

35th Annual TEI-SJSU High Tech Tax Institute

M&A Meets the TCJA
November 4, 2019

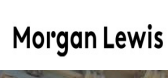
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Acquisition Structuring Considerations

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.

Carryforward of disallowed amounts, which are treated as business interest paid or accrued in next succeeding taxable year.

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

- any income, gain, deduction, or loss which is not properly allocable to a trade or business;
- any business interest or business interest income;
- the amount of a net operating loss deduction under section 172;
- the amount of any deduction allowed under 199A; and
- 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.

Definition of Business Interest under Proposed Regulations

- ▶ Proposed regs define interest to include any amount paid or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement treated as a debt instrument, or an amount that is treated as interest under the Code and regulations:
 - ▶ Conventional debt instruments;
 - ▶ *Merk* and *Mapco* type transactions; *Merk & Co., Inc. v. U.S.*, 652 F.3d 475 (3rd Cir. 2011) and *Mapco, Inc. v. Comm'r*, 556 F.2d 1107 (Ct. Cl. 1977).
- ▶ Treat as interest certain amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis.
- ▶ Anti-avoidance rule that treats as interest expense for purposes of section 163(j) an expense or loss predominantly incurred in consideration of the time value of money in a transaction or series of integrated or related transactions in which a taxpayer secures the use of funds for a period of time.
- ▶ Consolidated group has a single section 163(j) limitation; in contrast, members of an affiliated group that does not file a consolidated return would not be aggregated for purposes of section 163(j) limitation.

Section 163(j) and CFCs

- ▶ Proposed regs provide general rule that Section 163(j) applies to determine deductibility of CFC's interest expense in the same manner as for domestic C corporations; however, if business interest is paid by one CFC to a related CFC, Section 163(j) could result in an inappropriate mismatch of deduction and income items, which could inappropriately impact the calculation of the tax liability of a US shareholder under GILTI.
- ▶ Because money is fungible within a group of highly related CFCs, proposed regs provide for an allocable share election, which would limit the amount of business interest expense of a CFC group member subject to Section 163(j) limitation to CFC group member's allocable share of CFC group's applicable net business interest expense (ANBIE). Prop. Reg. §1.163(j)-7(b)(3).
- ▶ If election is made and there is only intercompany debt within CFC group, then amount of the CFC group's ANBIE is zero. No business interest expense of any CFC group member would be subject to Section 163(j) limitation. No increase in GILTI inclusion under Section 951A(a) solely by reason of the use of intercompany debt within a CFC group.
- ▶ US shareholder of a CFC generally is required to include in its gross income its pro rata share of the CFC's subpart F income, investments in U.S. property under Section 956 and GILTI.
- ▶ To avoid double counting of taxable income of a CFC already taken into account to determine the CFC's section 163(j) limitation, the proposed regs provide that ATI of US shareholder is computed by subtracting inclusions under sections 78, 951(a), and 951A(a) that are properly allocable to a non-excepted trade or business of the US shareholder ("specified deemed inclusions") reduced by any deduction allowable under section 250(a)(1)(B), without regard to the taxable income limitation in section 250(a)(2), by reason of a specified deemed inclusion.

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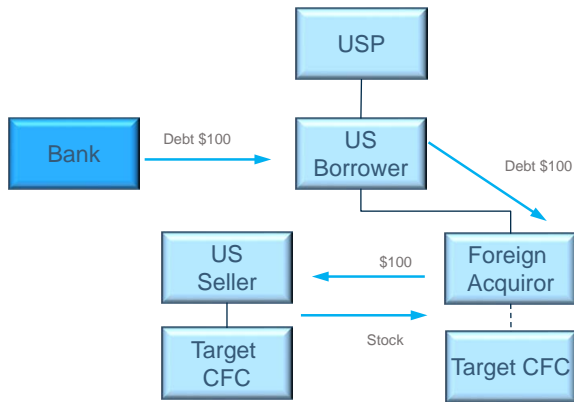
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Deal Financing Considerations under Section 163(j)

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



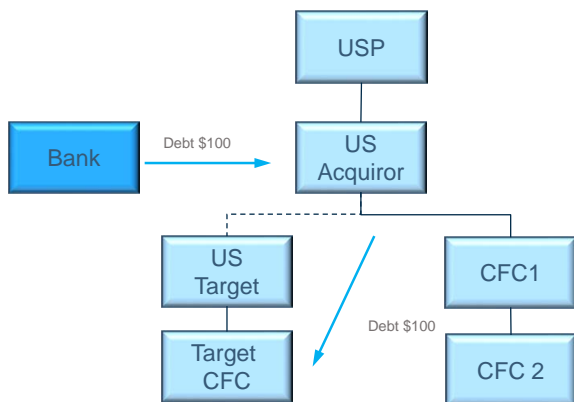
Transaction Steps

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)?

