

34th Annual TEI-SJSU HIGH Technology Tax Institute

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

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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)

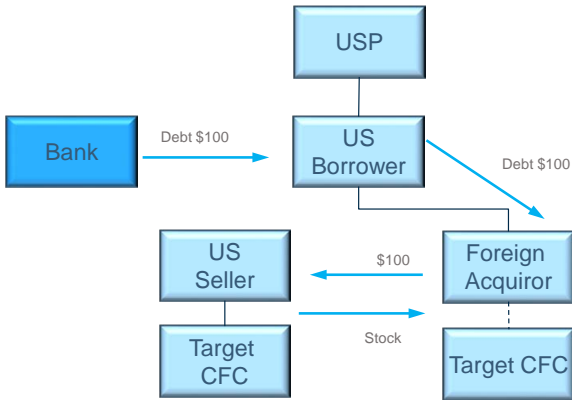
➤ Location of acquisition debt – offshore/onshore or a combination

- 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



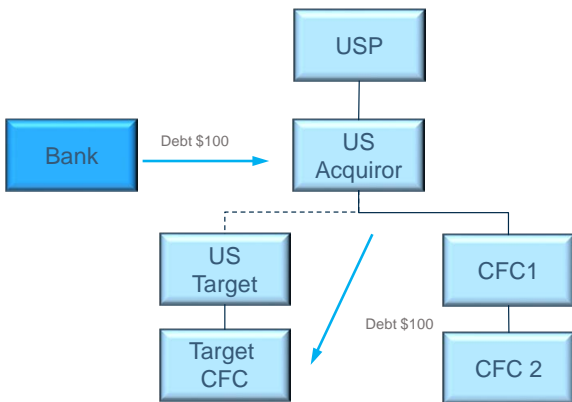
Transaction Steps

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

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

Transaction Structure & Payment Mechanism

- Form consistent with parties' intent & understanding?
- Definition of Included & Excluded Assets & Liabilities.
- Seller Rollover (in private equity deals).
- Withholding taxes.

Purchase Price & Adjustment Provisions

- Working Capital (adjusts purchase price to the extent closing working capital differs from the target working capital or "peg").
- Debt-like Items (typically reduce purchase price)
- Trapped Cash (pre-TCJA reduced purchase price). Trapped cash post-965?

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 Agreement Considerations

965 Tax liability for S Corps

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 shareholder remain jointly and severally liable for unpaid installments.

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.
- Pre-2018 NOLs still may be carried back 2 years and but only forward for 20 years.
- No changes to Section 382 rules beyond potential inclusion of excess interest carryforward in the limitation.

Net Operating Losses

Assumptions:	
2019 Taxable Income	100,000
Pre-2018 NOL Carryforwards	20,000
2018 NOL Carryforwards	90,000

Example 1: with Pre-2018 NOL Carryforwards

2019 Taxable Income	100,000
Limitation on NOLs (80% of Taxable Income)	80,000

2019 Taxable Income	100,000
Less: Pre-2018 NOL Carryforwards	(20,000)
Taxable Income after Pre-2018 NOLs	80,000
Less: 2018 NOL Carryforwards Available	(80,000)
2019 Taxable Income after NOL Usage	None

Example 2: without Pre-2018 NOL Carryforwards

2019 Taxable Income	100,000
Limitation on NOLs (80% of Taxable Income)	80,000

2019 Taxable Income	100,000
Less: Pre-2018 NOL Carryforwards	None
Taxable Income after Pre-2018 NOLs	100,000
Less: 2018 NOL Carryforwards Available	(80,000)
2019 Taxable Income after NOL Usage	20,000

- Pre-2018 NOLs must be used first to offset taxable income but no longer subject to AMT so still a valuable attribute.
- The limitation for post-2017 NOLs is calculated as 80% of taxable income without taking into consideration any pre-2018 NOLs used.

