

NYSBA Tax Section Summer Meeting

**RELEARNING
CORPORATE TRANSACTIONS**

June 24, 2018

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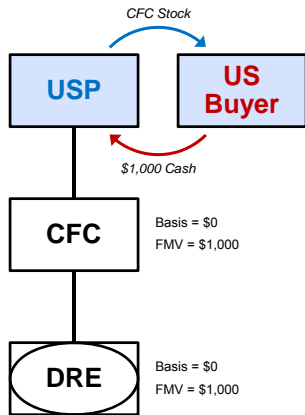
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International M&A

Forgetting (Most of the) Old Intuitions

Sale of First-Tier CFC to US Buyer



Facts

- No pre-existing E&P or PTI
- No GILTI (except due to transaction)
- No limit on GILTI deduction and no FTCs
- No Subpart F income

Sale of CFC Stock on last day of CFC taxable year

No Section 338(g) election

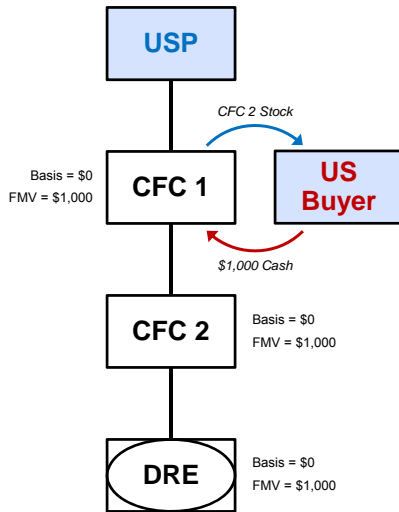
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|-----------------|--|
| USP | <ul style="list-style-type: none"> • \$1,000 gain on stock sale taxed at 21% = \$210 tax |
| US Buyer | <ul style="list-style-type: none"> • \$1,000 basis in CFC stock • Historic asset basis |

Section 338(g) election

- | | |
|-----------------|---|
| USP | <ul style="list-style-type: none"> • \$1,000 GILTI inclusion on deemed asset sale, and \$500 Section 250 deduction <ul style="list-style-type: none"> • $\\$500 * 21\% = \\105 tax • Basis step up of \$1,000 in CFC stock and PTI of \$1,000 • No further gain or loss on stock sale |
| US Buyer | <ul style="list-style-type: none"> • \$1,000 basis in CFC stock and \$1,000 basis in DRE assets |

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Sale of Second-Tier CFC to US Buyer



Facts

- No pre-existing E&P or PTI
- No GILTI (except due to transaction)
- No limit on GILTI deduction and no FTCs
- No Subpart F income

Sale of CFC 2 Stock on last day of CFC 2 taxable year

No Section 338(g) election

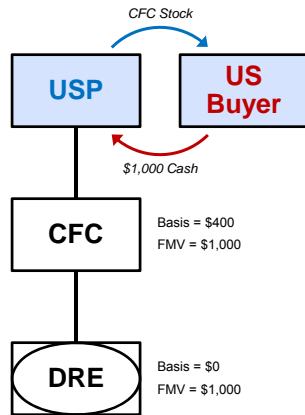
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|-----------------|--|
| USP | <ul style="list-style-type: none"> • CFC 1 has \$1,000 of Subpart F income, includible by USP <ul style="list-style-type: none"> • $\\$1,000 * 21\% = \\210 tax • \$1,000 basis step up in CFC 2 stock and PTI of \$1,000 |
| US Buyer | <ul style="list-style-type: none"> • \$1,000 basis in CFC 2 stock • Historic asset basis |

Section 338(g) election

- | | |
|-----------------|---|
| USP | <ul style="list-style-type: none"> • \$1,000 GILTI inclusion on deemed asset sale by CFC 2, and \$500 Section 250 deduction <ul style="list-style-type: none"> • $\\$500 * 21\% = \\105 tax • Basis step-up of \$1,000 in stock of CFC 2 and CFC 1, PTI of \$1,000 at CFC 2 • Sale of CFC 2 stock by CFC 1 <ul style="list-style-type: none"> • No 964(e) dividend • Basis step-up in CFC 2 stock for purposes of Section 951. No subpart F, but is there GILTI? |
| US Buyer | <ul style="list-style-type: none"> • \$1,000 basis in CFC 2 stock and \$1,000 basis in DRE assets |

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Sale of First-Tier CFC to US Buyer – I/O Basis Differential



