
34th
M&A Meets the TCJA – Who Wins?
November 6, 2018

Acquisition Structuring Considerations

Deal Financing Considerations under 163(j)

Deal Financing Considerations under Section 163(j)

Key Terms:

Business Interest Limitation: Deduction limited to the sum of *business interest* income and 30% of adjusted taxable income (ATI).

Business Interest: Interest properly allocable to a trade or business excluding investment interest.

Adjusted Taxable Income: Taxable income of a taxpayer without regard to:

i) any income, gain, deduction, or loss which is not properly allocable to a trade or business;
ii) any business interest or business interest income;
iii) the amount of an net operating loss deduction under section 172;
iv) the amount of any deduction allowed under 199A; and
v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion…"

Small Business Exemption: Deduction limit doesn't apply to businesses with gross receipts no exceeding $25 million.

Deal Financing Considerations under Section 163(j)

Key Considerations:

Amount of leverage

Disallowed interest carried forward indefinitely

No excess limitation carryforward – careful modeling of debt ratios pre-deal

Excess interest subject to Section 382 limitations (no different from other attributes)

Location of acquisition debt – offshore/onshore or a combination

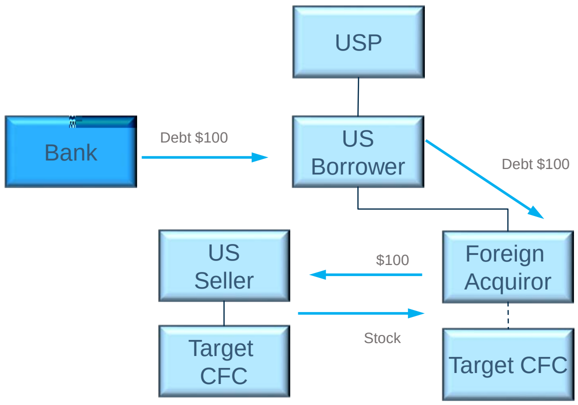
Local country interest limitations (e.g., UK 30% cap)

Lender required asset pledges/guarantees

Plantation Patterns issues

956 traps for the unwary

Acquisition Debt Push-Down



Transaction Steps

1. US Borrower secures bank debt of $100.
2. US Borrower loans $100 to Foreign Acquiror.
3. Foreign Acquiror acquires Target CFC

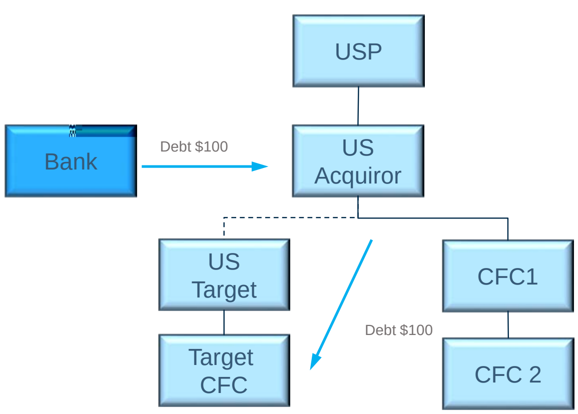
Considerations

Mirroring of interest rates for external and internal debt may mitigate 163(j).

Withholding tax issues?

Are debt issuance costs treated as OID subject to 163(j)?

Acquisition Debt Push-Down



Transaction Steps

1. US Acquiror secures bank debt of $100.
2. US Acquiror acquires US Target for $100.
3. US Acquiror makes a loan to either US Target or Target CFC.

Considerations

Mirroring of interest rates for external and internal debt may mitigate 163(j).

What about Section 385?

Withholding tax issues?

Are debt issuance costs treated as OID subject to 163(j)?

Purchase Agreement Considerations

- **Transaction Structure & Payment Mechanism**
- **Purchase Price & Adjustment Provisions**
- **Representations & Warranties**
- **Covenants & Conditions to Closing**
- **Indemnity / Escrow**
- **Post-closing Responsibilities**

Purchase Agreement Considerations

Purchase Price Adjustments for 965 Tax liability

Tax liability for Section 965 could be treated as a debt-like item adjusting purchase price.