Deal Modeling – NOLs

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.
- Tax benefit payment provisions related to losses generated in pre-transaction short period have become increasingly common as a result of no carryback for post-2017 losses.

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.

Net Operating Losses

Section 382 Proposed Regulations

- The IRS has issued proposed regulations that would withdraw and obsolete Notice 2003-65 (and other guidance associated with Sec. 382(h)) when finalized.
- The proposed regulations modify the Sec. 1374 safe harbor of Notice 2003-65 and make its use mandatory when computing NUBIG and NUBIL. The Sec. 338 safe harbor approach under Notice 2003-65 would be eliminated.
- The regulations are proposed to be effective for ownership changes occurring after they are finalized, but taxpayers and their related parties may apply them to any ownership change occurring during an open tax year, as long as they consistently apply the proposed regulations to that ownership change and any subsequent ownership changes that occur before the regulations are finalized.
- The proposed regulations significantly curtail the benefits that were previously available under Notice 2003-65, which could impact the ability of a buyer to utilize NOLs post-transaction.

Purchase Agreement Considerations

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

RWI Policy Considerations

- Representations and warranties insurance (“RWI”) policies have become an important part of private M&A practice
- Increasing number of Sellers asking Buyers to obtain RWI policies
- Minimizes post-closing exposure
- Distribute sale proceeds faster
- May be desirable to Buyer, depending on scope of coverage (as compared to scope of indemnity provided by Seller, if any)

Purchase Agreement Considerations

Important Terms

- What claims are covered
 - breach of rep/warranties (including tax?)
 - pre-closing taxes (only?)
- What claims are not covered
 - known tax liabilities
 - disclosure schedule items
 - tax items uncovered in diligence
- Other typical exclusions
 - taxes accrued or reserved on closing statement or books and records as of last balance sheet date
 - transfer pricing liabilities
 - transfer taxes
 - tax exposure for specific transactions (e.g., pre-positioning steps)
 - availability of NOL carryforwards

Purchase Agreement Considerations

Tax Gross-Up

- Gross up for taxes on insurance proceeds?
- Consider whether definition of “Loss” includes taxes on insurance proceeds
- Are insurance proceeds taxable to the insured?
 - Consider treatment as PPA
 - Consider *Freedom Newspaper*

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: 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
- **Trapped Cash**

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?

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)).

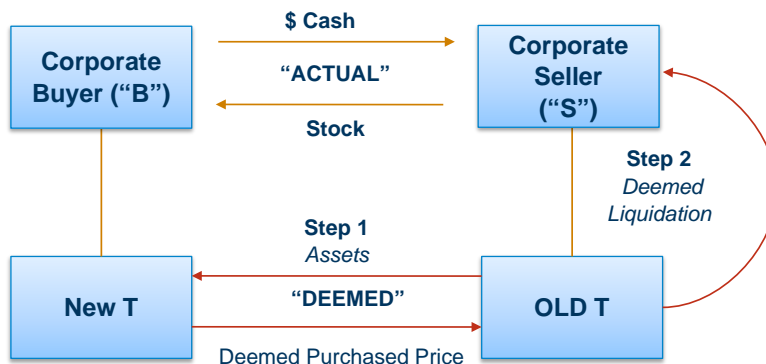
Tiered Targets

- 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

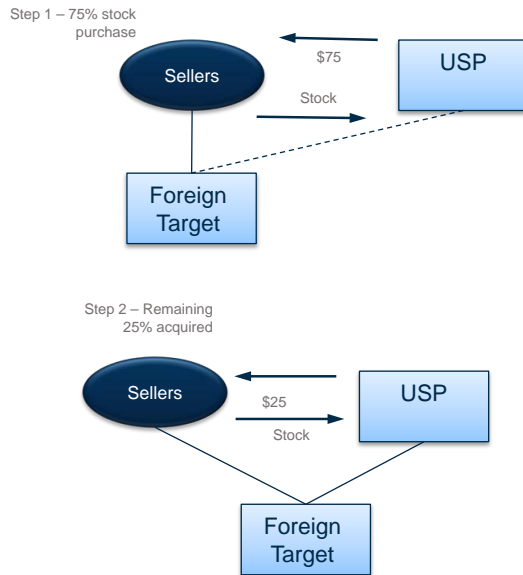
Section 338(g) Elections – New Considerations Post TCJA

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.