Net Operating Losses

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

Assumptions:	
2018 Taxable Income	100,000
Pre-2018 NOL Carryforwards	100,000
382 Base Limit	10,000

Example 1: Pre-Notice 2018-30

Basis step-up on 168(k) Qualified Property (10 year asset)	150,000
382 Base Limit	10,000
NUBIG Uplift to 382 Base Limit	150,000
2018 Taxable Income	100,000
Less: Available NOL Carryforwards	(100,000)
Taxable Income after NOL Deduction	None

Example 2: Notice 2018-30

2018 Taxable Income	100,000
Pre-2018 NOL Carryforwards	80,000
382 Base Limit	10,000
NUBIG Uplift to 382 Base Limit	15,000
2018 Taxable Income	100,000
Less Available NOL Carryforwards	(25,000)
Taxable Income after NOL Deduction	75,000

- Notice 2018-30 modifies Notice 2003-65 for purposes of computing NUBIG/BIL and RBIG/BIL and applies to ownership changes that occur after May 8, 2018.
- The 338 approach under Notice 2003-65 treats as RBIG an amount equal to the cost recovery deduction that would have been allowed had a 338 election been made.
- Prior to Notice 2018-30, taxpayer could increase RBIG for 382 limitation purposes by the bonus depreciation amount under 168(k).
- Notice 2018-30 modifies the 338 and 1374 approach set forth in Notice 2003-65 to exclude 168(k) bonus depreciation in determining RBIG.

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)

- Disallowed interest expense carryforwards are “pre-change losses” under Section 382.
- Section 163(j)(2) provides that any business interest not allowed for any taxable year shall be treated as business expense paid or accrued in the succeeding taxable year.
- Statutory conflicts? How can disallowed interest be both a pre-change loss for 382 and an item accrued/paid in a successive (e.g., post-382 change) year?
- Impact on 382 limitation?
- Ordering rules for attribute usage?

Section 338 Elections

Overview of Election Types

338(h)(10) election is made jointly 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 member of a consolidated group or a “target affiliate” or an S corporation.

338(g) Election is Made Unilaterally by The Purchasing Corporation

- Buyer must be a US or foreign corporation.
- Seller can be a US or foreign corporation, individual, partnership or trust.
- Target must be a US or Foreign Corporation.

Section 338 Elections

QSP Elements

- Corporate Buyer.
- Purchase at least 80% (vote & value) of the stock of another corporation.
- In one or a series of transactions.
- Within a 12 month period.
- Buyer and Seller must not be related (See Section 338(h)(3)(B)).

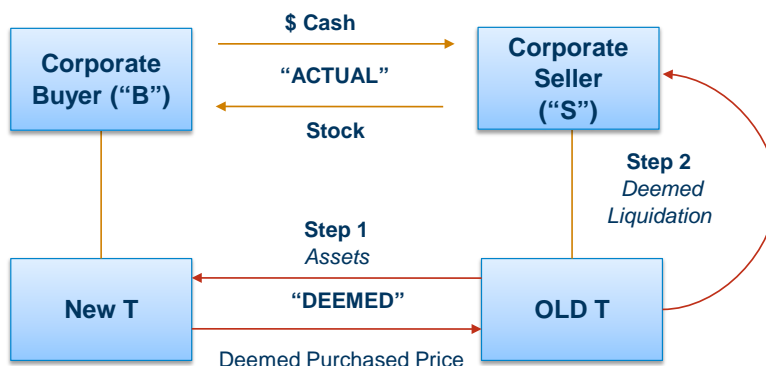
Tiered Targets

- Elections down a chain of targets
- Deemed QSP for lower-tier targets

Section 338(h)(10) Elections

➤ Tax Fiction Overview:

- Target “Old T” is treated as selling its assets to unrelated “New T” for the consideration paid for T stock plus New T’s assumption of Old T’s liabilities. Old T is then treated as liquidating into S.
- No gain or loss on the liquidation.
- Attributes flow up under §381 (where S is a C corp) assuming T is solvent.