Section 965(h) allows for US Shareholders to elect to pay the federal tax liability over 8 installment periods – resulting in cash payment during Buyers ownership period.

For a calendar year US Shareholder installment period is as follows:

Installment 1 : April 15, 2018 (extension not taken into account) 8% of the net tax liability
Installment 2 : April 15, 2019, 8% of the net tax liability
Installment 3: April 15, 2020 , 8% of the net tax liability
Installment 4: April 15, 2021, 8% of the net tax liability
Installment 5 : April 15, 2022, 8% of the net tax liability
Installment 6 ; April 15 ,2023, 15% of the net tax liability
Installment 7 : April 15, 2024 20% of the net tax liability
Installment 8 : April 15, 2025 25% of the net tax liability

Purchase Agreement Considerations

Purchase Price Adjustments for 965 Tax liability

Certain acquisitions and internal restructurings will accelerate the 965 tax liability payment installments.

The unpaid portion of the remaining installments will be due **on the date of the acceleration event**.

Acceleration events include:

1. An addition to tax assessed for failure to timely pay an installment;
2. Liquidation or sale of substantially all the assets of the taxpayer;
3. A cessation of business by the person (other than an individual);
4. A person no longer being a US person;
5. A person that was not a member of any consolidated group becoming a member of a consolidated group;
6. A consolidated return group ceasing to exist (**including by reason of acquisition of the group)**
7. A consolidated group no longer files a consolidated return

Eligible transferees and transferors can enter into an agreement with Commissioner whereby transferor assumes 965 installment liability. Parties remain jointly and severally liable for unpaid installments.

Purchase Price Adjustments:

Tax liability under Section 965 applies to S corp shareholders not the S Corp – no purchase price adjustment required

Seller Asks – Assume 965 Tax Liability:

Section 965(i) allows S Corp shareholders to elect to defer payment of their 965 liability until a triggering event.

Triggering events include:

1. Corporation ceases to be an S corp;
2. Liquidation, sale or other disposition of substantially all the assets of the S corp;
3. Transfer of any share of stock of the S corp.

S corp shareholder and eligible transferee (US person that is not a domestic pass-thru entity) can enter into an agreement whereby transferee (i.e., Buyer) assumes installment liability.

Both Buyer and S corp

Purchase Agreement Considerations

Representations and Warranties

- Tax Compliance (Filing & Payment).
- Corporate Structure and Filing Status (e.g., consolidated returns, S status).
- Tax Attributes (e.g., NOLs / Basis).
- Audit Status.
- Special Situations / Industry Specific Matters (e.g. FIRPTA).

Made at Signing / Re-affirmed at Closing

Survival

- Typically negotiated by parties.

1. Buyer favorable - survive through the statute of limitations plus a reasonable period (30 – 60 days).

- Public-to-public deals – reps and warranties don't survive closing.

Qualifiers (Knowledge & Materiality)

Purchase Agreement Considerations

Buyer indemnified for

- Pre-closing & Straddle Period taxes (stand alone).
- Breaches of Representation.
- Taxes of another (e.g., 1.1502-6, transferee).
- Failure to timely pay 965 installments?

Ceilings and Floors on Claims

Interplay with Working Capital / Taxes on the Balance Sheet

Time for Asserting Claim

Purchase Agreement Considerations

Covenants Limit or Require Certain Actions Between Signing and Closing to Protect Buyer Before Buyer is in Control - TCJA Considerations

- Restrictions on 965 basis elections
- Section 78 gross-up elections (965 and 951A)
- Section 168(k) elections
- Distributions of foreign cash/PTI
- Section 179 expensing

Deal Modeling – NOLs, 168(k), 163(j)

Net Operating Losses

NOLs generated after 2017 limited to offset 80% of taxable income

Limitation of 80% of taxable income of NOLs generated after December 31, 2017.

NOLs prior to December 31, 2017 are not limited. No AMTI going forward, able to utilize 100% of pre-2018 NOLs.

No carryback of post-2017 NOLs, but indefinite carryforward.