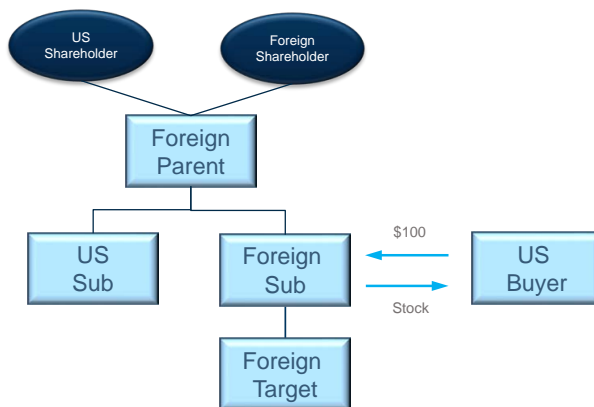
Step 2: Within 12 months, USP acquires the remaining outstanding stock for \$25.

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?

Acquisition Case Studies – Onshore versus Offshore IP

Post-TCJA Case Study

Key Facts:

- SaaS business, headquartered in Australia, all IP developed and owned in Australia
- Subsidiaries in U.S., UK, and Japan
- Sales: 51% U.S. Customers, 49% ROW
- Relevant Tax Rates:

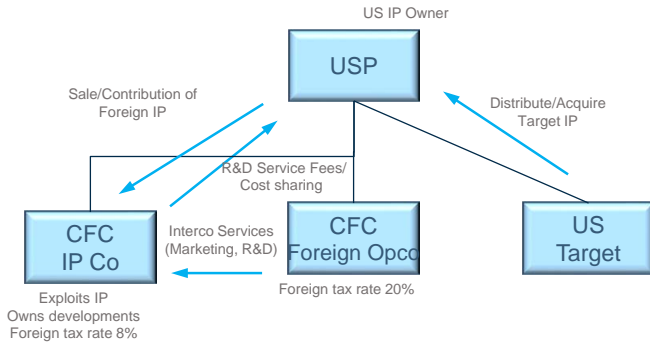
United States	29%
Australia	27.5%
UK	20%
Japan	30%

- Purchase Price of \$60M
 - IP/Intangible comprised 95% of purchase price
- Detailed forecast model indicated \$2M in net tax savings by on-shoring IP to U.S. in the first 5 years

Key Considerations:

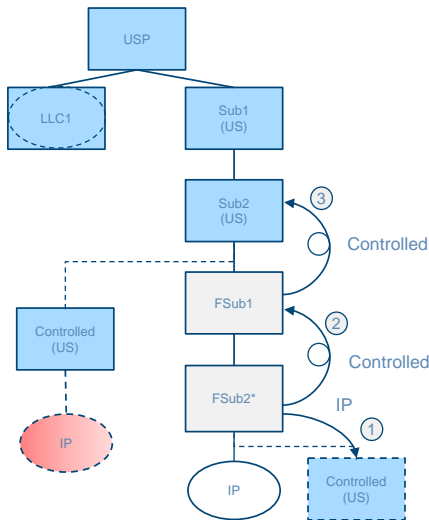
- IP/Intangible Valuation
- FDII
- GILTI
- Transfer Pricing
- Cash Needs/Repatriation Plans
- Tax Benefits/Intangible Amortization

Post-TCJA Case Study – US to Foreign Ownership IP Migration



- GILTI: USP pays 10.5% GILTI rate on foreign profits
- If cost sharing, 1.482-7 applies
- If sale/contribution, 367(d)(4) and 482 applies
- Should have full cross-crediting in GILTI basket
- Consider having CFC IP Co bear R&D/sales fees to reduce burden of BEAT
- Subpart F considerations apply

Coming Back Onshore -- PLR 201936004



* FSub2 pays USP a **Deemed Royalty** as the result of a prior transaction whereby USP transferred the IP to FSub2 in a transaction subject to section 367(d).

