M&A in 2019

The NY State Bar Association – Tax Section Annual Meeting

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January 15, 2019

Agenda

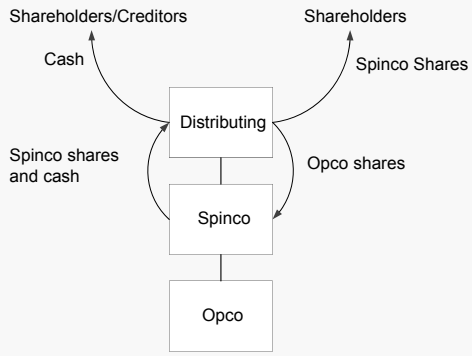
- **Spin-Off Developments**
- **Buying and Selling CFCs after Tax Reform**
- **New Section 168(k)**

Spin-Off Developments

1. Spin-Offs Involving Debt
2. Active Trade or Business
3. Spin-Offs by CFCs Post-Tax-Reform
4. Evolution of PLR Program

Spin-Offs Involving Debt

Debt-Financed Cash Distribution



- Distributing contributes Opco shares or assets to Spinco in exchange for Spinco stock and cash
- Cash does not exceed D's basis in the Opco shares or assets (less any liabilities assumed)
- Pursuant to a plan, D distributes Spinco stock to its shareholders and uses the cash received from Spinco to repay D debt, make a special distribution to shareholders, or buy back stock
- Alternatively, Spinco could assume existing Distributing debt

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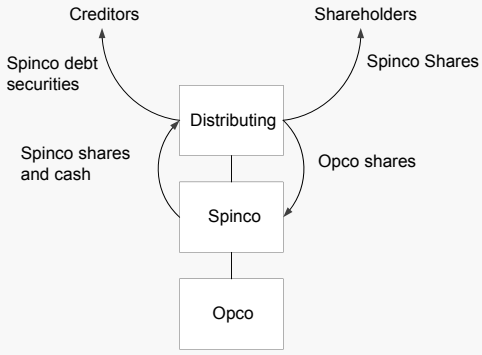
Debt-for-Debt Exchange



- Distributing contributes Opco shares (or assets) to Spinco in exchange for Spinco stock and debt "securities" of Spinco
- Pursuant to a plan, Distributing distributes Spinco stock to its shareholders and Spinco debt securities to D's creditors
- Often facilitated by investment bank, which purchases D debt in advance of spin-off and sells Spinco securities to public after spin-off
- Under prior PLRs, investment bank took principal risk based on 5/14-day standard

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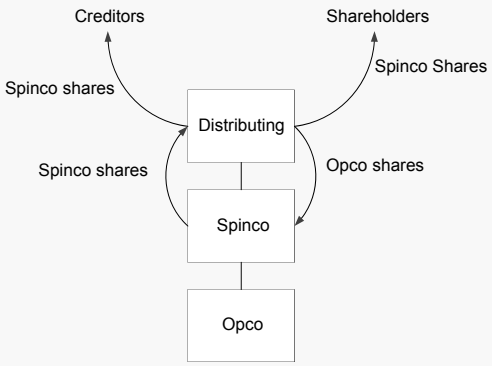
Debt-for-Equity Exchange



- D contributes Opco shares (or assets) to Spinco in exchange for Spinco stock
- Pursuant to the plan, D distributes Spinco stock to its shareholders and creditors
- Up to 20% of the Spinco stock may generally be distributed to creditors, or up to 50% using high-vote/low-vote stock structure
- Often facilitated by investment bank (5/14-day standard)
- Generally involves delay between spin and debt exchange

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Questions Raised

- Respecting retired Distributing debt as historic Distributing debt
- Treatment of investment bank as creditor for purposes of Section 361
- Distribution of cash boot or Spinco stock or securities “pursuant to the plan of reorganization”
- Delay in distributing cash or Spinco stock or securities
- Retained stock issues

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October 2017 IRS Statement

- October 13, 2017 IRS statement:

  "If, in connection with a section 355 distribution, a distribution of stock, securities or other property to the distributing corporation's shareholders or creditors is substantially delayed, IRS will continue to rule on whether the delayed distribution is tax-free under section 355 or section 361. However, rulings on such issues will not be based solely on the length of the delay. Instead, IRS will rule on this issue only based on substantial scrutiny of the facts and circumstances (including the circumstances of the delay) and full consideration of the legal issues and the effects of a ruling on federal tax administration.

  . . . in determining whether a retention of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax, within the meaning of section 355(a)(1)(D)(ii), IRS will continue to follow the guidelines in Appendix B of Rev. Proc. 96-30, even though Rev. Proc. 2017-52 has superseded Rev. Proc. 96-30. Thus, IRS will continue to rule in accordance with prior practice as to the application of section 355 to the distribution of the stock, or stock and securities, that are not retained."

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Revenue Procedure 2018-53

- Provides representations for rulings on debt assumption/retirement, including:
  - The holder of Distributing debt that is assumed or satisfied will not hold the debt for the benefit of Distributing or Controlled
  - The value of the §361 consideration received by holder in satisfaction of the D debt will not exceed the amount to which the holder is entitled under the terms of the D debt
  - D debt is "historic debt" (issued before the ruling request is submitted and at least 60 days before the earlier of (i) the public announcement or (ii) the approval by the Distributing board)
  - D debt does not exceed the historic average of D debt (or DSAG) owed to third parties measured over 8 quarters prior to board approval
  - There are substantial business reasons for the delayed satisfaction of D debt and it will occur no later than 6 months after spin
  - D will not replace debt assumed/satisfied with previously committed debt (other than ordinary course)

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PLR 201802007

- Cash boot used to pay down debt held by 3rd parties within e months
- Within f months any remaining proceeds used for stock repurchases under a buyback program adopted in connection with the distribution
- Representation that repaid D debt does not exceed weighted quarterly average of D debt outstanding for the 12-month period as of day before distribution
- Representation that D does not have a commitment to borrow an amount equal to repaid debt on same terms from same lenders
- IRS ruled that cash used to repay debt and used to repurchase stock treated as being distributed pursuant to a plan of reorganization for purposes of section 361(b)

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PLR 201835001

- DRE of D issued $f of New Debt 1 to financial institution prior to spin-off
- Cash equal to $f used to repay existing D debt or other purposes
- Spinco debt securities issued in the spin-off used to retire New Debt 1 in a debt-for-debt exchange (using 5/14-day standard)
- DRE of D issued $g of New Debt 2 to financial institution
- Spinco stock used to retire New Debt 2 in debt-for-equity exchange (5/14-day standard) by Deadline (first full financial accounting quarter beginning after the spin-off)
- Representation that the sum of the amount of D debt assumed under §357 and satisfied under §361 does not exceed the historic average of the total debt owed to unrelated persons, computed as of the close of the eight fiscal quarters immediately before the date that is at least 60 days before the spin-off is disclosed to the public or approved by Distributing's board of directors (whichever is earlier)

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PLR 201851005

- Retained Spinco stock to be used to retire D debt in debt-for-equity exchange facilitated by investment bank (5/14-day standard) by g days after the due date for the Form 10-K or 10-Q (as applicable) for the first full financial accounting quarter beginning after the spin-off
- Exchange ratio based on FMV based on arm's-length negotiations; determined taking into account relevant factors that are intended to reflect the costs to the bank of acquiring D debt (including cash purchase price, accrued but unpaid interest, and the transaction fees paid by the bank)
- Bank may finance D debt "in a manner customary for financing dealer inventory" (pledges, repos, swaps, etc.) and may hedge D debt
- Sum of the amount of D debt assumed under §357 and satisfied under §361 does not exceed the historic average of the total debt owed to unrelated persons, computed as of the close of __ fiscal quarters immediately before the date that is at least __days before the spin-off is disclosed to public or approved by D's board of directors (whichever is earlier)

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PLR 201731004

- In connection with internal restructuring transactions, internal spin-off and external spin-off, Spinco stock recapped into high-vote/low-vote and D retains low-vote stock to be used to retire D debt through one or more debt-for-equity exchanges facilitated by investment bank (5/14 days)
- Debt-for-equity exchanges will occur no later than 12 months after spin-off except if market conditions and sound business judgment prevent debt-for-equity exchanges, D will dispose of retained stock no later than 5 years after spin-off and will use proceeds to repay third-party D debt
- Representation that D debt was not issued in anticipation of the spin-off
- Representation that C would take no action that could unwind high-vote/low-vote before the earlier of 12 months after spin-off or last debt-for-equity exchange

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PLR 201731004 (cont.)

