International Mergers and Acquisitions

Inversions Through M&A Transactions, Tax-Efficient Acquisition Structures and Post-Acquisition Integration Planning

Tax Executives Institute---Houston Chapter
Twenty-Fifth Annual Tax School

May 9, 2013

Your Trusted Tax Counsel®
Presenter

Jonathan Martin (Houston)
jonathan.martin@bakermckenzie.com
(713) 427-5062
Inversions Through M&A Transactions
In General

Merger Sub and USCo merge, with USCo surviving as a subsidiary of Foreign Target. Historic USCo shareholders receive Foreign Target shares in the transaction.
Foreign Parent Alternatives

Alternative One:
Foreign Target as Parent

Alternative Two:
3rd Country Newco as Parent
Section 7874 - In General

– Applies if:

– A foreign corporation acquires, directly or indirectly, substantially all of the properties held by a US corporation or partnership;

– After the acquisition, at least 60% of the foreign corporation (by vote or value) is held by former shareholders or partners of the US entity by reason of having held shares/interests in the US entity; and

– After the acquisition, the expanded affiliated group does not have substantial business activities in the foreign country in which the foreign acquirer is incorporated.
Section 7874 - In General (Cont.)

- Section 7874(a): if at least 60%, but less than 80%, of the foreign corporation is held by former shareholders or partners of the US entity by reason of having held shares/interests in the US entity, the US entity is respected as a foreign corporation for U.S. federal tax purposes but restricted from using NOLs to offset inversion gain, etc.

- Section 7874(b): if at least 80% of the foreign corporation is held by former shareholders or partners of the US entity by reason of having held shares/interests in the US entity, the foreign corporation is treated as a US corporation for U.S. federal tax purposes.
Section 7874 - Post-Acquisition Ownership

- Section 7874 requires ownership of less than 80% of shares by vote and value.

- No authority under section 7874 as to which factors, if any, may affect valuation of shares, e.g. control premium, minority discount.

- 2012 Regulations clarify treatment of options
  - Retains approach of treating options as having a value equal to the holder’s claim on the corporation’s equity, less any amount required to be paid to exercise the option.
  - Clarifies that options are not treated as having voting power unless a principal purpose of issuing or acquiring the option is to avoid treating the foreign corporation as a surrogate foreign corporation.
Section 7874 - Substantial Business Activities

- 2006 regs included facts and circumstances test and safe harbor (10% of personnel, assets, and sales).
- 2009 regs eliminated safe harbor in favor of solely a facts and circumstances test.
- 2012 regs replace facts and circumstances with bright-line rule which requires at least 25% of the following be located or derived in the foreign country in which the foreign parent corporation is created or organized:
  - group employees (headcount and compensation)
  - group tangible assets and real property used in active trade or business; AND
  - group income from transactions with customers.
Inversion/Acquisition with Leverage

- USSub delivers cash/foreign target shares to the USCo S/Hs in exchange for USCo shares in a transaction that is not a Section 368(a) reorganization.
Inversion/Acquisition with Leverage (Cont.)

Historic USCo S/HS

Historic Foreign Target S/HS

Foreign Target (Non-US)

F Target USSub (US)

Foreign Target Subs

USCo (US)

USCo Subs (US)

Note
Inversion/Acquisition with Leverage (Cont.)

– Depending on percentage of ownership received by USCo shareholders, may need to do planning to avoid the application of Section 304 to the transaction.
  – See Section 304(c)(2)(B) (“Where 2 or more persons in control of the issuing corporation transfer stock of such corporation to the acquiring corporation and, after the transfer, the transferors are in control of the acquiring corporation, the person or persons in control of each corporation shall include each of the persons who so transfer stock”).
  – As long as USCO shareholders get less than 50% of the shares in the foreign parent, there should be no Section 304 issue.
  – If USCO shareholders get 50% or more of the shares in the foreign parent, planning can be implemented to avoid potential issue.
Section 4985

- Section 4985 imposes a one-time, 15% excise tax on the “fair value” of any previously untaxed, stock-based compensation of directors, officers, and 10% or greater shareholders.
  - Only applies if greater than 60% but less than 80% ownership identity exists and substantial business activities test is not met.
  - This is a one-time exit tax on unexercised stock options, unvested RSUs and other stock-based compensation held by a limited category of corporate insiders.
  - Gross-up for tax is also subject to 15% excise tax.
  - Note that even underwater, unexercised options may be subject to the excise tax.
Section 457A

– Prevents deferral of income with respect to otherwise valid deferred compensation if plan sponsor is “non-qualified” foreign entity and compensation is paid to a U.S. taxpayer (e.g., a U.S.-resident board member or officer).