Facts

- No pre-existing E&P or PTI
- No GILTI (except due to transaction)
- No limit on GILTI deduction and no FTCs
- No Subpart F income

Sale of CFC Stock on last day of CFC taxable year

No Section 338(g) election

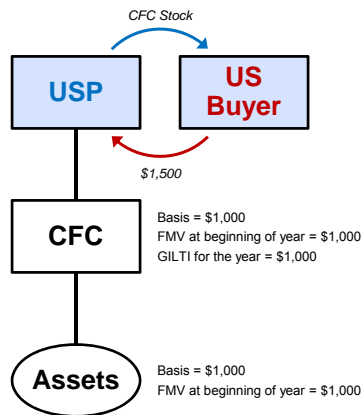
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|-----------------|--|
| USP | <ul style="list-style-type: none"> • \$600 gain on stock sale taxed at 21% = \$126 tax |
| US Buyer | <ul style="list-style-type: none"> • \$1,000 basis in CFC stock • Historic asset basis |

Section 338(g) election

- | | |
|-----------------|--|
| USP | <ul style="list-style-type: none"> • \$1,000 GILTI inclusion on deemed asset sale, and \$500 Section 250 deduction <ul style="list-style-type: none"> • $\\$500 * 21\% = \\105 tax • Basis step up of \$1,000 in CFC stock and PTI of \$1,000 • \$400 loss on stock sale |
| US Buyer | <ul style="list-style-type: none"> • \$1,000 basis in CFC stock and \$1,000 basis in DRE assets |

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Sale of First-Tier CFC to US Buyer – GILTI



Facts

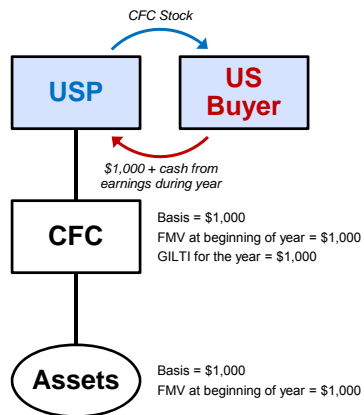
- No pre-existing E&P or PTI; 245A holding period met
- \$1,000 of GILTI for the year
- No limit on GILTI deduction and no FTCs
- No Subpart F income

Sale on 6/30 for \$1,500 (no Section 338(g) election)

- | | |
|-----------------|--|
| USP | <ul style="list-style-type: none"> • No GILTI inclusion as USP is not a U.S. shareholder on last day of year that CFC is a CFC • \$500 gain on sale of CFC stock, recharacterized as a dividend under Section 1248(a) and eligible for Section 245A DRD under Section 1248(j) <ul style="list-style-type: none"> • \$0 tax |
| US Buyer | <ul style="list-style-type: none"> • Inclusion of \$500 pro rata share of GILTI for the year under Sections 951A(e)(1) and 951(a)(2)(B) ($\\$1,000 - (50\% * \\$1,000) = \\$500$), and \$250 Section 250 deduction <ul style="list-style-type: none"> • $\\$250 * 21\% = \\52.5 tax • Had USP had preexisting PTI such that a portion of the \$500 gain is not recharacterized under 1248(a), such amount does not reduce buyer's GILTI inclusion under 951(a)(2)(B) • \$500 of "inherited" PTI |

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Sale of First-Tier CFC to US Buyer – GILTI