As a result of the proposed transactions, (1) IP is transferred from FSub2 to Controlled and (2) Controlled joins USP's consolidated group

Under Treas. Reg. § 1.367(d)-1T(f)(3), USP would continue to receive the deemed royalties and Controlled would be treated as the "transferee foreign corporation."

IRS ruled that:

-Deemed Royalty will be excluded from USP's gross income for the remaining useful life of the IP under Treas. Reg. § 1.1502-13(c)(6)(ii)(D)

-USP's intercompany item from the receipt of the Deemed Royalty will not be considered taxable or tax-exempt income or a distribution with respect to stock for purposes of Treas. Reg. § 1.1502-13(c)(1) and will not be taken into account for purposes of E&P

-Controlled's corresponding item from the deemed payment of the Deemed Royalty will not be (i) a non-capital/non-deductible amount within the meaning of Treas. Reg. § 1.1502-32(b)(2) or (ii) taken into account for purposes of E&P under Treas. Reg. § 1.1502-33

Post Acquisition Integration – Focus on Gap Period

245A & M&A

Section 245A provides a 100% dividends-received-deduction (“DRD”) on the foreign-source portion of dividends received by a corporate U.S. shareholder from a specified 10% owned foreign corporation (“SFC”)

- “Hybrid dividends” are not eligible for the 100% DRD. § 245A(e)(1)
- Section 245A DRD applies to distributions made after December 31, 2017

Section 1248(a), in general, treats gain recognized on the sale of stock of a controlled foreign corporation (“CFC”) as a dividend to the extent of earnings and profits (“E&P”)

- Amounts treated as a dividend under section 1248 are treated as dividends for purposes of applying section 245A. § 1248(j)

Treas. Reg. § 1.245A-5T Background

On June 18, 2019, Treasury and the IRS issued temporary and proposed regulations under section 245A, which apply *retroactively* to distributions made *after* December 31, 2017.

Includes dividends under sections 964(e) and 1248(a)

Overall effect is to limit the availability of the section 245A DRD in two targeted scenarios:

- Distributions of E&P generated during the GILTI gap period
- Sales (or issuances) of CFC stock resulting in untaxed E&P

Treas. Reg. § 1.245A-5T Background

Specifically, the section 245A DRD is allowed only for the portion of the dividend that exceeds the “ineligible amount”

The ineligible amount is the sum of:

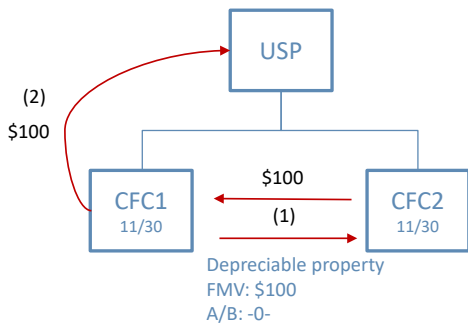
- 50% of the extraordinary disposition (“ED”) amount and
- The extraordinary reduction (“ER”) amount

Determined on a “section 245A shareholder” by shareholder basis

- A domestic corporation that is a U.S. shareholder with respect to an SFC that owns directly or indirectly stock of the SFC

Extraordinary Dispositions

Extraordinary Dispositions: Targeted Transactions



1. CFC1 sells built-in gain property to CFC2 during the GILTI Gap/Disqualified Period
 - No tested income;
 - Increased basis in tangible property

2. CFC1 distributes \$100 to USP as a dividend
 - \$100 dividend eligible for section 245A DRD (assuming requirements otherwise met)

Extraordinary Dispositions: Definition

An extraordinary disposition (“ED”) is:

- Any disposition of property, of which the gain recognized would constitute gross tested income under section 951A
- To a related party (under either section 267(b) or 707(b))
- During the “Disqualified Period” (when the SFC was a CFC)
 - January 1, 2018 through the close of the taxable year of the SFC that begins before January 1, 2018 and ends after December 31, 2017
- That is outside the ordinary course of the SFC’s activities
 - Generally determined through a facts and circumstances test
 - **Per se out of the ordinary course if the disposition is either of intangible property or undertaken with a principal purpose of generating E&P**

Dispositions to related U.S. persons, including by distribution, and indirectly through certain flow-through entities are included

Extraordinary Dispositions

Gain recognized from EDs give rise to “ED E&P”