Section 338 Elections – New Considerations Post TCJA

338(h)(10) Buyer and Seller Considerations

- Buyer may want more basis allocated to 168(k) qualified property to allow for bonus depreciation
- Sellers will continue to ask for gross-up for tax rate differential.
- Selling S corp shareholders may also ask for Buyer to assume of 965 tax installment liability as consideration for agreeing to (h)(10) election.

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 Old T’s liabilities.
- Old T recognizes gain or loss on the deemed asset sale.
 - Sub F and GILTI potential

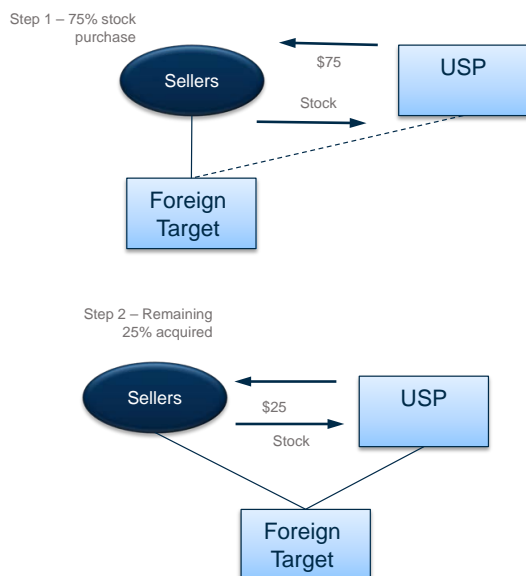
Section 338(g) Elections – New Considerations Post TCJA

Results to Buyer

- New T is treated as purchasing Old T’s assets as of the beginning of the day after the acquisition date.
- New T gets stepped up basis in the assets deemed purchased.
- T’s tax attributes (e.g., NOLs and E&P) disappear.
- 338(g) for foreign target mitigate Section 951A GILTI inclusions to Buyer post-close

Section 338(g) Elections – New Considerations Post TCJA

Results to Buyer – Traps for Unwary Creeping 338



Transaction Steps:

Step 1: USP acquires 75% of the stock of Foreign Target for \$75.

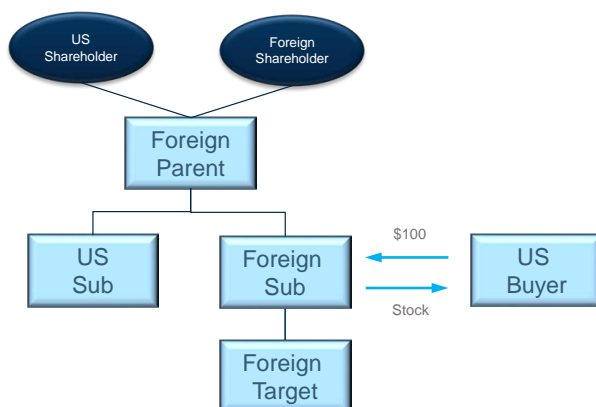
Step 2: Within 12 months, USP acquires the remaining outstanding stock for \$25.

Issue:

- At time the QSP is completed Foreign Target is a CFC and USP
- 30 day limitation on subpart F inclusions was repealed
- Potential Subpart F and 951A GILTI recognized by USP if 338(g) election made

