Empire State of Mind: International M&A Post Tax Reform

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Empire State of Mind: International M&A Post Tax Reform

- Introduction
- Post Tax Reform Acquisition and Post Tax Reform Disposition Considerations
- Case Studies

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Introduction

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Introduction

- The Tax Cuts and Jobs Act ("TCJA") is the most significant change to U.S. tax law since 1986

- TCJA did not generally change subchapter C or gain/loss recognition rules

  - Instead, consequences of transactions being taxable or tax-free may be substantially different

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Introduction

— Current income and losses/deductions fall into different buckets with different rates following TCJA

Current Income Category	Pre-Tax Reform Treatment	Post-Tax Reform Treatment
Non-FDII income/loss in U.S.	• 35% corporate tax rate	• 21% corporate tax rate
FDII income/loss in U.S.	• 35% corporate tax rate, generally less foreign tax credits (“FTCs”)	• 13.125% rate less FTCs
Subpart F income/loss	• 35% rate less FTCs	• 21% rate less FTCs
GILTI	• None until repatriation	• Taxable in year earned at 0-10.5% U.S. rate / 10.5%-13.125% global rate plus excess FTCs
Other CFC income (including high-tax subpart F) and 10/50 dividends	• Earnings taxed on repatriation with FTCs	• Not subject to tax assuming 12-month holding period satisfied on distributions

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Introduction

- Lower Rate: Reduces the cost of taxable dispositions to U.S. corporate sellers, but reduces the value of step-ups (and other tax attributes, such as interest deductions and net operating losses ("NOLs")) to U.S. corporate buyers
- Bonus Depreciation: Mostly domestic benefit, but can create an NOL (now 80% limited NOL) and may impact ability to utilize lower GILTI and FDII rates
- Interest Limitation/Financing: Section 163(j) limits ability to utilized U.S. deductions and reduction in U.S. rate reduces value of U.S. deductions
- Transition Tax/Foreign DRD: Earning generally can be repatriated without incremental U.S. tax cost; may allow efficient funding with foreign generated cash

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Introduction

- GILTI: Profile may have substantial impact on transaction structure and section 338 election decisions
- BEAT: Deductible payments to related persons potentially disfavored

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Post Tax Reform Acquisition and Disposition Considerations

Post Tax Reform Acquisition Considerations

– A key consideration in structuring an acquisition is whether a CTB or section 338(g) election should be made

- An election would have the benefit of stepping up asset basis for US tax purposes and eliminating the target's history, but, under certain circumstance, may result in a cost compared to if there were no step-up (section 901(m) not repealed)

- A U.S. seller will typically want to minimize its subpart F income on the sale with a CTB or section 338 election

– Because of the low rate applicable to GILTI (13.125%), targets will typically generate excess GILTI basket FTCs going forward

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Post Tax Reform Disposition Considerations

- Actual Asset Sale: One theoretical way to dispose of a business with the gain treated as GILTI rather than subpart F stock gain or gain taxable in the United States, but will typically not be feasible from a local tax perspective or from a legal perspective
- “Check and Sell”: Making a CTB election on the target prior to the sale converts the gain on a stock sale into gain on assets, which will be GILTI if the target is held by a CFC
- Section 338(g) Election: If the purchaser makes a section 338(g) election, the target will be treated as selling its assets prior to the sale of stock
  - Gain on the deemed asset sale will be GILTI included by the seller, but because the actual stock sale is still respected, the section 338(g) election may be more or less beneficial than a CTB election

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Case Studies

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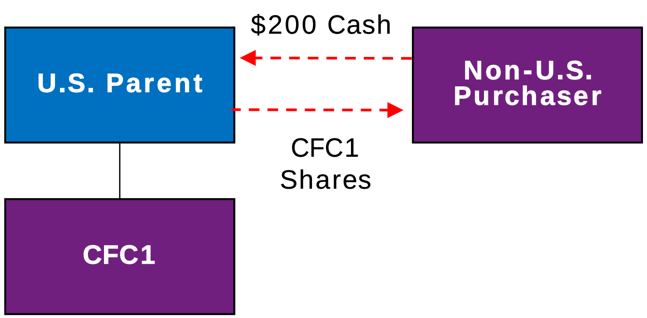
Case Studies