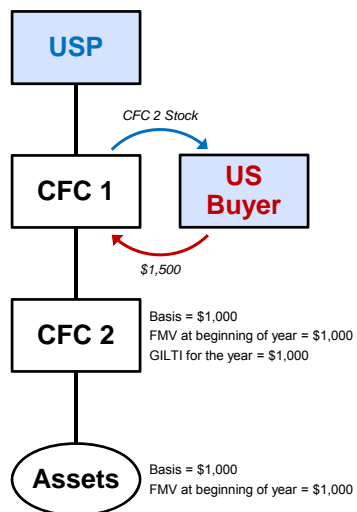


Same facts other than sale timing

Sale of CFC stock (no Section 338(g) election)	
Sale on 11/30 for \$1,917	
USP	<ul style="list-style-type: none"> No GILTI inclusion \$917 gain on sale of CFC stock, recharacterized as a dividend under Section 1248(a) and eligible for Section 245A DRD under Section 1248(j) <ul style="list-style-type: none"> \$0 tax
US Buyer	<ul style="list-style-type: none"> Inclusion of \$83 pro rata share of GILTI for the year ($\\$1,000 - (91.7\% * \\$1,000) = \\$83$), and \$41.5 Section 250 deduction <ul style="list-style-type: none"> $\\$41.5 * 21\% = \\8.74 tax \$917 of inherited PTI
Sale on 1/30 for \$1,083	
USP	<ul style="list-style-type: none"> No GILTI inclusion \$83 gain on sale of CFC stock, recharacterized as a dividend under Section 1248(a) and eligible for Section 245A DRD under Section 1248(j) <ul style="list-style-type: none"> \$0 tax
US Buyer	<ul style="list-style-type: none"> Inclusion of \$917 pro rata share of GILTI for the year ($\\$1,000 - (8.3\% * \\$1,000) = \\$917$), and \$458.5 Section 250 deduction <ul style="list-style-type: none"> $\\$458.5 * 21\% = \\96.3 tax \$83 of inherited PTI

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Sale of Second-Tier CFC to US Buyer – GILTI



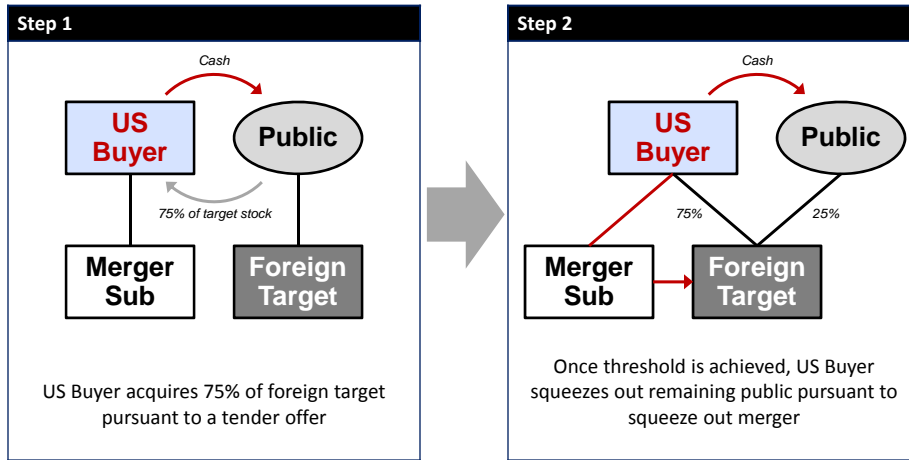
Same facts other than extra tier/seller

Sale on 6/30 for \$1,500 (no Section 338(g) election)	
USP	<ul style="list-style-type: none"> No GILTI inclusion as USP is not a U.S. Shareholder on last day of year that CFC 2 is a CFC CFC 1's \$500 gain on sale of CFC 2 stock is recharacterized as a dividend under Section 964(e)(1) and then again recharacterized under Section 964(e)(4) as Subpart F income of CFC 1, includible in income of USP and eligible for a Section 245A DRD (\$0 tax) What result if instead (1) all of CFC 2 income was Subpart F, (2) CFC 2 distributed \$500 to CFC 1 as a dividend prior to the sale, and (3) dividend did not qualify for same country exception (or look-through exception)? <ul style="list-style-type: none"> Would CFC 1 have a deduction under Section 245A? If so, why the special rule in Section 964(e)(4) in stock sale at gain scenario?
US Buyer	<ul style="list-style-type: none"> Inclusion of pro rata share of GILTI for the year under Sections 951A(e)(1) and 951(a)(2)(B) <ul style="list-style-type: none"> Reduced on account of \$500 Subpart F inclusion? Section 951(a)(2)(B) only reduces Subpart F income on account of dividends and Section 1248(a) amount Obtains \$500 of PTI on account of Subpart F inclusion?

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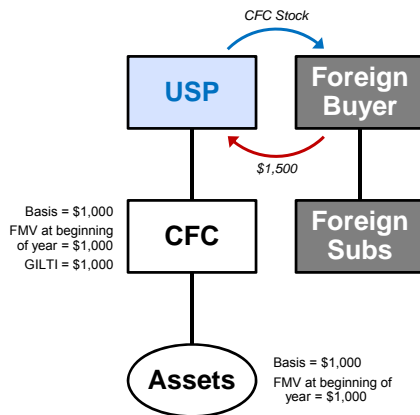
US Buyer Considerations