Net Operating Losses

Interaction of Section 382 and Section 168(k) Bonus Depreciation

Assumptions:	
2018 Taxable Income	100,000
Pre-2018 NOL Carryforwards	

TCJA & NOLs: Potential M&A Impacts?

Interaction with Section 168(k): if unable to use entire section 168(k) in initial year, consider whether NOL limit eliminates benefit of 168(k)

Section 168(k) Bonus Depreciation (5-Year Asset)						
Tax Year	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
Taxable Income	100,000	100,000	100,000	100,000	100,000	100,000
168(k) Bonus Depreciation	(500,000)					
NOL Deduction		(80,000)	(80,000)	(80,000)	(80,000)	(80,000)
TI After NOL		20,000	20,000	20,000	20,000	20,000
Tax		4,200	4,200	4,200	4,200	4,200
NOL carryforward	(400,000)	(320,000)	(240,000)	(160,000)	(80,000)	-
NPV						
No Section 168(k) Elected						
Tax Year	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
Taxable Income	100,000	100,000	100,000	100,000	100,000	100,000
Depreciation	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	
NOL Deduction	-	-	-	-	-	-
TI After NOL	-	-	-	-	-	100,000
Tax	-	-	-	-	-	21,000

Results in the same overall cash taxes and NPV over the period but frees up cash flow in earlier years.

Net Operating Losses

Interaction of Section 382 and Section 163(j)

Acquisition Structures – 338 Elections

Section 338 Elections

Overview of Election Types

338(h)(10) election is made <u>jointly</u> by the purchaser and seller

- Buyer must be a US or Foreign Corporation.
- Seller must be a US consolidated group, a “selling affiliate” or S corporation shareholder.
- Target must be a US or member of a consolidated group or a “target affiliate” or an S corporation.

338(g) Election is Made <u>Unilaterally</u> by The Purchasing Corporation

- Buyer must be a US or foreign corporation.

Section 338 Elections – New Considerations Post TCJA

338(h)(10) Buyer and Seller Considerations

Buyer may want more basis all to 168(k qualfild property to all for bonus depre6 -8ld ion

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Section 338(g) Elections – New Considerations Post TCJA

Results to Target Shareholders

Selling shareholders are treated as selling their stock.

Gain/loss on the sale is generally treated as capital gain.

Caution: Treas. Reg. §1.338-9 pertaining to foreign targets has not been updated post TCJA.

Does 1248 gain have any real impact post 965?

If foreign target is a CFC potential for Subpart F and/or 951A GILTI inclusions

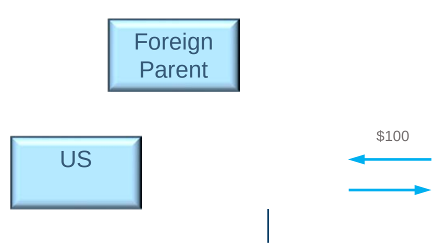
Sellers may negotiate restrictive covenants to preclude 338(g) elections

Results to Target

T (Old T) is treated as having sold all of its assets at the close of the acquisition date (at their FMV) to unrelated "New T" in exchange for the consideration paid for Target's stock plus New T's assumption of

Section 338(g) Elections – New Considerations Post TCJA

Traps for Unwary – Notice to Selling US Shareholders



Transaction Steps:

Step 1: US Buyer acquires all of the stock of Foreign Target in a QSP.

Issue:

- Due to the CFC expansion rules Foreign Target is a CFC. If US Buyer fails to notify Foreign Parent 338(g) election could be at risk.
- Function of purchase agreement reps to identify potential US shareholders?
- Indemnity considerations for Buyer?
- Potential Subpart F and 951A GILTI recognized by US Shareholder if 338(g) election made – seller considerations?

