment transactions by a foreign person in U.S. business that (1) owns, operates, manufactures, supplies, or services critical infrastructure; (2) produces, designs, tests, manufactures, fabricates, or develops critical technologies; or (3) maintains or collects sensitive personal data of U.S. citizens.

2. CIFIUS, FIRRMA & ERCA

- Routine Intellectual Property licensing transactions not typically covered.

- Special Treatment of Investment Funds
  - If a non-U.S. party invests through an investment fund as an LP, the investment is not normally a covered transaction if (1) the fund is managed exclusively by a U.S. GP or equivalent; (2) if this LP is on advisory board, the advisory body does not control the investment decisions of the fund or decisions of the GP; (3) the foreign person does not have the ability to control the fund; and (4) the foreign person does not have access to material, nonpublic technical information as a result of joining the advisory board or committee.

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3. Structuring the Transaction – How to Mitigate

- If the target has “critical technology” or “critical data”
  - Divide up the target: Transfer IP to a separate company, while keeping the operation and other business within the target; have inter-company agreement where IP is under strictly confidentiality and security protection
    - Jurisdictions to consider for IP-Co: Cayman, BVI, Bermuda, Ireland, UK, Malta, USA.
- Invest through a managed fund where the GP is a US entity/US citizens with sole discretion to manage the fund.
- Take minority positions and/or take no-voting position and/or no-governance or low-governance investments
- Use an Acquisition Co with a board composed entirely of U.S. citizens; Use of a U.S. proxy board with respect to sensitive industries.
- Use of debt or combination of debt and equity

4. Acquisition Consideration

- Cash
- Foreign publicly traded acquirors may consider offering target's shareholders its common stock or depositary receipts (*e.g.*, ADRs).

5. When the target is a US public company

- Understanding Disclosure – Schedule 13 filing
- Understanding Board's role in US public companies
- Understanding Shareholder rights
- Understanding litigation risks

C. Negotiations and Cultural Differences - Factors that causes failure:

To interview Ms. Kee and Mr. Xie Pengfei

- With whom should you negotiate - Understand the role of different transaction participants
- When to bring up certain issues – specially price
- Language barriers
- Cultural barriers
- Integration Issues

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The next level of service

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- Melanie has over 20 years of experience in advising multinational companies on tax planning and financial reporting for cross-border transactions between China and the U.S.

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- She practiced law in China as an attorney for five years, worked for Deloitte & Touche in Shanghai and Ernst & Young in New York as an international tax specialist for five years, and joined UHY to lead its China practice since 2005.

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Tax Planning Involving U.S. Targets with Significant NOLs – A Case Study

Background

Target

- U.S.-based company in healthcare industry with cutting edge technology in cancer treatment
- Target's enterprise value was $180 million. Based on the historical balance sheet as of June 30, 2017, Target had total tangible assets of approx. $62 million. Assuming the book adjusted basis of these tangible assets equate to their FMV, approx. $118 million would be allocated to Target's IP
- Target had approx. $273 million NOLs as of 6/30/2017

Investor

- A consortium of Chinese institutional investors (Investor) set up a new entity (NewCo) to purchase 100% of the equity of the Target
- Plan to operate the Target as an R&D center, and build a new facility in China (NewCo-China) to manufacture parts and assembly equipment to sell to customers in China

Objectives & Challenges for Tax Planning

Objectives

- Have a structure that is easy to execute upon the acquisition of Target, and flexible enough to stay tax efficient through various phases of growth.
- Have a structure that provides NewCo flexible to do an IPO in the U.S. or Asia without having to do restructuring for financial reporting purposes.

Challenges

- IRC §382 limitation imposes an annual cap on the amount of post-change-year income that may be offset by pre-change-year losses, which is the fair market value of the stock of the "old loss corporation" multiplied by the long-term tax-exempt rate.
- Identify an optimal jurisdiction to form NewCo that would minimize the worldwide income tax burden of NewCo and its investors.

Section 382 Limitation Analysis

- If an acquisition results in a change of ownership, IRC §382 imposes an annual cap on the amount of post-change-year income that may be offset by pre-change-year losses, which is the fair market value of the stock of the "old loss corporation" multiplied by the long-term tax-exempt rate.
- Target had NOLs totaling $273 million. The FMV of its assets immediately before the ownership change was $180 million. If NewCo acquires Target's capital stock for $180 million, based on the 1.93% monthly long term tax-exempt rate as published by the IRS in September 2017, the section 382 limitation initially was $3.474 million per year.
- Assuming Target fully utilizes the allowable annual limitation NOLs for 20 years for a total of $69.48 million [$3.474 * 20 Years], the balance of **$203.52 million NOLs** would expire as of the end of 2037 [NOL balance = $273 million NOLs – Section 382 Limitation of $69.48 million].