Sale of CFC by a U.S. Shareholder <u>with no 338 Election</u> by Non-U.S. Purchaser (without U.S. subsidiary)

Sale on 12/31



$50 CFC1 Stock Adjusted Basis (before CY GILTI)
$20 CY CFC1 GILTI
$25 CY CFC1 E&P ($5 untaxed)

<u>Result</u>

GILTI	$20 ($2.1 pre-FTC tax)
Gain on stock sale	$130
1248 dividend (245A exempt)	$5
Capital gain recognized	$125 ($26.25 tax)

- U.S. Parent required to include CFC1's GILTI in the year of the sale because it was a US shareholder of CFC1 as of the last day on which CFC1 qualified as a CFC during the taxable year
  - GILTI inclusion increases CFC1 stock basis and reduces taxable gain
- Sections 1248 and 245A applicability
- Gain in excess of 1248 dividend subject to US tax
- If Non-U.S. Purchaser had a U.S. subsidiary, CFC status will not end, and U.S. Parent will not have a GILTI inclusion absent a 338(g) election
  - No U.S. shareholder will have a GILTI inclusion because no 958(a) ownership

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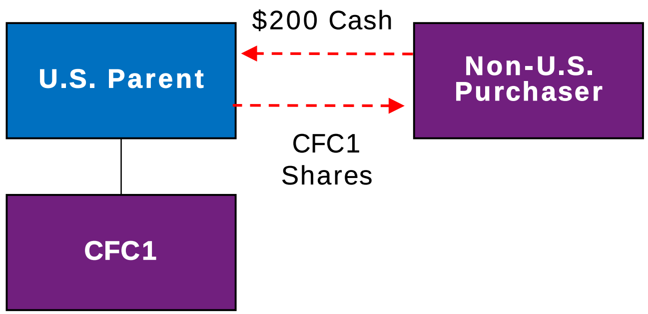
Case Studies

Sale of CFC by a US Shareholder <u>with 338 Election</u> by Non-U.S. Purchaser (without US subsidiary)

Sale on 12/31



$50 CFC1 Stock Adjusted Basis (before CY GILTI)
$50 CFC1 Inside Asset Basis
$20 CY CFC1 GILTI (without 338)
$25 CY CFC1 E&P (without 338 and $5 untaxed)
No CFC1 Subpart F Assets

<u>Result</u>

GILTI	$170 ($17.85 pre-FTC tax)
Gain on stock sale	$0
1248 dividend (245A exempt)	$0
Capital gain recognized	$0

- Non-U.S. Purchaser 338 election at request of U.S. Parent
- U.S. Parent includes CFC1's GILTI because section 338 election causes CFC1 short year ending on the sale date with U.S. Parent as U.S. shareholder
  - GILTI inclusion increases CFC1 stock basis and reduces taxable gain
  - Possible application of section 338(h)(16) prevents excess GILTI FTC utilization against GILTI resulting from the section 338 election
- Sections 1248 and 245A applicability
- Gain in excess of 1248 dividend subject to US tax

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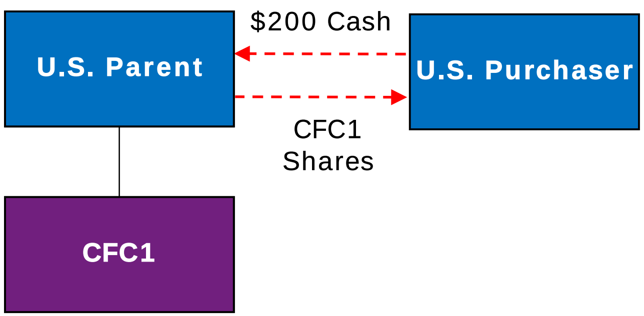
Case Studies

Sale of CFC by a US Shareholder <u>with no 338 Election</u> by U.S. Purchaser (or CFC)

Sale on 12/31



$50 CFC1 Stock Adjusted Basis
$20 CY CFC1 GILTI
$25 CY CFC1 E&P ($5 untaxed)

<u>Result</u>

Gain on stock sale	$150
1248 dividend (245A exempt)	$5
Capital gain recognized	$145 ($30.45 tax)