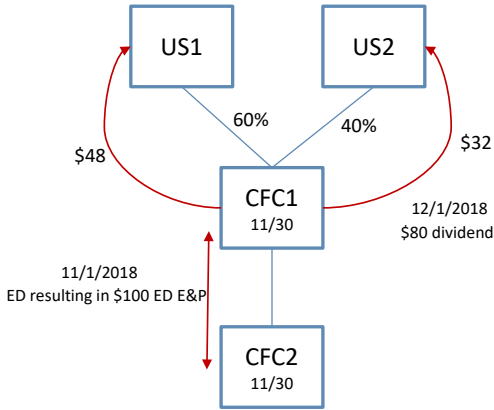
- Each section 245A shareholder at the beginning of the Disqualified Period has an ED account consisting of its proportionate share of the SFC’s ED E&P
- ED account balance cannot increase after the close of the Disqualified Period
- ED account is reduced by certain dividends paid by the SFC

The amount of a dividend paid out of an ED account is the “ED amount”

- Ordering rules generally provide that dividends are treated as paid first out of non-ED E&P and account for multiple dividends paid in the same year

50% of the ED amount is an ineligible amount, i.e., section 245A DRD is disallowed

Treas. Reg. § 1.245A-5T(j)(2) Example 1



1. CFC1 sells built-in gain property to CFC2 during Disqualified Period, resulting in \$100 of E&P.
 - CFC1 does not make a distribution in the year of the sale
2. The following year, CFC1 pays an \$80 dividend, \$48 to US1 and \$32 to US2.
 - CFC1 has \$110 of E&P at the close of the year of the distribution

	CFC1	US1	US2
ED E&P	100		
Non-ED E&P	10		
EDA		60	40
Dividend		48	32
Non-ED Amount		6	4
ED Amount		42	28
Ineligible Amount		21	14

Extraordinary Dispositions & Section 954(c)(6)

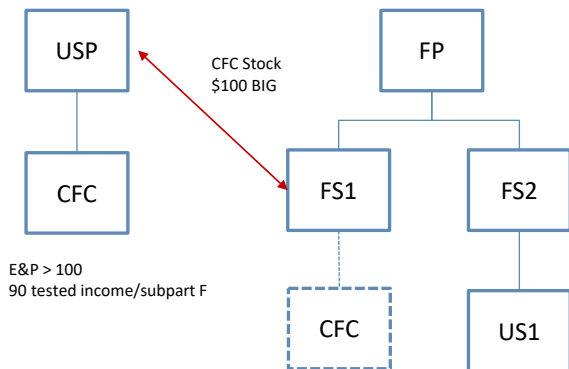
Section 954(c)(6) is turned off to the extent a section 245A DRD would be denied if the dividend was paid directly to a section 245A shareholder

- Specifically, 50% of the tiered extraordinary disposition amount is not eligible for the exception to foreign personal holding company income under section 954(c)(6)
- Limitation does not apply to the “same-country” exception under section 954(c)(3)

Result: a portion of the dividend is subpart F income

Extraordinary Reductions

Extraordinary Reductions: Targeted Transactions



- On 7/31, USP sells the stock of CFC to FS1
- CFC remains a CFC post-sale
 - US1 is treated as owning 100% of the stock of CFC under § 958(b)
 - US1 does not own stock of CFC within the meaning of § 958(a)
- USP Tax Consequences
 - \$100 BIG is a dividend under § 1248(a)
 - \$100 dividend is eligible for 245A DRD pursuant to § 1248(a)
 - No amount is included in income of USP
- US1 Tax Consequences
 - No amount of CFC's subpart F and/or tested income is included in income of US1

Extraordinary Reductions

The ineligible amount includes 100% of the extraordinary reduction (“ER”) amount

When an “extraordinary reduction” occurs, the ER amount is the lesser of:

- The amount of the dividend; and
- The sum of the section 245A shareholder’s “pre-reduction pro rata share” of the CFC’s subpart F income and tested income for the taxable year reduced by the prior ER amount

Extraordinary Reductions: Definitions

Extraordinary Reduction occurs pursuant to either a 10% transfer event or 10% dilution event

10% Transfer Event

- A “controlling section 245A shareholder” transfers directly or indirectly stock in a CFC that constitutes at least (i) 10% (by value) of its direct or indirect interest in the CFC and (ii) 5% (by value) of the outstanding stock of the CFC
- Transfers must occur within the taxable year