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

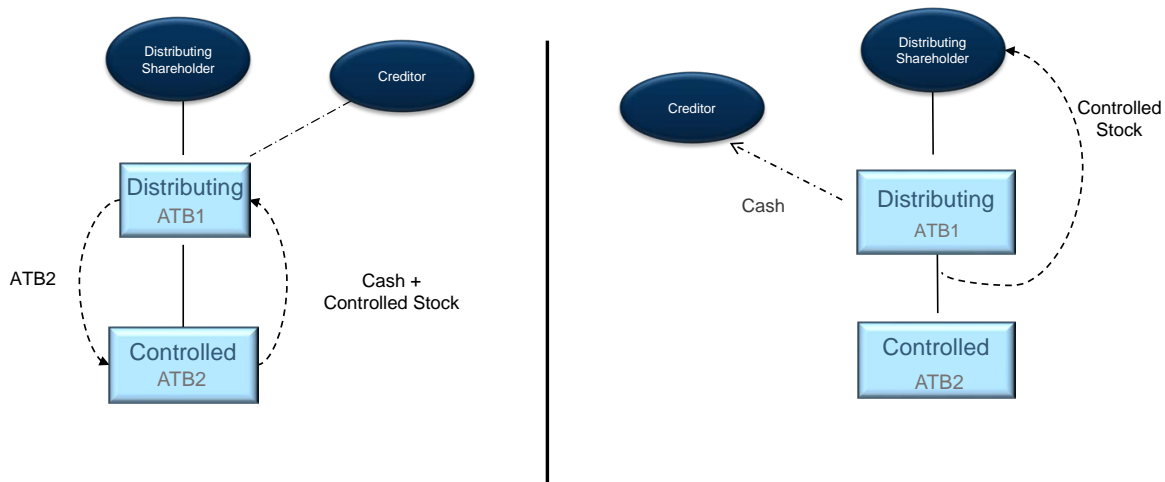
Extracting Value in a Section 355 Spin-Off

- **Cash distribution:** Controlled distributes cash to Distributing as part of a Section 368(a)(1)(D) reorganization.
- **Liability assumption:** Controlled assumes a liability of Distributing as part of a Section 368(a)(1)(D) reorganization.
- **Securities-for-debt exchange:** Distributing transfers business to Controlled in exchange for Controlled stock and Controlled securities (*i.e.*, long-term debt). Distributing repays Distributing debt with the Controlled securities and distributes Controlled stock to its shareholders.
 - Current holders of Distributing debt may prefer cash. Investment bank may be able to facilitate by acquiring Distributing debt for cash, but not as Distributing's agent.
 - Only old and cold debt or newly issued debt too?
- **Stock-for-debt exchange:** Distributing transfers business to Controlled in exchange for Controlled stock. Distributing uses up to 20% of the Controlled stock to repay debt and distributes the balance of the Controlled stock to its shareholders.

Extracting Value in a Section 355 Spin-Off

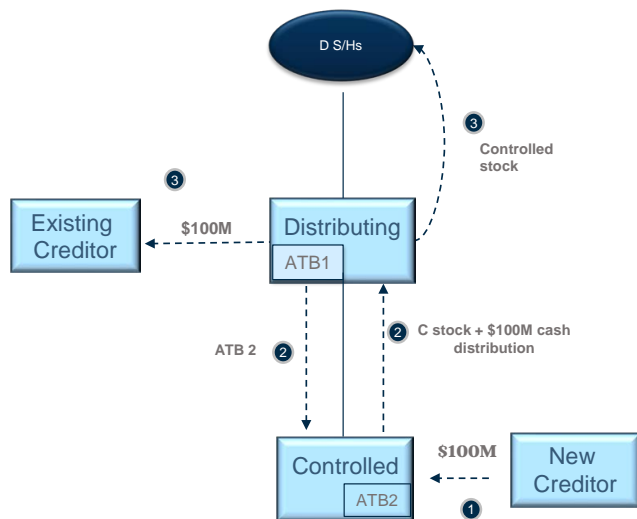
- Cash distributions to Distributing and liability assumptions by Controlled are subject to additional limitations:
 - **Basis limitation** – For the cash distribution or liability assumption by Controlled to be tax-free to Distributing, amount of cash distributed/liabilities assumed cannot exceed Distributing's 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



- Cash distributed by Controlled in excess of tax basis in contributed assets generally will have gain implications.
- Boot purging rule of Section 361--Cash distributed pursuant to plan of reorganization (within 18 months) to repay debt, make distributions to shareholders or for stock buybacks is not treated as boot in Section 361(a)(1)(D) reorg, subject to basis limitation where used to repay debt.
- Debt repaid can be incurred post-distribution and may include ordinary course liabilities (e.g., compensation).