Spin-off Transactions

Extracting Value in a Section 355 Spin-Off

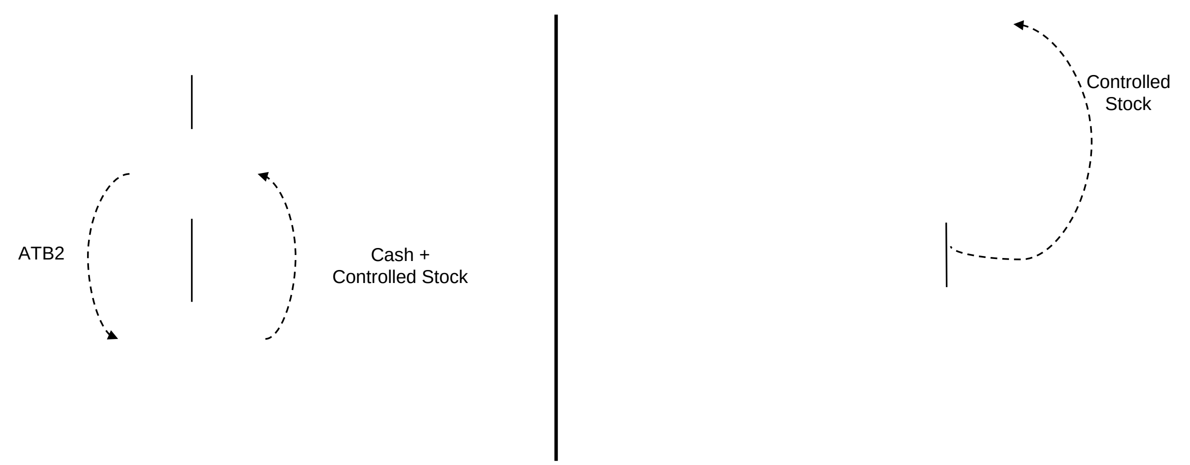
Cash distributions to Distributing and liability assumptions by Controlled are subject to additional limitations:

Basis limitation – For the cash distribution or liability assumption by Controlled to be tax-free to Distributing, amount of cash distributed/liabilities assumed cannot exceed Distributing's basis in its Controlled stock.

Use of proceeds limitation – Cash received by Distributing as part of a Section 368(a)(1)(D) reorganization will be taxable boot unless used to pay off debt or distributed to shareholders. Distribution to shareholders is not subject to basis limitation, but also does not result in monetization for Distributing.

Securities-for-debt exchanges and stock-for-debt exchanges generally are not subject to basis limitation.

Extracting Value in a Section 355 Spin-Off
Example 1: Cash Distribution



Extracting Value in a Section 355 Spin-Off Example 2: Liability Assumption

Extracting Value in a Section 355 Spin-Off
Example 3: Debt-for-Debt Swap with Control0.7( )c3oe55

Extracting Value in a Section 355 Spin-Off
Example 3A: Intermediated Debt-for-Debt Swap

Controlled
stockB43k7.0067Tw reme.20.ank o.028poe 0 m 2.63tting ebt

Facts: Distributing is engaged in two lines of business, ATB1 and ATB2, each of which is actively conducted. ATB2 has basis of $100M FMV of $400M

Step 1: As part of a plan, investment bank purchases Distributing debt from creditor and holds the debt for its own account. After a sufficient period of time, investment bank enters into an agreement with Distributing to accept Controlled securities in retirement of the Distributing debt.

Step 2 Distributing contributes ATB2 to Controlled in exchange for $200M of Controlled stock and $ 200M of Controlled securities.

Step 3 Distributing distributes Controlled stock to Distributing's shareholders and repays investment bank using $ 200M of C securities.

See e.g. PLR 201032017

Extracting value in a Section 355 Spin-Off
Example 4: Debt for Equity Swap with controlled Stock

80% Controlled stock

Retained share transfer may be facilitated by investment bank [subject to 5/14 standard]?. . Retained shares should be

Revenue Procedure 2018-53

Rev. Proc. 2018-53 applies to both transactional and significant issue rulings relating to assumption by C of liability for D debt or satisfaction of D debt with C stock, securities, other debt obligations, or other property.

The D debt must be an obligation of D evidenced by a debt instrument that is not a CPDI and by its terms is payable only in money (and not, e.g., payable at D's option with C stock or securities).