10% Dilution Event

- As a result of one or more transactions during the taxable year, the controlling section 245A shareholder’s ownership in the CFC as of two dates is reduced by more than 10% (by value) and at least 5% of the total value

Relevant Dates

- Day of the taxable year on which the controlling section 245A shareholder owns directly or indirectly its highest percentage of stock by value and
- Day immediately preceding the first day on which stock was transferred in the preceding taxable year in a transaction (or series of transactions) occurring pursuant to a plan to reduce the percentage of CFC stock owned directly or indirectly

Extraordinary Reductions: Definitions

Controlling section 245A shareholder

- Any section 245A shareholder owning directly or indirectly more than 50% (vote or value) of the stock of the CFC
 - Includes CFC stock owned by a related party and other persons acting in concert with the section 245A shareholder to undertake an ER
 - There can be more than one controlling section 245A shareholder

Extraordinary Reductions: Definitions

Pre-Reduction Pro Rata Share

- Controlling section 245A shareholder's pro rata share of the CFC's subpart F and tested income
 - Determined based upon direct or indirect ownership immediately before the extraordinary reduction
 - But only to the extent that such subpart F or tested income is not included in the controlling section 245A shareholder's pro rata share of the CFC's subpart F or tested income
 - Reduced to the extent each U.S. tax resident's pro rata share is increased as a result of the transfer or stock issuance

Extraordinary Reductions: Definitions

Prior ER Amount

- Sum of the ER amounts of each prior dividend received during the taxable year; plus
- Dividends that were ineligible for the 245A DRD by reason of section 245A(e) or the section 246 holding period requirement; plus
- To the extent the CFC is a lower-tier CFC, amounts included in the section 245A's shareholder's income under section 951(a) on account of:
 - Portion of prior dividends included in the upper-tier CFC's FPHCI by reason of section 245A(e) and
 - Tiered extraordinary reduction amounts

Extraordinary Reductions: Exceptions

E and F reorganizations

CFC taxable year ends via either:

- Transaction pursuant to which CFC taxable year ends
 - Controlling section 245A shareholder must own the stock, directly or indirectly, on the last day of the CFC's taxable year
 - Examples: complete liquidations, acquisitive reorganizations, section 338(g) elections, CFC status ends
- Tax *election* to close CFC's tax year

Extraordinary Reductions: Elective Exception

Treas. Reg. § 1.245A-5T(e)(3) Elective Exception

CFC's tax year closes for all purposes of the Code

- As of the end of the date on which the ER occurred or
- As of the end of each date on which a transaction forming a part of the ER occurs if an ER occurs by reason of multiple transactions

A controlling section 245A shareholder is treated as owning the same amount of stock on the end of the date on which the ER occurred as it owned immediately before the ER

- No other person is treated as owning such stock as of the close of the CFC's taxable year

Result is to generally cause US shareholders of the CFC to include subpart F and tested income that accrues prior to the ER

- Section 250 deduction available (provided otherwise applicable)
- Basis adjustments in determining gain from sale? Timing of such adjustments?

Section 245A DRD applies to residual amount of dividend (if any)

Extraordinary Reductions: Elective Exception

Each controlling section 245A shareholder must file a statement with original return for taxable year in which ER occurred and

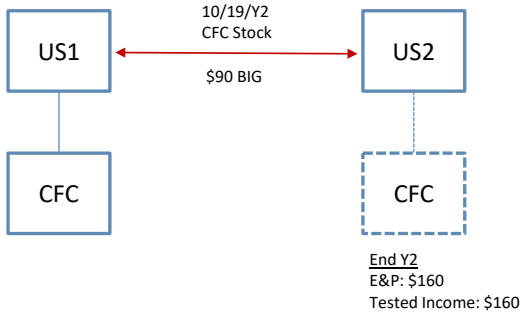
- Transition rule for ERs that occurred prior to publishing of the regulations

All controlling section 245A shareholders and each other U.S. tax resident that is a U.S. shareholder of the CFC on the end of the day must enter into a written, binding agreement agreeing to close the year

Is election unilateral or bilateral?

- -5T(e)(3)(i) language indicates unilateral
- Example indicates bilateral
- If bilateral, why?