- U.S. Parent recognizes gain or loss on the sale of CFC1 stock
- Section 1248 applicability
- Section 1248 amount qualifies for the section 245A 100% DRD; the balance of any gain would be subject to tax
- Only U.S. Purchaser includes CFC1's GILTI or subpart F income in the year of the sale because U.S. Parent is not a U.S. shareholder of CFC1 as of the last day of the CFC's taxable year (or as of the last day on which CFC1 qualified as a CFC during the taxable year)
- Because of sections 245A and 951(a)(2)(B), E&P may go untaxed (Treasury may provide guidance)

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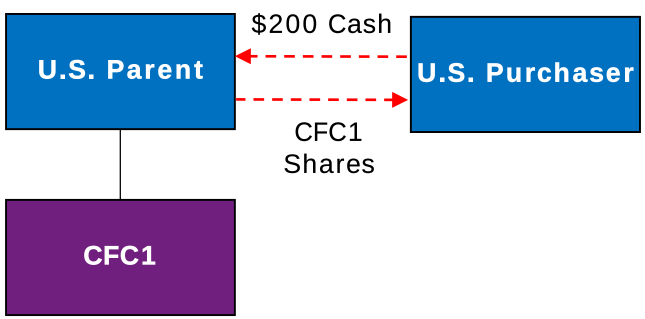
Case Studies

Sale of CFC by a US Shareholder <u>with 338 Election</u> by U.S. Purchaser (or CFC)

Sale on 12/31



$50 CFC1 Stock Adjusted Basis (before CY GILTI)
$50 CFC1 Inside Asset Basis
$20 CY CFC1 GILTI (without 338)
$25 CY CFC1 E&P (without 338 and $5 untaxed)

<u>Result</u>

GILTI	$170 ($17.85 pre-FTC tax)
Gain on stock sale	$0
1248 dividend (245A exempt)	$0
Capital gain recognized	$0

- U.S. Parent recognizes gain or loss on the sale of CFC1 stock
- U.S. Parent includes CFC1's GILTI because section 338 election causes a CFC1 short year ending on the sale date with U.S. Parent as U.S. shareholder
  - GILTI inclusion increases CFC1 stock basis and reduces taxable gain
  - Possible application of section 338(h)(16) prevents excess GILTI FTC utilization against GILTI resulting from the section 338 election
- Sections 1248 and 245A applicability
- U.S. Purchaser gets inside asset basis step-up and subject to section 901(m) but historic E&P and PTI of CFC1 are eliminated

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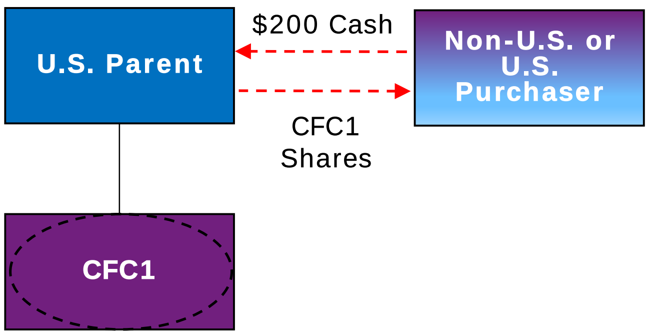
Case Studies

Tax-Free CTB Election – Sale of CFC by a U.S. Shareholder

CTB and Sale on 12/31



$50 CFC1 Stock Adjusted Basis
$50 CFC1 Inside Asset Basis
$20 CFC1 CY GILTI
$25 CFC1 CY E&P ($5 untaxed)

<u>Result</u>

GILTI	$20 ($2.1 pre-FTC tax)
All E&P amount (245A exempt)	$5
Gain recognized	$150 ($31.5 tax)

- Asset gain subject to U.S. tax
  - Potential benefit if inside basis exceeds the outside basis
- No inbound all E&P toll charge provided 12-month holding period satisfied
- U.S. Parent is required to include CFC1's GILTI
  - CTB election closes CFC1's tax year
  - Avoids potential subpart F income or incremental GILTI due to purchaser's actions if Non-U.S. Purchaser
  - Triggers GILTI or subpart F inclusion that otherwise could be avoided if U.S. Purchaser and no section 338 election