- Representation that C will not engage in a transaction with one or more persons that results in an unwind of the high-vote/low-vote within 24 months after the earlier of the last debt-for-equity exchange ("Date X") or 12 months after the spin-off ("Date Y") unless: (1) there is no agreement, understanding, arrangement, or substantial negotiations (within the meaning of § 1.355-7(h)(1)) or discussions (within the meaning of § 1.355-7(h)(6)) concerning the transaction or a similar transaction (applying the principles of § 1.355-7(h)(12) and (13), relating to similar acquisitions), at any time during the 24-month period ending on the earlier of Date X or Date Y; and (2) no more than 20 percent of the interest in the other party, in vote or value, is owned by the same persons that own more than 20 percent in vote or value of the stock of C. For purposes of the preceding sentence, ownership is determined by application of the constructive ownership rules of section 318(a) as modified by section 304(c)(3), except that for purposes of applying section 318(a)(3)(A) and (B), the principles of section 304(c)(3)(B)(ii) (without regard to section 304(c)(3)(B)(ii)(I)) apply. In the case of a corporation the stock of which is listed on an established market (within the meaning of § 1.355-7(h)(7)), the persons referred to in clause (2) of this representation (h) are limited to controlling shareholders (within the meaning of § 1.355-7(h)(3)(i), taking into account § 1.355-7(h)(8) but without regard to whether stock of a corporation is transferred) and ten-percent shareholders (within the meaning of § 1.355-7(h)(14) but without regard to the second sentence thereof or whether stock of a corporation is transferred). Other than with respect to a transaction with one or more persons described in clauses (1) and (2) of this representation (h), no action will be taken (including the adoption of any plan or policy), at any time prior to 24 months after the earlier of Date X or Date Y, by C's board of directors, its management, or any of its controlling shareholders (as defined in § 1.355-7(h)(3)) that would (if implemented) actually or effectively result in an unwind of the high-vote/low-vote.

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PLR 201731004 (cont.)

- IRS ruled involvement of investment bank would not preclude 361(c)(3) from applying provided debt-for-equity exchanges occur within 12 months

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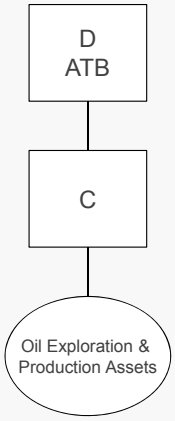
Active Trade or Business

IRS Announcement Regarding ATB

- On September 25, 2018, the IRS announced that it is studying aspects of the active trade or business requirement and willing to entertain certain ruling requests in fact patterns involving lengthy periods of entrepreneurial research and development.
- An active trade or business must "ordinarily include the collection of income and the payment of expenses."
- The IRS announced the study in response to pharmaceutical and technology oriented businesses spending many years and many millions of dollars in developing new products before any income is collected.
- The IRS requests comments regarding the scope of guidance needed and any existing guidance should be withdrawn, revoked, modified, or declared obsolete.

Rev. Rul. 57-492



Facts

1. D is engaged in refining, transporting, and marketing of petroleum products.
2. In year 1, D began exploring for oil.
3. In year 7, D drilled its first exploratory well.
4. In year 8, D discovered commercial quantities of oil.
5. In year 8, D contributed the oil exploration and production assets to C.

Analysis

- Held that C's business did not constitute a 5 year ATB in year 8.
- Activities prior to year 8 were preparatory to conducting an ATB.
- No ATB prior to discovery of commercial quantities of oil?
- No ATB without revenue?
- Different standard for real estate ATBs?
- Rev. Rul. 57-464; Treas. Reg. § 1.355-3(c), Ex. 3.

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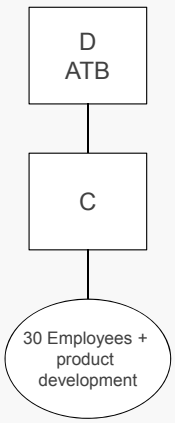
Rev. Rul. 57-492



Facts

1. D conducts ATB.
2. C has 30 employees engaged in R&D for D business.
3. Before spin-off, C has only related party revenue from D for five years but expects to earn revenue from D and other third parties after spin-off.

Analysis

- Held that C has a valid 5 year ATB. Treas. Reg. § 1.355-3(b)(5) Ex. 9
- Held that C would have a valid ATB even without third party revenue.
- Device without third party revenue?
- The IRS has requested information regarding business practices and regulatory considerations in research-oriented ventures.

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Spin-Offs by CFCs Post-Tax-Reform

Spin-Offs by CFCs Post-Tax-Reform

- Prior international tax system
  - Deferred taxation of most CFC earnings until repatriated
    - Generally resulting in only modest amounts of PTI
  - Taxed sales of CFC stock and treated unrepatriated earnings as a deemed dividend upon disposition of CFC stock
  - Provided indirect tax credits with respect to foreign taxes paid on repatriated CFC earnings to prevent double taxation
- Post-tax-reform international tax system
  - Most CFC earnings subject to tax currently or not at all
    - Generally resulting in significant amounts of PTI
  - Exempts dividends paid with respect to CFC stock and re-characterizes sales of CFC stock as deemed dividends
  - Limits indirect tax credits with respect to foreign taxes paid by CFCs

Spin-Offs by CFCs Post-Tax-Reform (cont.)

- Treas. Reg. § 1.367(b)-5
  - Aims to preserve section 1248 amounts by measuring section 1248 amounts of Distributing and Controlled before and after spin of CFC
  - Treas. Reg. § 1.367(b)-5(c) provides rules for pro rata spin-offs
    - If the distributee's post-distribution section 1248 amount with respect to Distributing or Controlled is less than the distributee's pre-distribution section 1248 amount with respect to Distributing or Controlled, then the distributee's basis in Distributing or Controlled is reduced by the amount of the difference (but not below zero)
    - Results in deemed dividend to distributee shareholder to extent section pre-distribution section 1248 amounts are not preserved by basis adjustments
  - Treas. Reg. § 1.367(b)-5(d) provides rules for non pro rata spin-off
    - Results in deemed dividend to distributee as a result of reduction in Distributing or Controlled section 1248 amount

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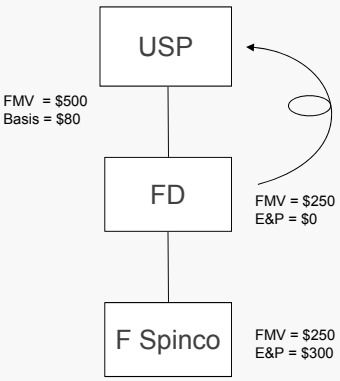
Spin-Off by CFC of F Spinco



- Reg. §1.367(b)-5(c)
- Compare the pre- and post-distribution section 1248 amounts
- USP's pre-distribution section 1248 amounts:
  - FD = $0
  - F Spinco = $300

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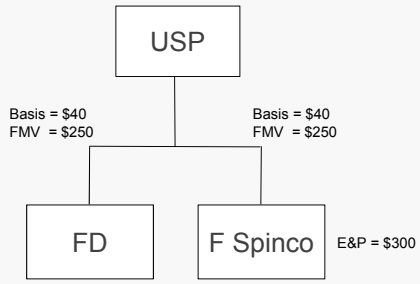
Spin-Off by CFC of F Spinco (cont.)