Extracting Value in a Section 355 Spin-Off Example 1A: Boot Purge



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

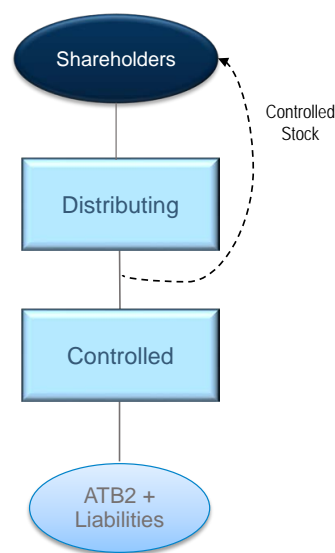
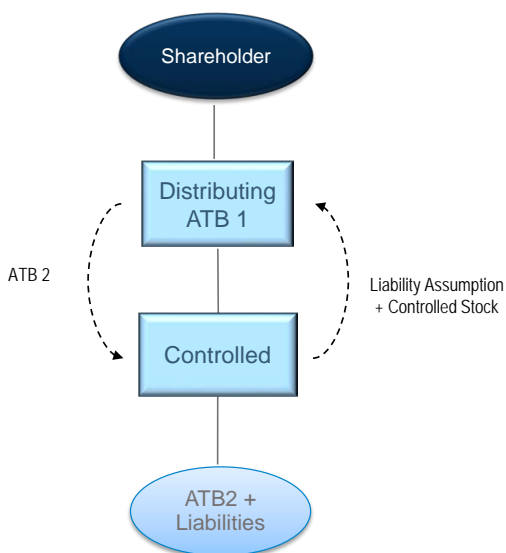
Step 1: Controlled issues debt to unrelated creditors

Step 2: Distributing contributes ATB 2 to Controlled in exchange for \$300M of Controlled stock and \$100M cash;

Step 3: Distributing distributes Controlled stock to Distributing's shareholders and repays existing Creditor \$100M cash.

See e.g., PLR 201818010

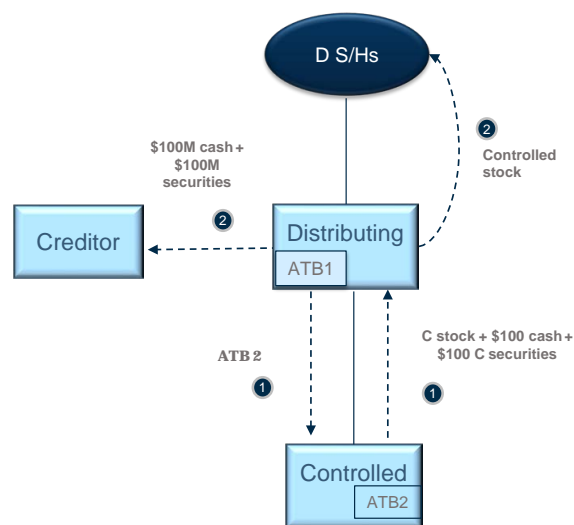
Extracting Value in a Section 355 Spin-Off Example 2: Liability Assumption



- Distributing recognizes gain on contributed assets if liabilities assumed by Controlled exceed basis in contributed assets.
- Gain is recognized under Section 357(c) rather than as an ELA under consolidated return rules. Treas. Reg. Sec. 1.1502-80(d)(1).

Extracting Value in a Section 355 Spin-Off

Example 3: Debt-for-Debt Swap with Controlled Securities



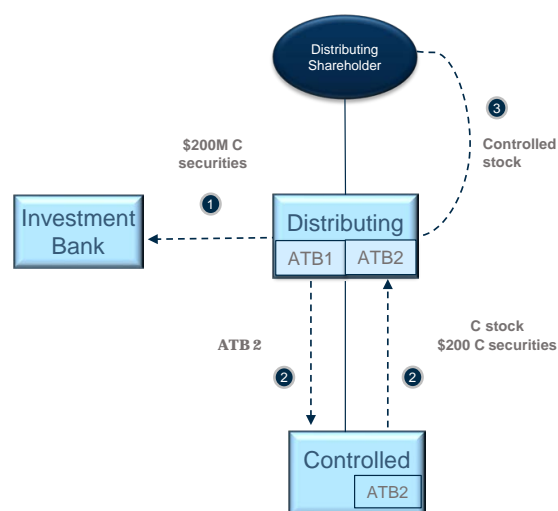
Facts: Distributing is engaged in two lines of business, ATB1 and ATB2, each of which is actively conducted. ATB2 has basis of \$100M, FMV of \$400M