– Should not apply to deferred comp arrangements “sponsored” by a U.S. operating company for its U.S. employees even if its foreign parent is “non-qualified.”
  – Sponsor is entity entitled to deduction under U.S. tax principles.

– Notice 2009-8 expands scope of section 457A.
Tax-Efficient Acquisition Structures
Funding the Acquisition

1. Pre-existing foreign cash

2. US Parent
   → US Bank
   $$$

3. Foreign HoldCo
   → Foreign Bank
   $$$

New Local Acquisition Co.
New Local Acquisition Co.
Funding the Acquisition (Cont.)

– Consider opportunities to use debt to fund the acquisition entity (or any intermediate entities).
  – Interest deductions to reduce overall taxable income.
    – Consolidation
    – Debt versus equity
    – Thin cap rules
  – Debt can facilitate tax-free repatriation.
Purchase of Parent Stock to Buy Foreign Target

- CFC’s purchase of Parent stock should be non-taxable under section 1032
- CFC’s exchange of Parent stock in the acquisition should not trigger any significant gain to CFC due to FMV basis
- Treas. Reg. §1.367(b)-10 rules/anti-killer B notices do not apply because there is no tax-free reorganization
A U.S. Target can liquidate tax-free into a foreign corporation so long as its only asset is stock of a domestic corporation. Treas. Reg. § 1.367(e)-2(b)(2)(iii)

The US Target must either not have E&P, or, it must have been in existence for 5 years or more. Section 332(d) (converts 332 into a section 301 distribution)

CFC will take US Sub with carryover basis, which will be a section 956 investment
Purchase & Liquidate Domestic Target with 338(h)(10) Election

- A Foreign Purchaser may make a joint section 338(h)(10) election with respect to a U.S. Target sold by a U.S. consolidated group.

- The US Target’s E&P is reduced to zero as a result of the election and may distribute foreign assets and foreign subsidiaries to CFC immediately after the acquisition as a tax-free return of capital.

- To eliminate section 956 exposure, CFC must sell US Target to Parent after distributing out non-US assets.

- The structure enables some foreign cash to be used to finance a US acquisition.
Use of Acquisition HoldCo

1. Cash loan 12/28/Y1
2. Repay loan in future years

US Parent

New Foreign HoldCo

Foreign Sub 1 (new target)

Foreign Sub 2 (new target)

Foreign Sub 3 (new target)

Acquire targets from third party, increase basis in HoldCo

Third Party Lender

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Post-Acquisition Integration Planning
Section 368(a)(2)(D) Reorganization
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- Assume Parent acquired Target recently for cash and has a full FMV basis in the shares of Target.
Section 368(a)(2)(D) Reorganization (Cont.)

‒ Forward subsidiary merger used to maximize amount of “boot” that can be issued.

‒ Outside the scope of Notices 2008-10 and 2012-39 and the 367 regulations because it is a section 361 transfer directly from one US corporation to another US corporation.

‒ Parent recognizes no tax on stock or cash boot received in the reorganization because there is no built-in gain in the shares of Target.
Section 368(a)(2)(D) Reorganization (Cont.)

– Section 956 will apply to investment in U.S. Subsidiary, but basis will be limited to US Target’s historic inside basis in its assets based on the over-the-top basis rules. It may be possible to further reduce the 956 inclusion by injecting acquisition debt into Target.

– US Target’s assets may be contributed to a partnership with other affiliates to integrate consistent with COBE.

– Must satisfy business purpose requirement.
Related Party “B” Reorganizations
Related Party “B” Reorganizations

1. Dry Holdco (Foreign)

2. Target Sub (Foreign)

Parent Treasury Shares

Parent (US)

Target (US)

Target Sub Shares

Sub (Foreign)

Other Subs

Note: Related Party “B” Reorganizations
Related Party “B” Reorganizations (Cont.)

Treas. Reg. 1.367(b)-10

- Parent is deemed to receive a section 301 distribution from Dry Holdco equal to the amount of the consideration Dry Holdco pays for the Parent shares. Treas. Reg. section 1.367(b)-10(b)(1).

- If Dry Holdco has no earnings and profits for U.S. tax purposes and has an outside basis in excess of the amount of the consideration Dry Holdco pays for the Parent shares, then no gain should be recognized by Parent under section 301(c).
Related Party “B” Reorganizations (Cont.)

Treas. Reg. 1.367(b)-10 (Cont.)

- Under current law, immediately after the deemed distribution, Parent is deemed to contribute the cash deemed distributed under section 301(c) to Dry Holdco, increasing Parent's basis in the Dry Holdco by the amount deemed distributed. Treas. Reg. section 1.367(b)-10(b)(2).