- USP's post-distribution section 1248 amounts:
  - FD = $0
  - F Spinco = $210 (reduction of $90)
- Treas. Reg. §1.367(b)-5(c)(2) basis reduction and deemed dividend
  - USP reduces basis in F Spinco to zero
  - Deemed dividend of $50 from F Spinco to FD and then from FD to USP
  - Section 245A DRD to USP
- Treas. Reg. §1.367(b)-5(c)(4) basis increase
  - USP increases basis in FD by $50 to $90

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Spin-Off by CFC of F Spinco (cont.)

- Device Considerations
  - Prevent taxpayers from using section 355 to convert a dividend to capital gains
  - Prevent separation of liquid and illiquid assets in a tax motivated spin-off
  - Device factors
    - Pro rata spin off
    - Subsequent sale or exchange
    - Nature and use of assets
  - Non device factors
    - Business purpose
    - Publicly traded Distributing
    - Distribution to domestic corporate shareholders (DRD available)

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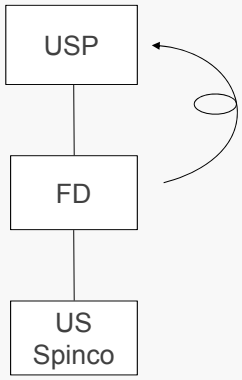
Spin-Off by CFC of US Spinco



- Section 243(a) DRD applies to dividends from US Spinco to FD
  - FD has subpart F inclusion for remainder of dividends
- Section 245(a) applies to US source dividends from FD to USP
- Section 245A applies to foreign source dividends from FD to USP
- Non-tax business purpose for spin-off?

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Spin-Off by CFC of US Spinco (cont.)

- Business Purpose Considerations
  - The transaction must be carried out for one or more corporate business purposes
  - The transaction must be motivated "in whole or substantial part" by one or more corporate business purposes
  - The "potential for the avoidance of Federal taxes" by Distributing or Controlled is "relevant in determining the extent to which an existing corporate business purpose motivated the distribution."
  - The business purpose requirement is "intended to provide nonrecognition treatment only to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate form."

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Evolution of PLR Program

Evolution of PLR Program

- Prior to 2003, IRS would issue whole spin (*e.g.*, full) private letter rulings under the comprehensive guidance of Rev. Proc. 96-30
- In Rev. Proc. 2003-48, IRS announced that it would no longer rule on:
  - Business purpose;
  - Device; or
  - Whether a distribution and an acquisition are part of plan under Section 355(e)
- In the aftermath of Rev. Proc. 2003-48, all ruling requests under Section 355 were required to include standard representations with respect to these "no rule" areas
- Taxpayers relied on the opinion of counsel for comfort

Evolution of PLR Program (cont.)

- In Rev. Proc. 2013-3, IRS announced that it would no longer rule on:
  - whether the control requirement is satisfied in a high-vote/low-vote transaction
  - certain debt exchange transactions (distributions of C securities in exchange for D debt issued "in anticipation" of the distribution)
  - whether North-South transactions would be respected as separate
- In Rev. Proc. 2013-32, IRS announced, effective August 23, 2013, that it will no longer rule on whether a transaction qualifies as tax-free under Section 355. Instead, it would only rule on one or more "significant issues" arising in the context of a spin-off
  - A "significant issue" is an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction

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Evolution of PLR Program (cont.)

- In Notice 2015-59, IRS announced that certain types of spin-offs involving relatively substantial investment assets, relatively small active businesses and conversions into RICs and REITs were under study and may raise concerns under the various requirements of Section 355
- In Rev. Proc. 2015-43, IRS announced that these types of spins were added to the "no-rule" lists so that, depending on the nature of the transaction, the IRS would either ordinarily not issue rulings on such spins absent unique and compelling reasons or would temporarily not issue rulings regardless of the circumstances pending the outcome of the study
- PATH Act enacted Section 355(h) and the Proposed Regulations under ATB and Device were issued in July 2017

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Evolution of PLR Program (cont.)

- In Rev. Proc. 2016-40, IRS provided safe harbors under which it would not assert that D lacked control of C as a result of certain recapitalization or other issuance transactions in which D obtained control of C if those transactions are unwound
  - The transaction: D owns C stock that does not constitute control; C issues one or more classes of stock to D or other shareholders of C as a result of which D achieves control; D distributes the stock of C; and after the spin, C engages in a transaction to unwind the issuance/recap to substantially restore the shareholders to the relative interests in C had the issuance not occurred or return the parties to the relative voting rights and value of C stock that were present prior to the issuance.
  - The safe harbors: (i) no action is taken is taken for 24 months after the distribution by C's board, C's management or C's controlling shareholders to unwind; or (ii) C engages in a transaction with one or more persons to result in an unwind and (A) there is no agreement, understanding, arrangement or substantial negotiation or discussion concerning the transaction or a similar transaction at any time during the 24 months ending on the date of the spin and (B) no more than 20% (by vote or value) of the interest in the counterparty is owned by the same persons that own more than 20% of C (applying attribution rules).

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Evolution of PLR Program (cont.)

- In Rev. Proc. 2016-45, IRS indicated that it would issue a significant issue ruling pertaining to corporate business purpose and pertaining to device, provided that the issue is a legal issue and not inherently factual in nature.
- In Rev. Rul. 2017-9, IRS addressed “North/South” issues
- In Rev. Proc. 2017-38, IRS said it would issue rulings on whether Section 355 or Section 361 applies to D's distribution of stock or securities of C in exchange/retirement of D debt issued in anticipation of the spin-off
- In Rev. Proc. 2017-52, IRS introduced 18-month pilot program expanding the scope of rulings available under Section 355 and would again issue rulings on the general federal income tax consequences of a spin-off
- In Rev. Proc. 2018-53, IRS set forth procedures for requesting advance rulings regarding the assumption of D’s debt in connection with divisive reorganizations under Sections 368(a)(1)(D) and 355

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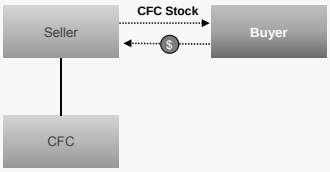
Buying and Selling CFCs After Tax Reform

Overview

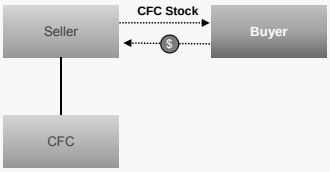
- The TCJA and subsequent guidance have significantly changed how purchases and sales of controlled foreign corporations, or "CFCs," are taxed
- As a result, M&A transactions involving CFCs will now present a number of new issues that will need to be considered by tax lawyers and the broader deal team
  - What were once reasonably straightforward structuring decisions—e.g., whether to make a Section 338(g) election—now frequently require considerable numerical analysis
  - The costs and benefits of such structuring decisions may not be apparent until extensive diligence has been completed. This type of diligence is typically not available until after the transaction documents have been signed, but it is usually difficult to preserve adequate structuring flexibility until that time because the buyer's and seller's interests are unlikely to be aligned
  - In addition, numerous uncertainties that have been identified by the government and practitioners persist
- Notwithstanding the significant and timely guidance that Treasury and the IRS have provided on the TCJA, these complexities are likely a permanent feature of planning going forward