Step 1: Distributing contributes ATB 2 to Controlled in exchange for \$200M of Controlled stock, \$100M cash, and \$100M of Controlled securities;

Step 2: Distributing distributes Controlled stock to Distributing's shareholders and repays Creditor using \$100M cash, and \$100M of Controlled securities.

Extracting Value in a Section 355 Spin-Off

Example 3A: Intermediated Debt-for-Debt Swap



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.

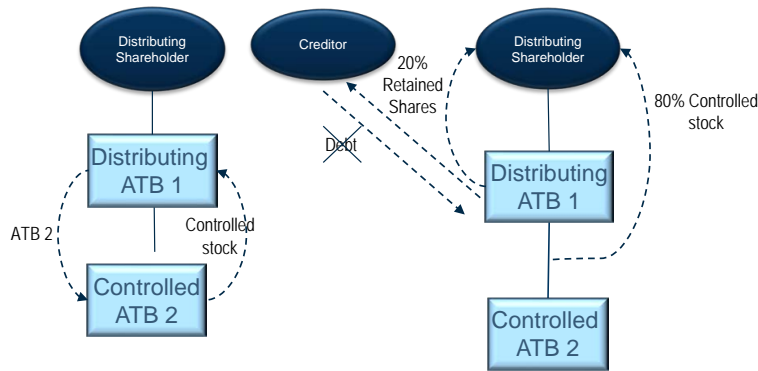
Step 2: Distributing contributes ATB2 to Controlled in exchange for \$200M of Controlled stock and \$200M of Controlled securities.

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



- Retained share transfer may be facilitated by investment bank [subject to 5/14 standard]?. . Retained shares should be transferred to Bank within 18 months after the distribution
- Within [18 months] retained shares may also be distributed to Distributing shareholders as a distribution or in exchange for shares of Distributing under Section 355. If not used to repay debt or distributed to shareholders, within five years shares will be sold.
- Consider business purpose, continuing relationships, overlapping board. Representation that there is no tax avoidance motive.

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.

Revenue Procedure 2018-53 Themes

- Covers transactions in which D transfers fixed leverage to C.
- IRS wants to understand the mechanics of transaction, but focus is on allocating historical D leverage to C, regardless of mechanics.
- Historic debt reps focus in quantifying the amount within the group, less concerned with timing of incurrence of debt that will be paid off.
- No requirement of so-called 5-14 reps, under which investment bank promises to acquire D debt at least 5 days before entering into exchange agreement and to hold debt for at least 14 days before executing exchange.

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.

Due Diligence

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

Why Undertake Due Diligence?

Inform Post-Close Planning

- Transaction Taxes.
- Transaction Deductions (e.g., advisor fees, bonuses, options).
- Incremental Taxes (e.g., 338(h)(10), 280G, DIGs, withholding).
- Transfer Taxes.
- Gain Deferral / Future Tax Shield.
- Basis Step-up and Corresponding Tax Benefits.
- NOL Utilization and Restrictions.
- Global Effective Tax Minimization / Repatriation Planning.
- Exit Strategies.

Diligence Considerations: Asset Acquisition Scope

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 §197(f)(9)

- Prohibits amortization of goodwill step-up if business was established in 1993 or earlier where the sale is to a related party (common ownership of more than 20%).

Diligence Considerations: Stock Acquisitions

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).
- State statute of limitations - 3-4 years for a filed-return unless waived. (6 years, in many states, if underreporting of more than 25% of gross income stated on original return).
- Analysis of Attributes (e.g., Pre-existing Basis / NOLs and Restrictions (Section 382)).