- Generally likely to prefer an asset sale or stock acquisition with a Section 338(g) election
 - Basis reduces future GILTI inclusions, PTI less relevant, no complications due to pre-sale GILTI
- Election not efficient in certain cases, including multi-step acquisitions if US Buyer becomes US Shareholder before 80% threshold reached (e.g., tender offer and squeeze out) given removal of minimum 30-day requirement for CFC status



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Sale of First-Tier CFC to Foreign Buyer With No US Subs - GILTI



Facts

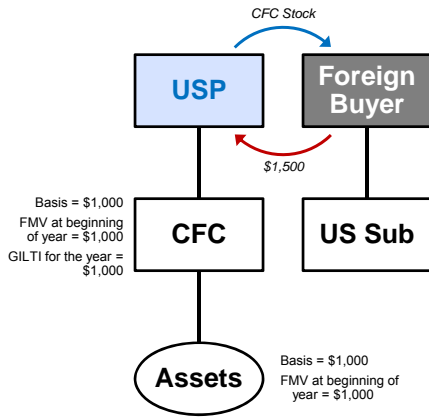
- No pre-existing E&P or PTI
- No limit on GILTI deduction and no FTCs
- \$1,000 of GILTI for the year
- No Subpart F income

Sale on 6/30 for \$1,500 (no Section 338(g) election)

USP	Foreign Buyer
<ul style="list-style-type: none"> • USP is a U.S. Shareholder on the last day of the taxable year in which CFC is a CFC. GILTI inclusion of \$500 under Sections 951A and 951(a)(2)(A), and a \$250 Section 250 deduction <ul style="list-style-type: none"> • $\\$250 * 21\% = \\52.5 tax • Basis step-up of \$500 in CFC stock and PTI of \$500 • No further gain or loss on sale 	<ul style="list-style-type: none"> • No GILTI (or Subpart F) inclusions • CFC is no longer a CFC

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Sale of First-Tier CFC to Foreign Buyer With US Subs - GILTI



Facts

- No pre-existing E&P or PTI; 245A holding period met
- No limit on GILTI deduction and no FTCs
- \$1,000 of GILTI for the year
- No Subpart F income

Sale on 6/30 for \$1,500 (no Section 338(g) election)

Entity	Details
USP	<ul style="list-style-type: none"> • Due to downward attribution resulting from repeal of Section 958(b)(4), CFC remains a CFC and USP is not a U.S. Shareholder on the last day of the taxable year; accordingly, there should be no GILTI inclusion • \$500 gain on sale of CFC stock recharacterized as a dividend under Section 1248(a), eligible for Section 245A DRD under Section 1248(j) <ul style="list-style-type: none"> • \$0 tax
Foreign Buyer	<ul style="list-style-type: none"> • Although CFC remains a CFC, no GILTI (or Subpart F) inclusions since no U.S. Shareholder owns CFC stock on last day of CFC tax year directly or indirectly under Section 958(a)

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The Transition Tax

An Adventure in Due Diligence, Risk Allocation and Transactional Planning

The Transition Tax Is Not Over

- New section 965 imposes a one-time “transition tax” on deferred foreign income, which is included as additional Subpart F income for the last taxable year of the foreign corporation beginning before 1/1/18.
- A special deduction provides a rate break on this inclusion (§ 965(c)).

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An Extended Statute of Limitations

- The additional inclusion comes with a special extended statute of limitations: six years from the filing of the return for the year of the Subpart F inclusion (§ 965(k)).

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Installment Payments

- A US Shareholder can elect to pay tax on the inclusion in eight annual installments (§ 965(h)).
- The installments are backloaded – 8% in each of the first five years, then 15, 20 and 25%.
- Certain events accelerate the remaining installments – details to follow.
- There are special rules for S Corp shareholders. What about partnerships?

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Consolidated Groups – Who pays?

- The operative provision of the tax is in the passive voice: “the Subpart F income of such foreign corporation ... shall be increased ...”
- Notice 2018-07:
Pursuant to the Secretary's authority under sections 965(o) and 1502, the Treasury Department and the IRS intend to issue regulations providing that, solely with respect to the calculation of the amount included in gross income by a consolidated group ..., all of the members of a consolidated group that are United States shareholders of one or more specified foreign corporations will be treated as a single United States shareholder. (§ 3.04)

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Installment Payments

- In the case of a United States shareholder of a deferred foreign income corporation, such United States shareholder may elect to pay the net tax liability under this section in 8 installments ... (§ 965(h)(1)).
- In the case of a consolidated group ... in which one or more members are United States shareholders of a specified foreign corporation, the agent for the group ... must make the election on behalf of its members. (IRS Q&A 5, 4/13/18)

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Sale of a Consolidated Subsidiary

- P1 owns S1; they file a consolidated return. S1 is the US shareholder of a DFIC. After 5 annual installments have been paid, P1 sells the stock of S1 to P2, the parent of another consolidated group.
- How much, if any, of the 3 remaining installments will be borne by S1 (or the P2 group)?
- If it is primarily S1's liability, will P1 nevertheless be severally liable for the 3 installments under 1.1502-6?
- Is P2 severally liable for those 3 installments?
- What would you provide in the Purchase and Sale Agreement for S1?