Acquisition of a First-Tier CFC—Pre-TCJA



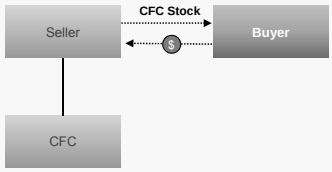
- Pre-TCJA, the impact of a Section 338(g) election with respect to the sale of CFC stock was reasonably straightforward and often favorable (or at least neutral) to both parties
- A Section 338(g) election benefited both parties by providing a "clean break" in closing the CFC's tax year
  - Absent the election, the CFC's tax year would remain open and that year's Subpart F inclusion would include Subpart F income generated on the buyer's watch and on the seller's watch
    - A U.S. buyer was required to include in income the Subpart F inclusion for the entire taxable year (reduced by any Section 1248 inclusion to a U.S. seller)
    - A U.S. seller would be liable for its share of the full year's inclusion if it sold the CFC stock to a foreign buyer
  - The parties could include covenants in the purchase agreement designed to limit activities likely to generate Subpart F income, but such covenants could be burdensome, particularly for foreign buyers
- A U.S. buyer also benefited from the elimination of existing e&p and an asset basis step-up in the CFC
- The election often caused no incremental tax to a U.S. seller
  - The deemed asset sale frequently would not create Subpart F income if the CFC's assets were active business assets
  - While the additional e&p generated by the asset sale would increase the U.S. seller's inclusion under Section 1248, a U.S. corporate seller was subject to the tax at the same rate on the Section 1248 inclusion as it would have been on capital gain
  - Section 338(h)(16) generally prevented the election from changing the foreign tax credit result to a U.S. seller

Acquisition of a First-Tier CFC—Post-TCJA



- The TCJA and related guidance have greatly complicated the decision whether to make a Section 338(g) election with respect to the first-tier CFC
- On the one hand, there are still benefits to a "clean break" and, in some respects, the TCJA has made them more important
  - A Section 338(g) election prevents pre-closing seller actions and post-closing buyer actions from affecting the Subpart F – and now GILTI – inclusion for a U.S. counterparty
  - Moreover, if the CFC's tax year remains open, it is not practical to rely on purchase agreement covenants designed to minimize the GILTI tax liability for a portion of the tax year because GILTI tax liability depends on "tested income" of the applicable CFC, which is a proxy for economic income
- On the other hand, allowing the CFC's tax year to remain open may allow some or all of the CFC's current year GILTI/Subpart F income to escape taxation altogether
  - As commentators have noted, the existing offset in Section 951(a)(2) causes Section 1248(a) amounts—which may no longer be subject to tax as a result of Section 245A—to exempt a portion of the CFC's GILTI and Subpart F income from tax
    - Draft technical corrections bill allocates tested income and Subpart F income to U.S. seller even though the U.S. seller does not hold the CFC's stock on the last day of the year that it is a CFC
  - Similarly, the CFC's entire GILTI or Subpart F inclusion for the year may escape taxation if the U.S. seller sells the CFC to a foreign buyer but the CFC remains a CFC following the sale (for instance, as a result of the repeal of Section 958(b)(4))
    - Draft technical corrections bill restores Section 958(b)(4) with certain targeted exceptions

Acquisition of a First-Tier CFC—Post-TCJA (cont.)



- Under current law, a Section 338(g) election will sometimes increase and sometimes decrease a U.S. seller's tax liability on the sale of its CFC because it effectively converts capital gain to tested income
  - The deemed asset sale now generates tested income that, depending on the other components of the U.S. seller's GILTI calculation, could increase its GILTI inclusion
  - If the tested income does increase the GILTI inclusion, the earnings will become PTI and therefore increase the U.S. seller's basis in its CFC under Section 961, thereby reducing gain on the sale
  - Certain sellers will prefer a GILTI inclusion and certain sellers will prefer capital gain
    - Tested income may not result in a GILTI inclusion if offset by tested losses or QBAI from related CFCs (or that CFC's QBAI)
    - Corporate sellers pay tax on GILTI at 10.5% (assuming Section 250 deduction is available) and capital gain at 21%; individual sellers pay tax on GILTI at 37% and capital gain at 23.8%
    - Foreign tax credits may be available to offset GILTI inclusion; capital losses may be available to offset capital gain
    - Additional tested income (or loss) in a CFC may change overall GILTI calculation in ways that are sometimes unexpected
      - For instance, an election may convert a tested loss CFC into a tested income CFC, which could make available additional net deemed tangible income return and foreign tax credits
      - An election may also cause certain QBAI held by the CFC to be disregarded for purposes of a U.S. seller's GILTI calculation under Prop. Reg. § 1.951A-3(h)(1)
- A Section 338(g) election will typically be favorable to a U.S. buyer because the resulting asset basis step-up will decrease the CFC's future tested income (or increase its future tested loss)
  - The election may also increase the CFC's basis in its QBAI property; the CFC's e&p is purged as a result of the election

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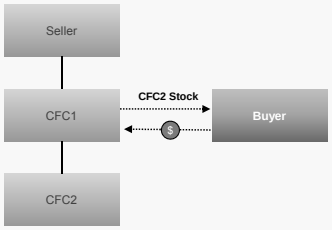
Acquisition of a Second-Tier CFC—Pre-TCJA



- The sale of CFC2 stock can be structured in three ways:
  - A straight sale of CFC2's equity
  - A check-the-box liquidation of CFC2 followed by a sale of its equity
  - A sale of CFC2's equity with a Section 338(g) election
- Prior to the TCJA, a straight sale frequently produced a bad result because (1) gain on the sale was subject to tax as Subpart F income (except to the extent of any deemed dividend under Section 964(e)) and (2) it did not close CFC2's tax year (and thereby provide a "clean break" for the parties)
- A check-and-sell structure solved both of these issues
  - CFC1 was treated as selling the assets of CFC2, which frequently would not generate Subpart F income
  - CFC2's taxable year closed when it was deemed liquidated as a result of the check-the-box election
- A Section 338(g) election generally produced a similar result
  - CFC2 was the deemed asset seller
  - The deemed dividend under Section 964(e)(6) would frequently not be taxable as Subpart F income under Section 954(c)(6)

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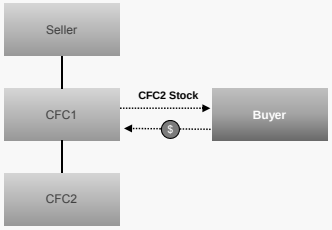
Acquisition of a Second-Tier CFC—Post-TCJA



- Under current law, any of these three options—a straight stock sale, a check-and-sell, and a stock sale with a Section 338(g) election—may produce the most tax efficient result for a U.S. seller
  - A stock sale will generally produce Subpart F income to the US shareholder, with the Section 964(e) amount entitled to a Section 245A deduction
  - An asset sale will generally create tested income in CFC2 (in the case of a Section 338(g) election) or CFC1 (in the case of a check-and-sell), which will be included in the U.S. shareholder's GILTI calculation
  - The amount of Subpart F income/deemed dividend versus tested income will depend on the inside versus outside basis
  - Moreover, assuming the same amount of income, some sellers will prefer Subpart F income and some will prefer GILTI
    - Applicable tax rates differ
    - Foreign tax credit calculations differ because (i) they are drawn from different baskets, (ii) Subpart F credits carry over, while GILTI credits do not, and (iii) Subpart F credits offset tax at a 100% rate, while GILTI credits offset tax at a 80% rate
  - A seller may have a preference between a stock sale with a Section 338(g) election and a check-and-sell because, although both are asset sales, the identity of the asset seller can produce different results in the U.S. shareholder's GILTI calculation
- A Section 338(g) election will typically be favorable to a U.S. buyer because the resulting asset-basis step-up will decrease the CFC's future tested income (or increase its tested loss)
  - The election may also increase the CFC's basis in its QBAI property; the CFC's e&p is purged as a result of the election