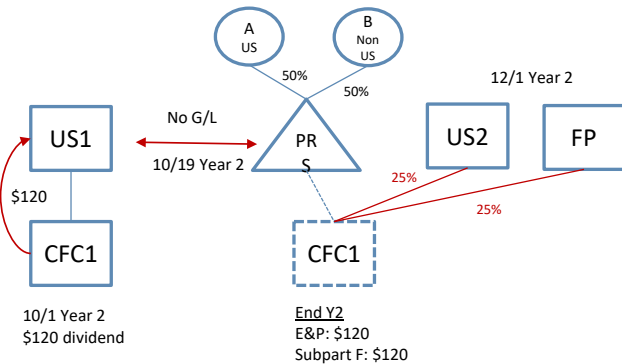
Treas. Reg. § 1.245A-5T(j)(4) Example 3



- On 10/19 Year 2, US1 sells the stock of CFC to US2
- At the end of Year 1, CFC has \$160 of E&P and tested income
- Absent the Extraordinary Reduction rules, the \$90 dividend US1 is treated as receiving in the sale would be eligible for a 245A DRD

	US1	
Pre-Reduction Ownership CFC	100%	
Tentative Pre-reduction pro rata share	160	100% of CFC's Y2 tested income
Specified Amount	(70)	Amount of Y2 tested income US2 takes into account
Pre-Reduction Pro Rata Share	90	
Dividend Amount	90	
Extraordinary Reduction Amount	90	Dividend amount is the same as pre-reduction pro rata share
Ineligible / Eligible Amounts	90 / 0	100% of 90 dividend is ineligible for 245A DRD; \$90 included in income at ordinary rates

Treas. Reg. § 1.245A-5T(j)(5) Example 4



- On 10/19 Year 2, US1 sells the stock of CFC to US2
- At the end of Year 1, CFC has \$160 of E&P and tested income
- Absent the Extraordinary Reduction rules, the \$90 dividend US1 is treated as receiving in the sale would be eligible for a 245A DRD

	US1	
Pre-Reduction Ownership CFC	100%	
Tentative Pre-reduction pro rata share	120	100% of CFC1's Y2 subpart F income
Specified Amount	(36)	Amount of Y2 subpart F income A and US2 take into account
Pre-Reduction Pro Rata Share	84	
Dividend Amount	120	
Extraordinary Reduction Amount	84	Lessor of dividend amount and pre-reduction pro rata share
Ineligible / Eligible Amounts	84 / 36	\$36 of the \$120 dividend is eligible for a 245A DRD; remaining \$84 is included at ordinary rates

Tiered Extraordinary Reduction Amount

If an ER occurs with respect to a lower-tier CFC, section 954(c)(6) applies to any dividend from a lower-tier CFC to an upper-tier CFC only to the extent the dividend exceeds the tiered ER amount.

Tiered ER amount =

$$\begin{aligned} & \text{(Sum of the subpart F and tested income} \\ & \text{of the lower-tier CFC for the taxable year)} \\ & \quad \times \\ & \text{(Percentage, by value, of the stock of the lower-tier CFC} \\ & \text{owned by the upper-tier CFC immediately before the ER)} \\ & \text{(Amounts included in the income of US tax residents under} \\ & \text{sections 951(a) or 951A or included in the subpart F income} \\ & \text{of the upper-tier CFC by reason of section 245A(e) or the ER rules)} \end{aligned}$$

General Rules

Anti-Abuse Rule

Treas. Reg. § 1.245A-5T(h) Anti-Abuse Rule

- “The Commissioner may make appropriate adjustments to any amounts determined under this section if a transaction is engaged in with a principal purpose of avoiding the purposes of this section.”

Appropriate adjustments?

Purposes of this section?

Ordering Rules

- Section 245A(e) if the dividend is a hybrid dividend or tiered hybrid dividend
- Extraordinary Reduction Rules
- Non-ED E&P
- Extraordinary Disposition Rules

If a dividend is subject to both the ER and ED rules, the portion of the dividend subject to the ER rules is treated as occurring first

If an SFC or a CFC pays multiple dividends in a taxable year or at different times on the same date, the regulations apply based on the order in which the dividends are paid

Miscellaneous Rules

De Minimis Rules

- No ED if sum of net gain recognized on dispositions of specified property does not exceed the lesser of \$50 million or 5% of the gross value of all of the SFC's property held immediately before the disqualified period
- No ER amount if sum of the CFC's subpart F and tested income does not exceed the lesser of \$50 million or 5% of the CFC's total income for the taxable year