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Acceleration of Installments

- If there is an addition to tax for failure to timely pay any installment required under this subsection, a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), a cessation of business by the taxpayer, or any similar circumstance, then the unpaid portion of all remaining installments shall be due on the date of such event (or in the case of a title 11 or similar case, the day before the petition is filed). The preceding sentence shall not apply to the sale of substantially all the assets of a taxpayer to a buyer if such buyer enters into an agreement with the Secretary under which such buyer is liable for the remaining installments due under this subsection in the same manner as if such buyer were the taxpayer.

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Sale of a Consolidated Subsidiary (338(h)(10) Election)

- P1 owns S1; they file a consolidated return. S1 is the US shareholder of a DFIC. After 5 annual installments have been paid, P1 sells the stock of S1 to P2, the parent of another consolidated group, subject to an election under section 338(h)(10).
- Does the liability for the last 3 installments accelerate? Can P2 or S1 (as “new S1”) assume the remaining installments? Can they instead remain with the P1 group without acceleration?
- What would you provide in the Purchase and Sale Agreement for S1?

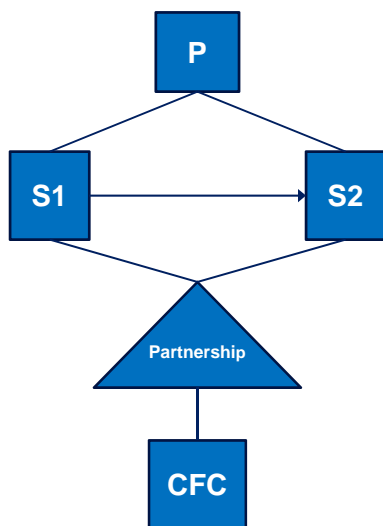
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Intragroup Section 381 Transaction

- P owns S1; they file a consolidated return. S1 is the US shareholder of a DFIC. After 5 annual installments have been paid, S1 converts into an LLC.
- Does the liability for the last 3 installments accelerate? Can it instead remain with the P1 group without acceleration? What will the regulations say?
- Compare § 1.108(i)-1 (similar statutory language; an exception for section 381 transactions).
- Observation: This is a domestic transaction.
- Observation: This the sort of transaction a client might do without asking your advice (unless you specialize in SALT issues).
- If you're planning an acquisition of or from the P group, what's on your diligence checklist?

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Controlled Partnership



- P owns S1 and S2; they file a consolidated return. S1 and S2 are the partners in a partnership that owns a DFIC. After five annual installments have been paid, S1 merges into S2 in a “D” reorganization.
- How is CFC factored into the P group's Subpart F inclusion?
- The installment election is to be made by the partners rather than the partnership. (Notice 2018-26, §3.05 (b))
- Does the liability for the last three installments accelerate? Can it instead remain with the P group without acceleration? What will the regulations say?
- How will audit adjustments work with respect to the first five years?

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Compare and Contrast: Life Ins. Co. Phase III Tax

- Section 13514(d) of the TCJA requires the recapture of the remaining policyholders surplus account, if any, of a life insurance company in eight annual installments (equal, this time).
- There are no acceleration events.
- The PSA account has always been treated as a section 381 attribute.
- The recapture into income seems to apply only in years in which the corporation is taxed as a life insurance company.

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Tax Assets(?) in Post TCJA Deals

Valuing Tax Assets/Transaction Deductions in Post TCJA Deals

- Consider impact of:
 - Reduced tax rates
 - New limits on utilization of NOLs, interest deductions and excess interest carry overs
 - Application of Section 382
 - Complex interaction of the new income categories created by the GILTI, FDII and BEAT regimes with NOLs and interest expense deductions

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Assuming the transaction is a stock acquisition or one to which § 381 applies, what do you need to know?