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Proposed GILTI Regulations and CFC Basis—Background

- Some of the most significant changes included in post-TCJA guidance are the basis adjustment rules contained in the new proposed GILTI regulations
- A U.S. shareholder calculates its GILTI inclusion based on the taxable items of its CFCs
  - The inclusion is equal to the excess of its "net CFC tested income" over its "net deemed tangible income return" (or "NDTIR")
  - Net CFC tested income is the excess of the tested income over the tested loss allocated to the shareholder from each of its CFCs
  - NDTIR is equal to the excess of 10 percent of the shareholder's share of its tested income CFCs' "qualified business asset investment" (or "QBAI"), over its share of its CFCs' net interest expense
- Accordingly, tested losses of one CFC can offset tested income of another CFC for purposes of calculating a U.S. shareholder's GILTI inclusion
- The statute provides that a U.S. shareholder's basis in its CFC is increased by the CFC's tested income to the extent the tested income results in a GILTI inclusion
- The statute does not, however, provide for a reduction in basis for tested losses that reduce GILTI inclusions
- The new proposed GILTI regulations include a "CFC Basis Reduction Rule" in Proposed Regulation § 1.951A-6(e) that requires a U.S. shareholder to reduce the basis in its tested loss CFCs for tested losses that offset tested income (more details are included in the following slides)
  - Additional rules under Prop Reg. §§ 1.1502-51 and 1.1502-32 require upper-tier basis adjustments to take into account offsetting between CFCs held by different members of a single consolidated group
- The stated purpose of the CFC Basis Reduction Rule is to ensure that a U.S. shareholder does not enjoy a double benefit from a tested loss incurred by its CFC

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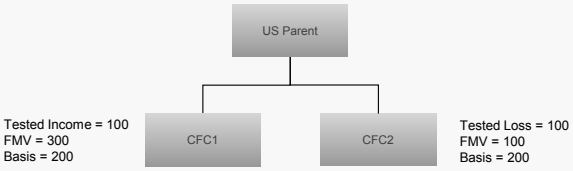
CFC Basis Reduction Rule—Example



- To illustrate the purpose of the CFC Basis Reduction Rule, consider the following example:
  - At the beginning of Year 1, US Parent, a domestic corporation, forms CFC1 and CFC2, each with $200 cash
    - US Parent is not part of a consolidated group and has no other CFCs
  - During Year 1, CFC1 has $100 of tested income and CFC2 has $100 of tested loss
  - At the end of Year 1, US Parent sells the stock of CFC2 for $100 (its fair market value), and causes CFC1 to make a $100 cash distribution
- US Parent has no economic net gain or loss in Year 1. Absent the CFC Basis Reduction Rule, however, US Parent would arguably reap a double benefit from CFC2's tested loss and recognize a net $100 tax loss
  - CFC1's $100 gain is not subject to tax because:
    - CFC2's $100 tested loss offsets CFC1's tested income such that US Parent has no net CFC tested income and, therefore, no GILTI inclusion
    - US Parent's receipt of the $100 distribution from CFC1 is not subject to tax under Section 245A
  - US Parent would recognize $100 of loss on the sale of CFC2 (the $100 tested loss would reduce CFC2's value below its initial $200 value but would not affect its initial $200 basis)

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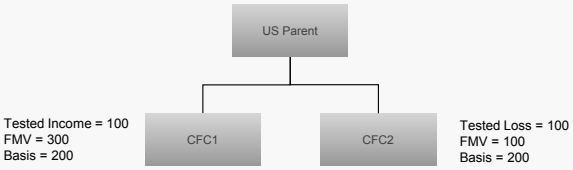
CFC Basis Reduction Rule—Example (cont.)



- The CFC Basis Reduction Rule causes US Parent to reduce its basis in CFC2 by its "net used tested loss amount" at the time it disposes of CFC2
  - In a given year, a CFC will have a "used tested loss amount" if its tested losses offset the tested income of other CFCs
  - Likewise, a CFC will have an "offset tested income amount" if its tested income is offset by another CFC's tested loss
  - Upon disposition, a CFC's "net used tested loss amount" equals (x) the aggregate of its prior used tested loss amounts for all prior years, minus (y) the aggregate of its prior offset tested income amounts for all prior years
  - In the Example, CFC2 would have a net used tested loss amount of $100
    - However, if instead of being sold in Year 1, CFC2 had $100 of tested income in Year 2 that was offset by CFC1's tested loss, it would have no net used tested loss amount if it were sold at the end of Year 2
  - If the CFC's basis is reduced below zero, the excess is treated as gain on the sale or exchange of the CFC stock
- Note that CFC2's basis may be adjusted downward even if, as a factual matter, US Parent would not enjoy a "double" tax benefit from the loss
  - If CFC1 owned QBAI that produced $100 of NDTIR in Year 1, US Parent would have had no GILTI inclusion in the absence of CFC2's tested loss
  - Even if the tested income would have resulted in a GILTI inclusion, US Parent also may have been able to eliminate that inclusion with foreign tax credits

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CFC Basis Reduction Rule—Implications

- Because the CFC Basis Reduction Rule does not take effect until disposition of a CFC, U.S. shareholders effectively have a "false" basis in the CFC that evaporates upon sale
  - The amount of "false" basis can increase or decrease over time depending on the shareholder's annual GILTI calculations
- In addition, basis will frequently not be consistent across a CFC's U.S. shareholders, even if those shareholders purchased their shares at the same time and at the same price
  - The GILTI inclusion and used tested loss amount for any shareholder depend on the tested income/loss, QBAI and interest income/expense of that shareholder's other CFCs
  - Accordingly, an allocation of tested loss might (i) cause a reduction in the basis of the CFC's stock upon disposition or (ii) have no effect on basis
  - Similarly, an allocation of tested income might (i) create an immediate basis increase (if the tested income results in a GILTI inclusion), (ii) negate a portion of the reduction in the CFC stock basis that would have occurred upon disposition or (iii) have no effect on basis
- Moreover, when the relevant CFCs are held by different members of a consolidated group, corresponding adjustments must be made to the stock of the group members that own the tested income CFC and tested loss CFC under Regulation § 1.1502-32
  - These adjustments include downward adjustments to reflect a CFC's used tested loss amounts and upward adjustments to reflect a CFC's offset tested income amounts
  - Contrary to the CFC Basis Reduction Rule, certain of the member adjustments must be done currently
  - These rules present considerable complexity and are beyond the scope of this presentation

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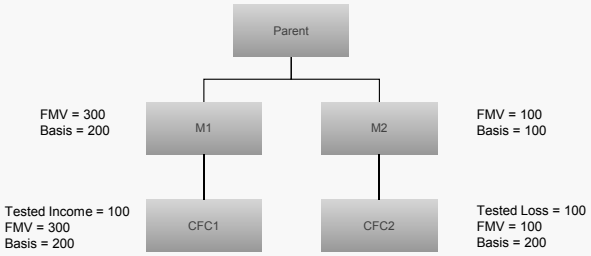
CFC Basis Reduction Rule—Sale of Member Stock