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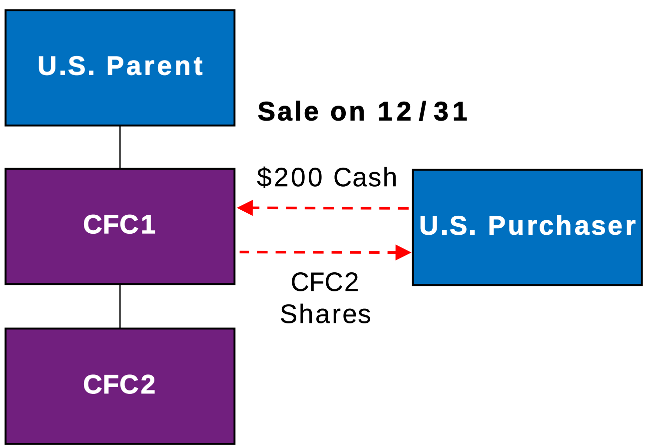
Case Studies

Sale of CFC by a CFC with no 338 Election by U.S. Purchaser (or CFC)



$50 CFC2 Stock Adjusted Basis
$25 CFC2 CY E&P ($5 untaxed)

Result

Gain on stock sale	$150
964(e) dividend (sub F) (245A available)	$5
CFC1 subpart F	$145 ($30.45 pre-FTC tax)

- CFC1 recognizes gain or loss on the sale of CFC2 stock
- Section 964(e) recharacterizes gain as dividend income which is subpart F; U.S. Parent allowed section 245A deduction with respect to such subpart F
- Only U.S. Purchaser is required to include CFC2's GILTI in the year of the sale because U.S. Parent is not a US shareholder of CFC2 as of the last day of the CFC's taxable year (or as of the last day on which CFC2 qualified as a CFC during the taxable year)
- Gain or loss recognized by CFC1 on the sale of CFC2 in excess of any section 964(e) dividend and adjusted basis is subpart F

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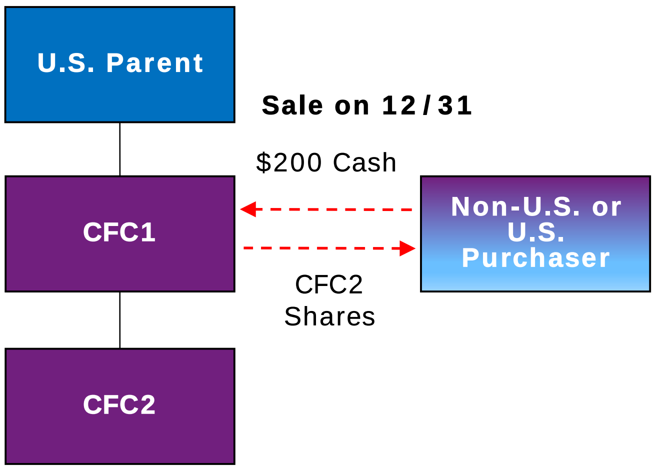
Case Studies

Sale of CFC by a CFC with 338 Election by U.S. Purchaser (or CFC) or Non-U.S. Purchaser



$50 CFC2 Stock Adjusted Basis (Before CY GILTI)
$50 CFC2 Inside Asset Basis
$20 CFC2 CY GILTI (without 338)
$25 CFC2 CY E&P (without 338 and $5 untaxed)

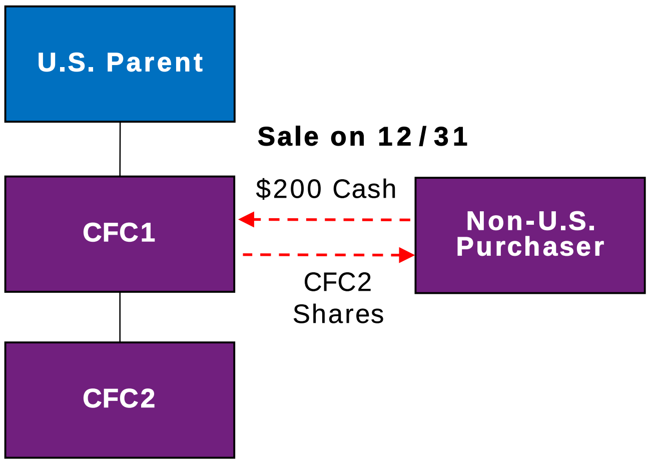
Result

GILTI	$170 ($17.85 pre-FTC tax)
Gain on stock sale	$0
964(e) dividend (sub F) (245A available)	$0
Subpart F gain	$0