- The regulations include an anti-abuse rule in Treas. Reg. section 1.367(b)-10(d) that states Dry Holdco must not be created, organized or funded with a view to avoid the section 367(b) regulations.
Outbound Section 368(a)(1)(F) Reorganization
Outbound “F” Reorganization of Domestic Target

- Convert recently acquired/purchased U.S. target into a foreign company
- Distributions of pre-acquisition E&P before the outbound “F” is tax-free under the consolidated return regulations
  - Pre-acquisition E&P may be repatriated after the outbound “F” with a DRD because the earnings have already been subject to US tax
- Allows repatriation through return of capital/basis
  - High/FMV basis in recently purchased entity
- Target must repatriate cash before new low taxed earnings accrue in the foreign target
  - Must manage the E&P pools
  - Must fund the distribution
Outbound “F” Reorganization of Domestic Target

- Key Costs
  - Basis step down in shares of Foreign Newco for the built-in gain in the tangible assets and stock of CFCs (but not the IP)
  - Potential waiting period under section 1059 if Target has E&P
  - Should sell or distribute US tangible assets to Parent prior to reorganization even though it triggers gain under section 311(b) or 1001
    - New regs would require Parent to recognize gain in US tangible assets in an outbound “F”
    - If Target retains US tangible assets there would also be a section 956 inclusion
Outbound “F” Reorg. Example – Step 1 Acquisition

- Assume that most appreciation is in Target’s intangibles, not US operating assets

**US Tax Consequences**
- Treated as a taxable stock purchase of Target by Parent
- Parent takes a full FMV basis in the target stock
Outbound “F” Reorg. Example – Step 2 Distribution

US Tax Consequences

- Distribution should result in tax on any built-in gain in the distributed assets under section 311(b), which gain is triggered when Target completes the outbound “F” reorganization. As noted above, Target should distribute the US tangible assets because gain will be recognized under the new regs whether they are distributed or not.

- Parent should reduce its basis in the Target shares in an amount equal to the fair market value of the distribution.
Outbound “F” Reorg. Example – Steps 3 and 4

US Tax Consequences

- Treated as an outbound “F” reorganization.
- Regulations under section 367(a)(5) require downward basis adjustments to reflect any deferred built-in gain in assets other than section 367(d) intangible assets.
- The formula for the basis step-down imperfectly estimates the deferred built-in gain with respect to section 367(a) assets. The formula is described in slides 41 and 42.
Outbound “F” Reorg. – 367(a) Issues

– Previously deferred intercompany gains within the Parent consolidated group with respect to Target should be triggered under the acceleration rule of Treas. Reg. 1.1502-13(d).

– Foreign Newco should succeed to Target’s E&P under section 381, but not any E&P generated while Target was a member of the Parent consolidated group. See Treas. Reg. 1.1502-33(e)(1), which eliminates the E&P of Target generated while it was a member of the US Parent consolidated group when Target leaves the US Parent consolidated group.

– Target must recognize any built in gain in Target’s section 367(a) assets other than (i) stock in foreign subsidiaries for which GRAs are timely filed, and (ii) assets that qualify as assets used in the active conduct of a trade or business outside the United States under section 367(a)(3).
Regulations under section 367(a)(5) require basis adjustments to the shares of Foreign Newco to reflect the deferred built-in gain in the section 367(a) assets.

- Regulations require Target and Foreign Newco to enter into an Elective Agreement with respect to section 367(a) assets that qualify for deferral.
Outbound “F” Reorg. 367(d) Issues

– Under section 367(d), Parent must recognize royalties contingent on the productivity, use or disposition of Target’s section 367(d) intangibles that are commensurate with income generated by the IP.

– Parent may repatriate cash equal to the section 367(d) inclusion to match cash with the income inclusion. Parent would have three years from the date of the inclusion to repatriate the cash.

– Foreign Newco should be entitled to a deduction with respect to the 367(d) payments to Parent, which should be allocable to offset any gross income Foreign Newco earns from the IP, including importantly any royalties that would otherwise be Subpart F income.
Outbound “F” Reorg. Example –Step 5

US Tax Consequences
• Target LLC may distribute any assets to Foreign Newco in a disregarded distribution. Foreign Newco may contribute assets to a partnership with affiliates to integrate.
Outbound “F” Reorg. – Basis Adjustment
Modified Example 3, Treas. Reg. 1.367(a)-7(g)

*DP1 has two blocks of shares in DC:

<table>
<thead>
<tr>
<th>Block</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Block 1</td>
<td>$100</td>
<td>$60</td>
</tr>
<tr>
<td>Block 2</td>
<td>$100</td>
<td>$120</td>
</tr>
</tbody>
</table>

*DC has two assets and $10 of deductible liabilities:

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business A</td>
<td>$150</td>
<td>$15</td>
</tr>
<tr>
<td>Patent</td>
<td>$50</td>
<td>$0</td>
</tr>
</tbody>
</table>

“367(a) Percentage” defined in Treas. Reg. 1.367(a)-7(f)(9)

FMV of Section 367(a) Property ($150) / FMV of Target ($200) = 75%
Outbound “F” Reorg. – Basis Adjustment
Modified Example 3, Treas. Reg. 1.367(a)-7(g)

367(a) “Attributable Inside Gain,” defined in Treas. Reg. 1.367(a)-7(f)(5), equals:

the amount by which FMV of 367(a) assets exceeds the sum of the inside basis of the 367(a) assets and the product of the Section 367(a) percentage and the deductible liabilities of DC

FMV of the 367(a) Assets ($150) – [The Sum of the Inside Basis of the Section 367(a) Assets ($15) and [Section 367(a) Percentage (75%) * Deductible Liabilities ($10)]] = $127.50

Basis Reduction under Treas. Reg. 1.367(a)-7(c)(3)

DP1’s aggregate section 358 basis in stock of FA is $180 (sum of basis in Block 1 and Block 2) and FMV is $200, resulting in $20 of outside gain, but only $15 of outside gain attributable to section 367(a) assets (367(a) Percentage (75%) * Outside Gain (20) = $15)

DP1’s basis must be reduced by the amount by which DC’s “attributable inside gain” ($127.50 as computed above) exceeds DP1’s outside gain in FA attributable to 367(a) property ($15) = $112.50

Thus, basis must be reduced by $112.50 (the excess of the “attributable inside gain” over the “outside gain” attributable to section 367(a) assets) to $67.50 ($180 - $112.50).

The basis reduction is allocated between Block 1 and Block 2 based on their relative section 358 basis amounts (i.e., 1/3 to Block 1 and 2/3 to Block 2).
All Cash “D” Reorganization
US Target has $20 of appreciated 367(a) property and $80 of appreciated patents

- NOL would be sufficient to shelter the built-in gain in the US Target’s section 367(a) property.

- Prior to Notice 2012-39, the built-in gain in the patents would not be recognized at the time of the reorganization and would instead be recognized over time under section 367(d). Notice announces that Treasury will issue regulations to treat boot in an outbound reorganization as a prepayment of section 367(d) royalties. In this example, $80 of the total purchase price would be treated as a prepayment of section 367(d) royalties and be recognized by USCO in the year of the outbound reorganization.
Partnership to Integrate IP
Partnership to Integrate IP

- Parent (US)
  - Successor to Acquirer IPCo
    - New Partnership
      - Acquirer IPCo
      - Target IPCo
  - Target (US)
    - Successor to Target IPCo (Foreign)
Partnership to Integrate IP (Cont.)

- Notice 88-108 permits a CFC to hold an obligation of its U.S. parent over the CFC’s year-end without triggering section 956 if the obligation is outstanding for no more than 30 days and the CFC holds such obligations for fewer than 60 days during the tax year.

- During the financial crisis of 2008, Notice 2008-91 extended the 30-day period of Notice 88-108 to 60 days and the 60-day period to 180 days.
Partnership to Integrate IP (Cont.)

- The IRS issued GLAM 2009-13 to confirm the application of Notice 2008-91 where multiple related CFCs hold obligations of their U.S. parent. Under GLAM 2009-13’s interpretation of Notice 2008-91, multiple CFCs may hold obligations of their U.S. parent, in the aggregate, for more than 180 days in a tax year provided that each CFC does not hold obligations for more than 180 days individually.

- Notice 2008-91 has expired, but the principle articulated in GLAM 2009-13 remains valid. Related CFCs may hold obligations of their U.S. parent, in the aggregate, for more than 180 days in a tax year without triggering a section 956 inclusion, provided that the CFCs’ obligations do not cross their respective quarter-ends.
Partnership to Integrate IP (Cont.)

- Under Revenue Procedure 2006-45, a CFC may obtain automatic approval to elect a one-month deferral of its tax year under section 898(c)(2).

- Therefore, GLAM 2009-13 permits two CFCs to make staggered loans covering, in the aggregate, almost the entire year. Staggered loans can give a U.S. parent access to up to 50 percent of its foreign cash 100 percent of the time.

- To avoid application of *Jacob’s Engineering*, the CFCs should avoid rollover loans by maintaining a divestment period in between loans that is roughly equal to the term of each loan.
Alternating Loan Illustration

Successor to Target IPCo (9/30 tax year-end)

Successor to Acquirer IPCo (10/31 tax year-end)

\[
\text{Disinvestment Period} = \frac{45 \text{ days}}{138 \text{ days}} = 32.6\%
\]
Thank you

*   *   *   *   *

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