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.
- Opportunity for 338(h)(10) election.
- Attribute / basis reduction pursuant to §1.1502-36.
- Apportionment of Consolidated §382 limit, 163(j) - §1.1502-95(c).
- Impact of 965 tax installment liability and related basis adjustments

Diligence Considerations: Acquisitions of S Corporations

Same considerations as in a Stock Acquisition - Plus:

- Evaluation of S corporation validity.
 - Potential opportunity for basis step-up under §338(h)(10) if 80% or more of S corporation stock is acquired in the acquisition.
 - Built-in gains tax (if converted from a “C” corporation).
 - Analysis of state tax treatment of S corporations.
1. Same as Federal.
 2. Was a separate state election required?
 3. Filing responsibilities including applicable shareholder consents, S corporation withholding requirements, composite returns.
 4. Entity level taxation

S Corporation Status is CRITICAL – if a Bad S Corporation, Then:

- The S corporation is a “C” corporation, liable for income tax from the point of termination forward.
- No §338(h)(10) election (i.e., no step-up).

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

- **Expanded CFC rules**
 - Potential for missed 965
 - Missed Subpart F and 951A GILTI (for 2018 onward)
- **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: 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

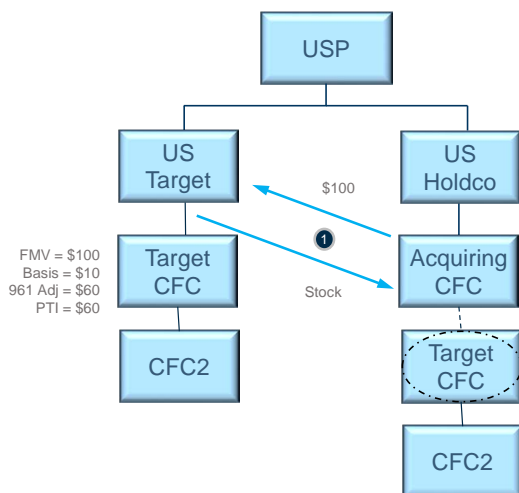
§1.1502-36(d)

§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?

Cash D Reorganization – 965 and 961 Basis Bump



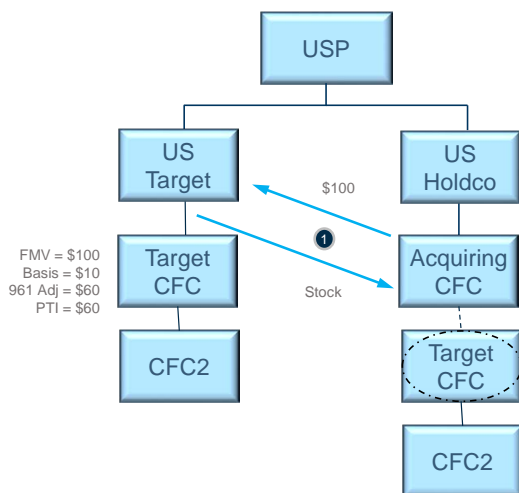
Transaction Steps

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-the-box election of Target CFC is treated as a "D" reorganization.
- Due to the 965 inclusion, US Target's basis in Target CFC is increased by the 965 inclusion amount of \$60 under Section 961.
- If US Target makes basis election under Prop. Reg. 1.965-2(f), US Target would also increase its basis in Target CFC by its Section 965(b) allocable deficit of \$30.
- US Target recognizes zero gain or loss in the "D" reorganization
- Potential downside?