IRS will continue to rule on transactions not described on Rev. Proc. (e.g., assumption or satisfaction of contingent liabilities.

Revenue Procedure 2018-53 Representations

Distributing is obligor in substance.

Holder is not a related person, and is not holding the D debt for the benefit of D, C, or a related person.

Intermediary, if any, will not acquire the D debt from D, C or a related person, nor will D, C or a related person participate in any profit gained by Intermediary from exchange of the C stock, securities or other property.

D debt is historic debt incurred (i) before request for PLR, and (ii) no later than 60 days before the earliest of date of (a) first public announcement of the spin-off, (b) D's binding agreement to engage in spin-off, and (c) board approval of spin-off.

Total AIP of D debt to be assumed or satisfied does not exceed historic average of total AIP of D debt owed to unrelated creditors and non-CPDIs owed by other members of DSAG to unrelated creditors.

If satisfaction of D debt will be delayed, there are one or more substantial business reasons for delay beyond 30 days after first distribution of C stock to D stockholders, and all D debt that will be satisfied with C stock, securities or other property will be satisfied within 180 days.

D will not replace the D debt that will be assumed or satisfied with previously committed borrowing, other than in the ordinary course of business under revolver or similar arrangement.

Other information to establish under general principles of tax law that the transactions should not be recast.

IRS Statement on ATB of R&D Enterprise without Income

On September 25, 2018, the IRS released a statement announcing a study of the ATB under Section 355 as applied to entrepreneurial ventures whose activities consist of lengthy phases of research and development.

Historically, satisfaction of ATB test must include the collection of income and payment of expenses.”

Pending completion of the study, IRS will entertain PLR requests regarding qualification for the ATB test without income.

IRS and Treasury are considering guidance regarding whether a business can satisfy the ATB Test if "entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected.”

IRS Statement on ATB of R&D Enterprise without Income

IRS is developing standards that could substitute for actual income, but must be predictable, repeatable, fair and reasonable.

Regular, continuing research and related activities by a significant number of full-time management and operational employees;

Regular, continuing and significant expenses for research and related activities;

Significant progress toward developing an income-producing product;

Holding out that the business is available to enter into an income-producing arrangement;

An actual offer or specific expression of interest made or received by the business to enter into an income-producing arrangement; and

Similarly situated businesses have entered into income-producing arrangements with research that has progressed to a similar level as the taxpayer’s research.

Why Undertake Due Diligence?

Identification of Pre-Closing Tax Exposures

Income (Statute of Limitations is Typically Three to Four Years).

Non-Income (Statute of Limitations Varies by Taxing Jurisdiction).

- Sales and Use Tax.
- Excise Tax, Gross Receipts- Based Tax e.g. Business and Occupation Tax.
- Payroll Tax.
- Property Tax.
- Unclaimed Property.

Identify Impediments/Opportunities for Acquisition Structure

Contract Review / Working Capital Analysis

Historical Income Tax Exposures

- Generally do not carry over.

Non-Income Taxes

- Sales and Use Tax.
- Excise Tax, Gross Receipts- Based Tax e.g. Business and Occupation Tax.
- Payroll Tax.
- Property Tax.
- Unclaimed Property.

Transfer Taxes

Incremental Taxes to Shareholders

- May be more expensive versus a stock sale.

Anti-Churning Rules

ated party (common ownershC /TT1p of more than 20%.

Asset Purchase Scope (i.e., Non-income Taxes) Plus:

Analysis of Pre-Closing Federal and State Income Taxes, generally through open years.

Federal statute of limitations - 3 years unless waived (6 years if underreporting of more than 25% of gross income stated on original return).

Diligence Considerations: Carve-out From Consolidated Group

Asset Purchases (same considerations apply as before).

Stock Purchases (same considerations apply as before) – **Plus:**

- Several liability under §1.1502-6. T is liable for the entire consolidated group's tax during the time in which it was a member.
- Analysis of consolidated attributes and restrictions may be different.
- Tax sharing / indemnity agreements may be applicable.
-

Diligence Considerations: Acquisitions of Partnerships

Acquisition of 100% of a Partnership or LLC is Treated Like an Asset Purchase From the Buyer's Standpoint (i.e., Buyer Gets a Basis Step-up) (Rev. Rul. 99-6).