- CFC1 recognizes gain or loss on the sale of CFC2 stock
- U.S. Parent includes CFC2's GILTI because the section 338 election causes a CFC2 short year ending on the sale date with U.S. Parent as the U.S. shareholder
  - GILTI increases CFC1 and CFC2 stock basis and reduces taxable gain
  - Possible application of section 338(h)(16) prevents excess GILTI FTC utilization against GILTI resulting from the section 338 election
- Section 964(e) recharacterizes gain as dividend income which is subpart F; U.S. Parent allowed section 245A deduction with respect to such subpart F
- Gain or loss recognized by CFC1 on the sale of CFC2 stock in excess of any section 964(e) dividend and adjusted basis is subpart F
- Uncertainty if section 961(c) basis applies for determining GILTI tested income of CFC1 on sale of CFC2 stock

Case Studies

Sale of CFC by a CFC with no 338 Election by Non-U.S. Purchaser (without U.S. subsidiary)



$50 CFC2 Stock Adjusted Basis (before CY GILTI)
$20 CFC2 CY GILTI
$25 CFC2 CY E&P ($5 untaxed)

Result

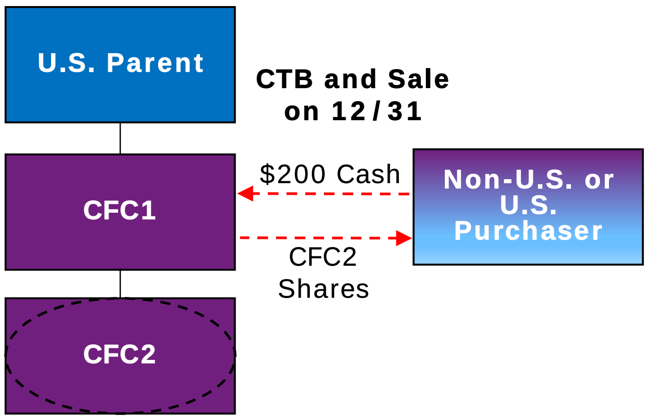
GILTI	$20 ($2.1 pre-FTC tax)
CFC1 Gain on stock sale	$130
964(e) dividend (sub F) (245A available)	$5
CFC1 subpart F	$125 ($26.25 pre-FTC tax)

- U.S. Parent is required to include CFC2's GILTI in the year of the sale
  - GILTI inclusion creates section 961(c) basis and reduces CFC1's subpart F gain on the sale
- Section 964(e) recharacterizes a portion of any gain as dividend income which is subpart F; U.S. Parent allowed section 245A deduction with respect to such subpart F
- Gain in excess of section 964(e) dividend (and PTI basis) is subpart F income subject to US tax (offset by any FTCs from allocable local tax on sale)
- Uncertainty if section 961(c) basis applies for determining GILTI tested income of CFC1 on sale of CFC2 stock

Empire State of Mind: International M&A Post Tax Reform

Case Studies

Tax-Free CTB Election – Sale of CFC by a CFC



$50 CFC2 Stock Adjusted Basis (Before CY GILTI)
$50 CFC2 Inside Asset Basis
$20 CFC2 CY GILTI
$25 CFC2 CY E&P ($5 untaxed)
No Subpart F Assets

Result

GILTI (operational)	$20 ($2.1 pre-FTC tax)
Gain on asset sale	$150
GILTI (asset sale)	$150 ($15.75 pre-FTC tax)

- CFC1 recognizes gain on the deemed sale of CFC2's assets
  - Subpart F depending on CFC2's underlying assets
  - Non-subpart F gain is tested income that increases U.S. Parent's GILTI inclusion
  - Avoids potential application of section 338(h)(16) for possible excess GILTI FTC utilization
- U.S. Parent includes CFC2's GILTI because it was a U.S. shareholder of CFC2 as of the last day on which CFC2 qualified as a CFC during the taxable year
  - Avoids potential subpart F income or incremental GILTI due to purchaser's actions if non-U.S. purchaser
  - Triggers GILTI or subpart F inclusion that otherwise could be avoided if U.S. Purchaser and no section 338 election