- One situation in which the application of the CFC Basis Reduction Rule is unclear involves the sale of a consolidated group member with CFCs, when no Section 338(h)(10) election is made. Consider the following facts:
  - Assume the same facts as in the prior Example, but that CFC1 and CFC2 are owned by M1 and M2, respectively, newly formed members of Parent's consolidated group
  - At the end of Year 1, Parent sells the stock of M2 to Buyer (instead of the stock of CFC2) without a Section 338(h)(10) election
- When Buyer purchases M2, CFC2 has a net used tested loss amount of $100. If M2 subsequently disposes of CFC2, should M2 reduce its basis in CFC2?
  - On the one hand, Proposed Regulation § 1.1502-51(e) defines "net used tested loss amount" as "with respect to a member," which suggests that such net used tested loss amount disappears when the U.S. shareholder ceases to be a member of the consolidated group
  - On the other hand, disregarding the "net used tested loss amount" in these circumstances may allow the tested loss to have a double benefit
    - Note that Parent's basis in M2 was reduced by the net used tested loss amount in CFC2 when CFC2 had that loss, such that Parent had additional gain on its sale of M2 stock

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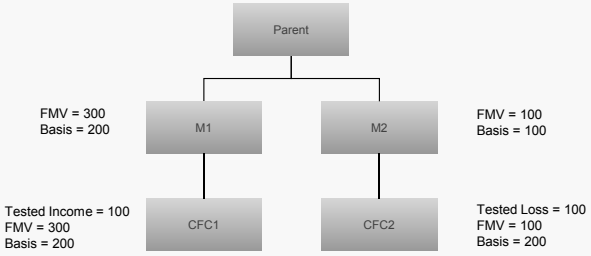
CFC Basis Reduction Rule—Sale of Member Stock (cont.)



- If CFC2's net used tested loss amount does carry over to Buyer, then Buyer will have to diligence Parent's entire GILTI calculation to know its basis upon the sale of CFC2
  - This means that Buyer will frequently not know the basis of its CFC subsidiaries going forward
- Given these uncertainties, Buyer may have an even stronger preference to make a Section 338(h)(10) election with respect to the sale of M2
  - The deemed sale of CFC2's stock by M2 will trigger application of the CFC Basis Reduction Rule
  - It would also allow Buyer to make a Section 338(g) election with respect to CFC2, which may be desirable for the reasons discussed earlier
  - However, if Parent has substantial basis in its M2 stock, then it may have a strong preference to not make a Section 338(h)(10) election

New Section 168(k)

New Section 168(k)

- In general, Section 168(k)(1)(A) provides for an additional first-year allowance with respect to "qualified property."
- Section 168(k)(2)(A)(ii) provides that qualified property only includes property "the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of [Section 168(k)(2)(E)(ii)]."
- Section 168(k)(2)(E)(ii) provides that an acquisition of property meets the requirements of Section 168(k)(2)(E)(ii) if:
  - such property was not used by the taxpayer at any time prior to such acquisition (the "**Prior Use Limitation**"), and
  - the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of Section 179(d) (which generally requires that the transaction is not between related parties or component members of a controlled group and that the property does not have a carryover basis) (the "**Purchase Requirement**").

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"No Prior Use"

- Under Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1), the acquired property cannot have been used by the taxpayer or a predecessor at any time prior to its acquisition.
- Property is treated as used by the taxpayer or a predecessor prior to its acquisition if the taxpayer or the predecessor had a depreciable interest in the property, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property.
- Prop. Reg. §1.168(k)-2(b)(3)(iii)(C) provides that, in the case of a "series of related transactions", the property is treated as directly transferred from the original transferor to the ultimate transferee and the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series.
  - Proposed regulations do not define this phrase "series of related transactions"; this phrase is not used in prior regulations under Section 168(k), but is used twice in Section 168(i)(3)(A) (as well as certain related regulations) without definition.

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Prior Use Limitation – Consolidated Return Rules

- Prior use of depreciable property by a current or previous member of a consolidated group generally prevents that property from ever satisfying the prior use requirement with respect to an acquisition by a member of that same consolidated group unless the transferee also departs the group pursuant to a series of related transactions that includes the acquisition.
- Prop. Reg. Section 1.168(k)-2(b)(3)(iii)(B)(3) contains special rules applying to consolidated groups:
  - (i) Same consolidated group. Solely for purposes of determining prior use, if a member of a consolidated group, as defined in Section 1.1502-1(h), acquires depreciable property in which the consolidated group had a depreciable interest at any time prior to the member's acquisition of the property, the member will be treated as having a depreciable interest in the property prior to the acquisition. For this purpose, a consolidated group will be treated as having a depreciable interest in property during the time any current or previous member of the group had a depreciable interest in the property while a member of the group.
  - (ii) Certain acquisitions pursuant to a series of related transactions. Solely for purposes of determining prior use, if a series of related transactions includes one or more transactions in which property is acquired by a member of a consolidated group and one or more transactions in which a corporation that had a depreciable interest in the property becomes a member of the group, the member that acquires the property will be treated as having a depreciable interest in the property prior to the time of its acquisition.
  - (iii) Time for testing membership. Solely for purposes of applying (i) and (ii) above, if a series of related transactions includes one or more transactions in which property is acquired by a member of a consolidated group and one or more transactions in which the transferee of the property ceases to be a member of a consolidated group, whether the taxpayer is a member of a consolidated group is tested immediately after the last transaction in the series.
- Thus, when determining prior use for an acquisition of depreciable property in a consolidated group context, extensive analysis of historical data may be necessary to determine whether the acquisition satisfies the requirements of the proposed regulations.

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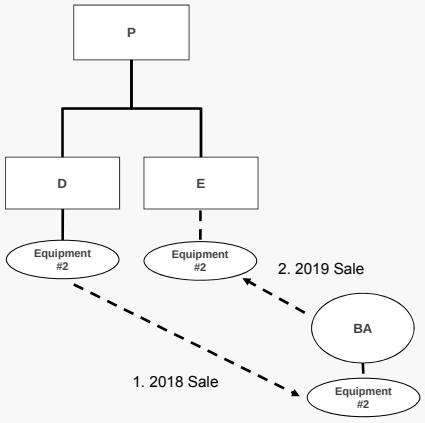
Prior Use Limitation – Prop. Reg. 1.168(k)-2, Example 20

Facts

- P, D, and E file a consolidated return.
- D has a depreciable interest in Equipment #2; no other member of the P consolidated group has had a depreciable interest.
- Transaction
  - 1) During 2018, D sells Equipment #2 to BA; BA is unrelated to the P consolidated group.
  - 2) In an "**unrelated transaction during 2019**," E acquires Equipment #2 from "**BA or another person not related to any membe**r" of the P consolidated group.



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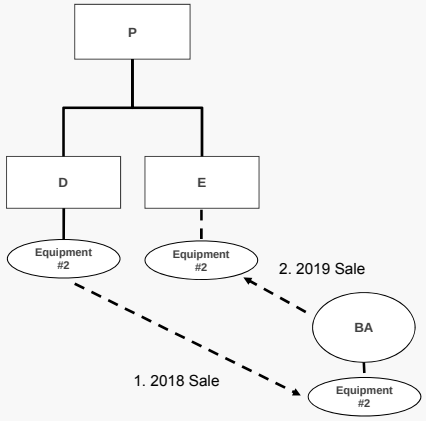
Prior Use Limitation – Prop. Reg. 1.168(k)-2, Example 20 Analysis

Analysis

- E Corporation is treated as previously having a depreciable interest in Equipment #2 because E Corporation is a member of the P consolidated group, and D, while a member of the Parent consolidated group, had a depreciable interest in Equipment #2.
- As a result, E's acquisition of Equipment #2 violates the Prior Use Limitation; thus, E's acquisition of Equipment #2 is not eligible for the additional first year depreciation deduction.
- The results would be the same if D had ceased to be a member of the Parent consolidated group after the sale of Equipment #2 to BA and prior to E's acquisition of Equipment #2.