Structures to Minimize Section 382 Limitation

Option A

- Transferring all of Target's IP (US and non-US) to NewCo or its affiliate in a non-US jurisdiction.
- NewCo or its affiliate pays $118 million to purchase Target's IP first and Target uses this cash to retire its debt and distributes the remainder to its pre-acquisition shareholders. Then NewCo pays $62 million to purchase 100% of the capital stock of Target.

Option B

- NewCo or its affiliate defers the purchase of Target's IP until shortly after the acquisition.
- Post acquisition, NewCo or its affiliate issues a $118 million interest-bearing promissory note to Target to purchase its IP.

Options A: Pros & Cons

- Post-acquisition, Target would still have approx. $155 million of NOL carryforwards [NOL = $273 million – Gain on Sale of IP: $118 million] that would be subject to the Section 382 limitation.

- Due to the fact that Newco would only be paying $62 million for the equity of Target, the annual limitation on the utilization of Target's NOLs would now only be approximately $1.197 million per year (i.e. $62 million purchase price x 1.93%, the monthly long term tax-exempt rate as published by the Internal Revenue Services in September 2017).

- Assuming that Target fully utilizes the allowable annual limitation NOLs for 20 years for a total of $23.9 million, the balance of **<u>$131.1 million NOLs</u>** would expire as of the end of 2037 (NOL balance = $273 million NOLs – $118 million gain on IP sales - $23.9 million Section 382 Limitation on NOL) .

- The new tax law that offers unlimited NOL carryover applies to NOLs generated after 1/1/2018.

Options B: Pros & Cons

- The benefit of the post-acquisition of Target's IP by NewCo is, essentially, for an old loss corporation with "net unrealized built-in gain," the Section 382 limitation is increased by "recognized built-in gains" up to the cap, i.e. $118 million in this case.

- Assuming that Target fully utilizes the allowable annual limitation NOLs for 20 years for a total of $69.48 million [$3.474 * 20 Years] plus $118 million gain on sale of IP, the balance of **<u>$85.52 million NOLs</u>** would expire as of the end of 2037 [NOL balance = $273 million NOLs – Section 382 Limitation of $69.48 million – Gain on Sale of IP of $118 million].

- One disadvantage to having NewCo or its affiliate to purchase Target's IP is that investors will incur higher transaction related-costs because a valuation of Target's tangible assets and IP will become necessary in order to determine the fair market value of the IP and the resulting gain on the disposition of the IP by Target.

Key Considerations for Identifying a Jurisdiction for NewCo

- The regulatory and administrative complexity of setting up NewCo and related maintenance cost;
- The withholding tax on cross-border passive income, including royalties, interest, and dividends under both bilateral income tax treaties and domestic tax laws in the relevant jurisdictions;
- The domestic corporate income tax considerations, including transfer pricing strategy, the utilization of Target’s existing net operating losses, and future IP development;
- Capital gain tax implications of future disposal of investment in NewCo.

Jurisdictions Considered for Setting Up NewCo

- United States
- China
- Hong Kong
- Cayman Islands
- Barbados
- Ireland

Recommendations

- Step 1: Investor sets up NewCo in Hong Kong.
- Step 2: NewCo acquires 100% capital stock of Target.
- Step 3: NewCo sets up a manufacturing facility in China (NewCo-China) immediately after the acquisition.
- Step 4: NewCo-China acquires all of Target’s IP shortly after the acquisition is closed via issuance of an interest-bearing promissory note with the principal amount at the fair market value of the IP.

Key Benefits of the Recommended Structure

- By setting up NewCo in Hong Kong, NewCo's investors will not be subject to capital gains tax in Hong Kong if they dispose of their investments in Newco either in a private placement, an IPO, or post-IPO.
- By transferring Target's IP to NewCo-China will enable it obtain 15% reduced income tax treatment as an entity possessing advanced technology.
- By entering into a promissory note for NewCo-China to purchase all of Target's IP, Target will be able to utilize its NOLs to the maximum extent possible. Assuming that the interest rate on the promissory note is 3%, the annual interest of $3.54 million would be sufficient to offset the Section 382 NOL annual limitation. On the other hand, Target will pay royalties to Newco-China based on its annual sales in the U.S. From transfer pricing considerations, the fair amount of royalty payments, at the least, should cover the interest and principal of the promissory note incurred by NewCo-China.
- With appropriate planning, the purchase of Target's IP could be structured as a cash-less transaction.

Q & A