- Amount and type of existing tax assets (*e.g.*, NOL carry overs, basis/built-in losses, excess interest expense carry overs)
- When tax assets were created (especially NOLs)
- Existing § 382 limitations?
- Amount and type of “transaction tax benefits”
- § 382 effects of new ownership change
- Capacity to utilize tax benefits in current and future periods (income projections, effects of debt financing, interaction of code provisions)

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Net Operating Losses

- For net operating losses (NOLs) arising in tax years ending after 12/31/2017:
 - NOL carrybacks not allowed
 - NOL carryforwards allowed indefinitely
 - Deduction is limited to 80% of taxable income for the year to which NOL is carried (compare prior law under which corporate AMT limited use of NOLs to 90% of taxable income)
- NOLs created prior to TCJA effective date are apparently not subject to the 80% cap

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Excess Interest Expense Carry Overs

- Section 163(j) limits the deduction for net business interest expense to 30% of adjusted taxable income (ATI).
- Excess interest expense can be carried forward indefinitely, but if the taxpayer is subject to a 163(j) limitation, the current value of any other deduction is reduced
- Excess interest is a § 381 attribute (§ 381(c)(20))
- Notice 2018-28 treats excess interest carried from old § 163(j) years as subject to new § 163(j)
- Section 163(j) applies to members of a consolidated group on a group-wide basis

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Section 382 Considerations

- A company with built-in losses and/or excess interest carry overs will be a “loss company” under § 382 whether or not it also has NOLs
- Unclear how the use of pre-change excess interest carry forwards impacts the § 382 limit
- Are RBILS following a § 382 ownership change also carried forward indefinitely?
- Is use of RBILS limited to offsetting 80% of taxable income?
- Does it matter whether the § 382 ownership change occurred prior to or after enactment?

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Complex Interactions

- The complex calculations required for the new income categories created by the GILTI, FDII and BEAT regimes affect the use of NOLs, excess interest carry overs and other attributes of U.S. multinationals
- If the GILTI deduction exceeds taxable income NOL carry over (or a portion of it) may be absorbed with GILTI deduction subject to elimination or reduction

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Complex Interactions *(cont'd)*

- The BEAT calculates “modified taxable income” without (or by adding back) the “base erosion percentage” of NOL carry forwards
- Section 163(j) deferred interest may be treated as base eroding payments if the relevant interest was paid to a foreign person deemed to be a related person for BEAT purposes
- Reductions of regular tax liability through utilization of certain credits (including FTCs) increases the BEAT tax liability

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Complex Interactions *(cont'd)*

- There are significant areas of uncertainty regarding application of the BEAT including how it interacts with GILTI and the Section 163(j) limits on net business interest expense
- Additional guidance will be necessary to deal with such things as allocation of certain tax attributes among members of a group, ordering rules when dealing with excess interest expense carry overs and NOLs, *etc.*

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Negotiating Transaction Tax Benefits

- Negotiating the benefit of transaction costs – *e.g.*, fees and compensatory payments like option cash-outs and bonuses – is significantly affected by inability to carry back NOLs to obtain a refund
- In many pre TCJA deals where the target had carry back capacity, the transaction tax benefit negotiation centered on entitlement to any refund produced by transaction tax benefits
- Post TCJA the discussion will shift to how and whether to share the potential benefit of carry over tax assets taking into account the application of § 382 and the effects of the new law

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Negotiating for Tax Assets Generally

- Quantification of future tax benefits has always been difficult, but the uncertainties and complex interactions of the new rules make it even less likely that the parties will attempt to value tax assets upfront and incorporate that value into the purchase price
- Where buyers do agree to share the benefit of tax benefits realized in the future, provisions dealing with payments to the sellers for those tax benefits will likely become more elaborate (*e.g.*, “pay-as-you-go” requiring annual “with and without” calculations)

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Negotiating for Tax Assets Generally *(cont'd)*

- Buyers will have concerns about complexity and uncertainty involved in agreements that contemplate a longer time frame for realization of tax benefits
- In addition to the concerns that arise from uncertainties in the new regime, buyers may also be concerned about the durability of the new rules
- Sellers may seek contractual protection against Buyer actions that could diminish payments to sellers

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Durability of the New Regime?

- Product of partisan process
- Aspects of international provisions (FDII/Section 250) arguably violate WTO rules and/or BEPS Action 5
- BEAT arguably violates anti-discrimination clauses in U.S. tax treaties
- Lack of guidance to deal with complex interactions and potentially unintended consequences
- Layers of complexity only beginning to be understood – full understanding may spur additional legislation

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