Cash D Reorganization – 965 and 961 Basis Bump



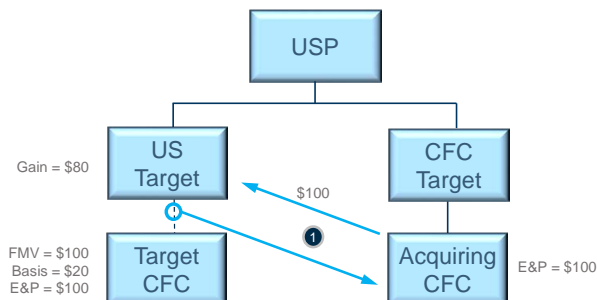
Transaction Steps

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-the-box election of Target CFC is treated as a "D" reorganization.
- Due to the 965 inclusion, US Target's basis in Target CFC is increased by the 965 inclusion amount of \$60 under Section 961.
- If US Target **does not** make basis election under Prop. Reg. 1.965-2(f), US Target would recognize \$30 of boot which would be treated as a dividend under Section 356.
- Is the dividend taxable to US Target?

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



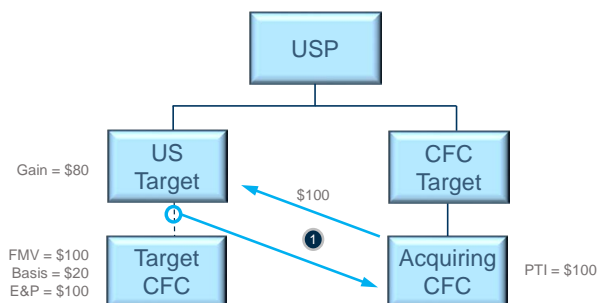
Transaction Steps

1. Acquiring CFC buys Target CFC for \$100

Consequences

- Section 304(a)(1) transaction – entire FMV is subject to dividend recast
- \$100 treated as dividend first to the extent of the acquiring corporation's E&P and then the issuing corporation's (i.e., target) E&P
- Would Section 245A exclude the deemed dividend from Acquiring CFC from income?
- Is US Target treated as satisfying the ownership holding period for Section 245A to apply?

Section 304(a)(1) Transaction – Section 965 PTI Pools



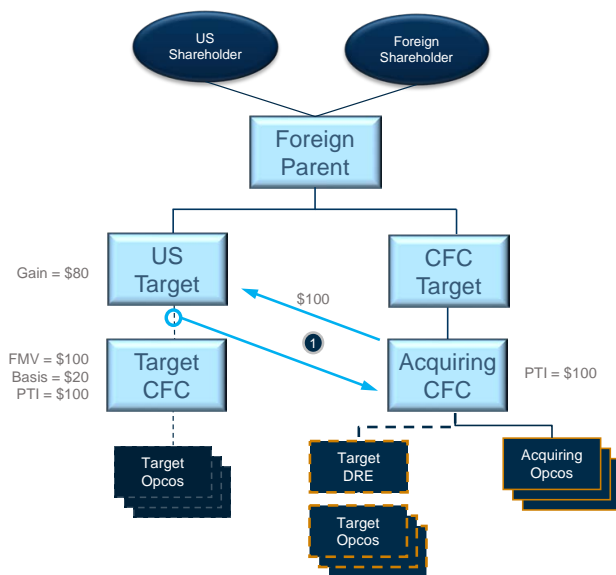
Transaction Steps

1. Acquiring CFC buys Target CFC for \$100

Consequences

- Section 304(a)(1) transaction – entire FMV is subject to dividend recast
- \$100 treated as dividend first to the extent of the acquiring corporation's E&P and then the issuing corporation's (i.e., target) E&P
- If Acquiring CFC had a PTI pool (for example due to 965), would US Target recognize taxable income?

§ 304(a)(1) Transaction – CFC Expansion Rules



Transaction Steps

1. Acquiring CFC buys Target CFC for \$100

Consequences

- ▶ § 304(a)(1) transaction – entire FMV is subject to dividend recast
- ▶ \$100 dividend sourced from Acquiring CFC's PTI
- PTI – Avoid §§ 245A and 1059(e) because the \$100 PTI distribution is excluded from gross income under to § 959(a)
- ▶ Avoids Section 951A and Subpart F to US Target going forward
- ▶ US Shareholder may not have Sub F and Section 951A inclusions.