If less than 100% if acquired, Buyer gets no step-up unless a Section 754 election is made or is in effect.

- If so, the buyer gets a proportionate step-up in its share of the partnership assets.

Diligence is Focused on:

- Non-Income taxes (i.e., sales and use, payroll, and property).
- Certain entity level taxes (e.g., Gross receipts, NYC UBT, partner withholding).
- Potential contractual or successor liability from historical mergers or acquisitions.
- Adoption of partnership audit rules

Diligence Considerations: Cross-Border Concerns

Trapped Cash

- 965 PTI pools
- FTCs

Section 965

- Proper identification of foreign deficit corporations
- Cash position computational errors
- Proper exchange rates
- Deficit offsets only if in excess of PTI
- E&P adjustments under ordering rules
- Basis adjustments

GILTI/BEAT

- Assess post-deal impact

Diligence Considerations: State Tax Considerations

Section 965 State Conformity – Uncertainty and variation in the area of deemed repatriation. The conformity question must be carefully navigated:

- Is the inclusion amount treated as a dividend?
- Are DRDs available?
- What is the impact of World-wide versus Waters-edge filing elections?
- To the extent an inclusion to income remains in the state tax base, is such income classified as business income included in the sales factor, business income excluded from the sales factor, or nonbusiness income?
- If includable in the sales factor, or if classified as nonbusiness income, how could such income be sourced?
- Is the federal deferral election ineffective at the state level?

Diligence Considerations: State Tax Considerations

Impact of Wayfair

- On June 21, 2018, in a 5-4 decision, the U.S. Supreme Court decided South Dakota v. Wayfair, Inc., a landmark case concerning sales and use tax nexus standards. This decision allows states to require remote sellers to collect sales tax even if they don't have a physical presence.
- Approximately 5 states had economic nexus thresholds in place for sales tax prior to the ruling, an additional 20 states have implemented economic nexus thresholds with effective dates prior to 12/31/2018, and at least 9 additional states will implement economic nexus thresholds in 2019 and beyond.
- The recent change, uncertainty around retroactive application, and magnitude of potential exposures is impacting escrows, reps & warranties in purchase agreements, and reps & warranty insurance coverage.

Existing Tax Attributes: Buyer vs. Seller Considerations

Will target's NOL carryover post-closing?

Is Target a stand alone C corporation? A member of a consolidated group?

How is the transaction being structured (asset versus stock)?

Valuation Considerations

What is the quality of the NOL?

Sufficiency of post-closing cash flow

Will a future buyer ascribe value to the NOL?

Implications of valuation allowance

- Does it suggest diminished value?
- Are the projections to support consistent with management's EBITDA?

How Fast Can Benefits Be Achieved?

What limitations will apply to the NOL?

- Section 382
- NUBIG/NUBIL
- Corporate contraction implications

Ability to carryback a pre-closing loss & file for refund?

Consolidated Return Considerations

§1.1502-36(d)

§1.1502-95(c)

Allocation of 163(j) limitation in year member departs group. See Notice 2018-28 – 163(j) limitation applies to group under single entity approach.

Treatment of allocable 163(j) interest carryforward as SRLY?

Post Acquisition Integration

Cash D Reorganization – 965 and 961 Basis Bump

Transaction Steps

1.

Cash D Reorganization – 965 and 961 Basis Bump

Transaction Steps

1. US Target recognizes a Section 965 inclusion of $60 with respect to Target CFC. The Section 965(a) amount is $100 and the allocable deficits under Section 965(b) is $30.
2. USP acquires US Target for $200.
3. Acquiring CFC buys Target CFC for $100
4. Target CFC elects to be classified as a disregarded entity

Consequences

The share transfer together with the check-

Section 304(a)(1) Transaction – Application of 245A?

Transaction Steps

1. **Acquiring CFC buys Target CFC for $100**

Consequences

Section 304(a)(1) transaction –

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