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Prior Use Limitation – Diligence Considerations

- The unlimited lookback period for the Prior Use Limitation potentially represents a significant diligence burden.
- The proposed regulations under Section 168(k) request comments regarding whether a safe harbor for the Prior Use Requirement should be created.
- Several approaches are possible (*see* New York State Bar Association, *Report No. 1405 on Proposed Regulations Under Section 168(k) Relating to Immediate Expensing of Capital Investments* (Nov. 2, 2018)):
  - Incorporate a plan-based exemption (e.g., concepts similar to Section 355 or Section 197 (see Reg. §1.197-2(h)(5)(ii)). This exemption would treat an asset as previously used only if the prior use or disposition of the asset occurred pursuant to a plan that included the taxpayer's reacquisition of the asset.
  - Limit lookback period to specific period, such as the lesser of the property's recovery period or a set number of years, thereby prohibiting immediate expensing for reacquired property until the property had lost at least a significant portion of its value.
  - Actual/constructive knowledge standard. A person would be treated as previously using an asset only if the person possesses actual or constructive knowledge of the prior use. This rule could provide that a taxpayer has constructive knowledge of the prior use of an asset with a FMV above a certain threshold, or of the prior use of certain kinds of assets with researchable chains of title (*e.g.*, aircraft).

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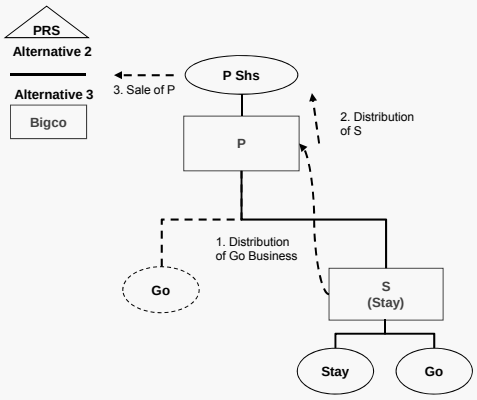
Sell-the-Seller Transaction

- P is the common parent of a consolidated group. S operates the Stay Business and the Go Business.
- Alternative 1:
  - 1) S distributes Go Business assets to P.
  - 2) P distributes S to the P shareholders
- Alternative 2: following Step 2, PRS purchases 100% of the stock of P for cash.
- Alternative 3: following Step 2, Bigco (consolidated parent) purchases 100% of the stock of P for cash.
- In each alternative, the steps are pursuant to prearranged plan
- Does Section 168(k) apply to the Go assets?
  - In Alternative 1, Prop. Reg. 1.168(k)-2(b)(3)(iii)(B)(3)(i) treats P as previously having a depreciable interest in the Go Business assets prior to the Step 1 distribution.
  - The same result appears to obtain in Alternative 2, even though the relationship between the Go assets and the ultimate economic owners has been severed.
  - In Alternative 3, the termination of the P consolidated group appears to invoke Prop. Reg. 1.168(k)-2(b)(3)(iii)(B)(3)(iii). Accordingly, Prop. Reg. 1.168(k)-2(b)(3)(iii)(B)(3)(i) does not appear to prevent the application of Section 168(k) to the Go Business assets.



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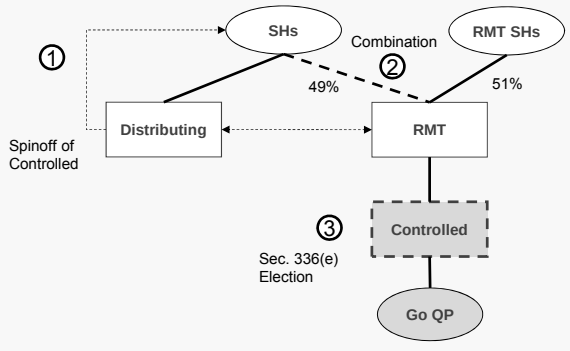
Section 355(e) Violation with Section 336(e) Election

Steps

1. Distributing transfers Go QP to Controlled and distributes Controlled to its shareholders (not depicted).
2. Controlled combines with RMT in exchange for 49% of the stock of RMT.
3. Distributing makes a Section 336(e) election for Controlled.

- Is Section 168(k) available under the "sale-to-self" model which applies to Section 355 distributions subject to Section 355(d) or Section 355(e)? Under this model, "old target" (i.e., Controlled) is treated as selling its assets to an unrelated party and, immediately thereafter, purchasing the assets from an unrelated party. Controlled is not deemed to liquidate.
- It appears that Controlled thus is considered to have previously used the property in violation of the Prior Use Limitation and to be ineligible for expensing.



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"Purchase" under Section 179(d)

- **Section 179(d)(2)(A)** requires that the property acquired in a purchase "is not acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under Section 267 or 707(b) (but, in applying Section 267(b) and (c) for purposes of this Section, paragraph (4) of Section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants)."
- **Section 179(d)(2)(B)** requires that the property acquired in a purchase "is not acquired by one component member of a controlled group from another component member of the same controlled group."
  - Generally, under Section 1563, a corporation will be treated as a component member if it was a member of the group for at least one-half of the number of days in the tax year that precedes the 12/31 in question.
- **Section 179(d)(2)(C)** requires that the basis of the property acquired in a purchase in the hands of the person acquiring it is not determined—
  - in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or
  - under Section 1014(a) (relating to property acquired from a decedent).
- Section 179(d)(3) provides that, for purposes of Section 179, "the cost of property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the person acquiring such property."
- Regulations provide that property deemed to have been acquired by a new target corporation as a result of a Section 338 election will be considered acquired by purchase for purposes of Section 179. Reg. 1.179-4(c)(2).

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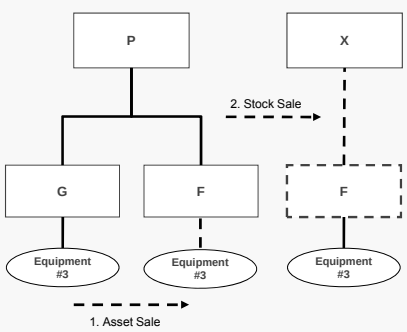
Prop. Reg. §1.168(k)-2, Example 21

Facts

- P, F, and G, file a consolidated return.
- X is the parent of a consolidated group; X is not related to any member of the P consolidated group.
- G has a depreciable interest in Equipment #3; no other entity has ever had a depreciable interest.
- Pursuant to a prearranged plan:
  - 1) G sold Equipment #3 to F.
  - 2) P sold the stock of F to X.

Analysis

- *Prior Use Limitation*: time for testing whether F corporation is a member of the P consolidated group is at the end of the series of related transactions; accordingly, because F is not a member of the P group at the end of the series, F is not treated as previously having a depreciable interest in Equipment #3 by reason of G's depreciable interest in Equipment #3. After the sale, F is a member of the X consolidated group; because no member of the X consolidated group previously had a depreciable interest in Equipment #3, F Corporation is not treated as previously having a depreciable interest in Equipment #3.



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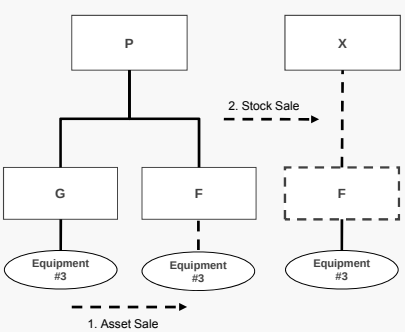
Prop. Reg. §1.168(k)-2, Example 21 (cont.)

Analysis Cont.

- *Relatedness Test*: because relatedness is tested after F leaves the P group, F and G are not related within the meaning of section 179(d)(2)(A) and Reg. §1.179-4(c)(1)(ii); accordingly, the acquisition of Equipment #3 satisfies at least part of the used property acquisition requirements.
- *Component Member Test*: Are F and G nevertheless both "component members" of the P controlled group ? If so, there is no purchase pursuant to section 179(d)(2)(B) and Reg. §1.179-4(c)(1)(iii).
  - Can a departing member ever avoid component member status? Reg. §1.1502-76(b)(1)(ii)(A) provides that F's tax year ends "for all Federal income tax purposes" at the end of the day of the stock sale and Reg. §1.1563-1(b)(1)(iii)(A) provides that if a component member of a controlled group has a short tax year that does not include a Dec. 31st, then the last day of that short tax year becomes that member's testing date and the end of its testing period.
  - Is this result intended? To what extent does Prop. Reg. §1.168(k)-2(b)(3)(iii)(C) impact component member analysis? Does that rule's reference to Sec. 168(k)(2)(E)(ii) and Prop. Reg. §1.168(k)-2(b)(3)(iii)(A) cause it to change or override component member analysis?
    - What result if F dropped Equipment #3 into Newco following the stock sale as part of the same plan?



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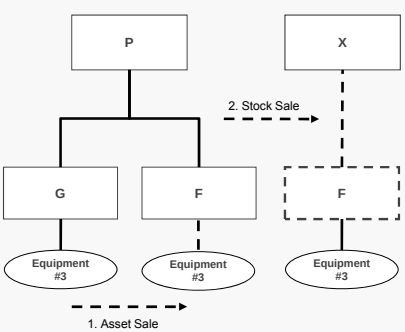
Prop. Reg. §1.168(k)-2, Example 21 Analysis (cont.)

Analysis

- Assuming all of the purchase requirements are satisfied, what is the effect of the application of Section 168(k)?
- Is the expensing deduction taken in the P group or the X group?
  - F places the equipment in service while a member of the P group. Does this mean that the deduction has to be taken in the P group?
- If the expensing deduction occurs in the P group:
  - Does Section 168(i)(7) apply to the extent of G's existing basis in the equipment? If not, can the P group get a net deduction? Does Reg. §1.1502-13(c) preclude such result?
  - With respect to the portion of the purchase price in excess of G's existing basis in the equipment, what is the effect of taking F's expensing deduction? Presumably G has to accelerate its gain to match the timing of the expensing deduction, and such gain will be ordinary income, under Reg. §1.1502-13(c).
  - Also, consider the impact on P's basis in F's stock under Reg. §1.1502-32. The net result of the transfer of the equipment is similar to a carryover basis transaction.
- Can different results be achieved if F is formed on the same day as it is sold to X in a "busted 351" transaction? See PLR 201644018 (Oct. 28, 2016).



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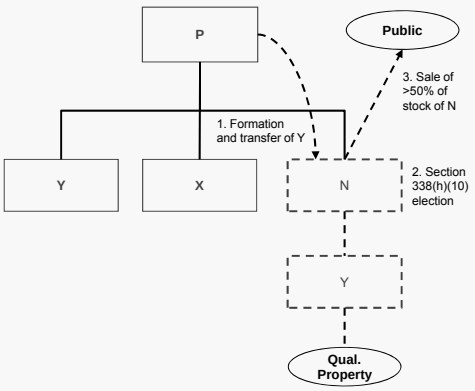
Sell-the-Buyer Section 338 Transaction

- P, X, and Y, file a consolidated return.
- P wishes to sell Y to the public and to step up the basis of the Y assets.
- Pursuant to a binding obligation:
  - 1) P forms Newco (N) and transfers Y to N for stock and a small amount of cash.
  - 2) P and N jointly make an election under Section 338(h)(10) for N's acquisition of Y.
  - 3) P sells more than 50% of the stock of N stock to the Public.
- The transfer of the Y stock to N should not qualify as a Section 351 transaction or a Section 368(a)(1)(B) reorganization. Taking the sale of N into account, P is not in control of N immediately after the transfer. Thus, N's acquisition of Y is a qualified stock purchase. See Reg. §1.338-3(b)(3)(iv), ex. 1.
  - "Old" Y is treated as if it sold all of its assets to an unrelated person. "New" Y is treated as having acquired the assets from an unrelated person. Moreover, "New" Y is treated as a new corporation that is, for most purposes (including Section 168), treated as unrelated to "Old" Y. See Reg. §1.338-1(a) and (b).



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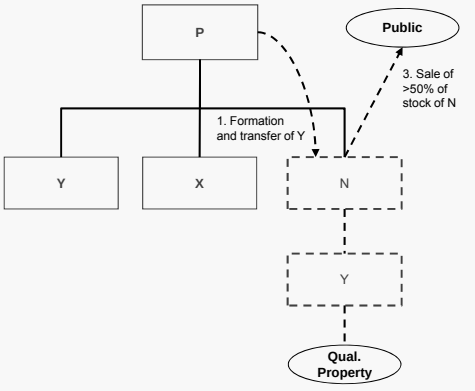
Sell-the-Buyer Transaction Considerations (cont.)

- Does Section 168(k) apply to Y's assets?
  - Presumably, the Prior Use Limitation and relatedness tests are satisfied as in Ex. 21 of the proposed regulations.
  - Do the Section 338 fictions (and the mandate of the Section 338 regulations that "Old" and "New" Y are treated as unrelated for Section 168(k) purposes) solve the component member problem? But see Prop. Reg. §1.168(k)-2(b)(3)(iii)(C). In any event, does Reg. §1.179-4(c)(2) negate the component member problem?
- Is Section 168(k) applies, how does it apply?
  - Does the selling group claim the deduction because "New" Y is a member of the P consolidated group when it places the assets in service?
  - What role do Section 168(i)(7) and Reg. §1.1502-13 play? Suppose the qualified property has positive basis. Does the selling group get a net deduction, or does the attribute redetermination rule apply?
  - Should the results for the selling group differ from those reached in Ex. 21 in the proposed regulations?



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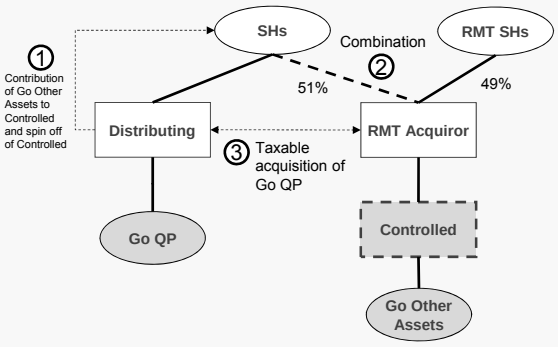
Reverse Morris Trust with Taxable Asset Purchase

Steps

1. Distributing transfers Go Other Assets to Controlled and distributes Controlled to its shareholders.
2. Controlled combines with RMT Acquiror in exchange for 51% of the stock of RMT Acquiror.
3. RMT Acquiror purchases Go QP from Distributing.

- Is Go QP eligible for Section 168(k) in RMT Acquiror's hands?
- Would the results differ if the Go QP assets subsequently were contributed by RMT Acquiror to Controlled?
- Would the results differ if the Go QP assets instead were acquired by an existing subsidiary of Controlled after the distribution and combination? Compare with Prop. Reg. §1.168(k)-2, Ex. 21.



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