Source of Dividends: a dividend received by any person is considered received directly by such person from the foreign corporation whose E&P gave rise to the dividend

Section 964(e) Inclusions: an amount included under section 964(e)(4) is considered received by the shareholder from the corporation whose E&P gave rise to the amount described in section 964(e)(1)

Stock Ownership and Transfers: generally, the principles of section 958(a) ownership apply without regard to whether the specified entity is foreign or domestic

Section 355 and Active Trade or Businesses

Statutory and Historical Background

- Section 355 provides for non-recognition treatment of a stock distribution of a controlled corporation, if, among other requirements:
 - both the distributing and the controlled corporations are engaged in an active trade or business (an “ATB”) immediately after the distribution, and
 - such business(es) have been actively conducted for the 5 years immediately before the distribution.
- Historically the Service’s interpretation of this ATB requirement required that, except for extraordinary or narrow circumstances, the business collect income throughout the entire 5-year period before the distribution, and continue to collect income after the distribution.
- E.g., Treas. Reg. § 1.355-3(b)(2)(ii) provides that the “group of activities *ordinarily* must include the collection of income and the payment of expenses.”

Section 355 and Active Trade or Businesses

Service’s September 2018 Statement

- Service and Treasury are considering guidance addressing the potential qualification under Section 355(b) of businesses that have not collected income, but are nevertheless engaged in an entrepreneurial activity (“No-Income ATBs”).
- Potential guidance might address whether a business can qualify as an ATB “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.”

Service’s May 2019 Statement

- Requesting specific information to assist it in identifying what types of No-Income ATBs should be treated as satisfying the ATB requirement.
- Information requested included, among other items:
 - How the ventures are funded (including grants) and on what terms;
 - Opportunities to collect income before a marketable product is developed and whether those opportunities increase as a result of preliminary regulatory approval; and
 - Following such a separation, how likely is it for Spinco to provide services to Parent or vice versa, or that other business relationships between Parent and Spinco continue?

Section 355 and Active Trade or Businesses

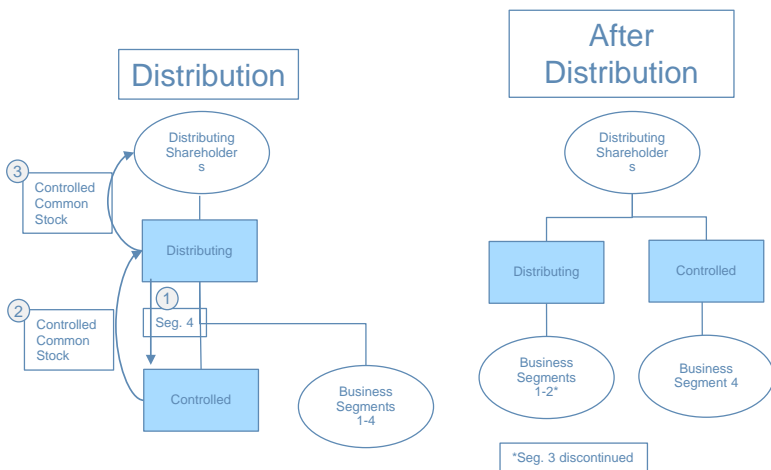
Rev. Rul. 2019-9

- Suspended the application of Rev. Rul. 57-464 (separation of manufacturing business from rental real estate business with nominal income and not net income) and Rev. Rul. 57-492 (separation of petroleum refining, transporting and marketing business from pre-revenue exploration and production business) pending completion of the study on the basis that those rulings “could be interpreted as requiring income generation for a business to qualify as an ATB.”

ABA Comment Letter

- No-Income ATB can constitute a “trade or business” under Reg § 1.355-3(b)(2)(ii) if it engages in regular and continuing research and/or developmental (including product development) activities by managerial and operational employees with the intent to generate income or profit and incurs significant regular operational expenses.
- Interpret the phrase “collection of income” in Reg. § 1.355-3(b)(2)(ii) as referring to the collection of gross income.
- No-Income ATB can satisfy the “active conduct” requirement of Reg. § 1.355-3(b)(2)(iii) if the business activities consist of developing intellectual property for commercial use.
- The Service’s PLR practice regarding No-Income ATBs should apply a flexible rule of reason that looks to whether the policy concerns underlying the ATB requirement are satisfied.

PLR 201920008 – “No Income – No Problem”



Facts:

Distributing engaged in four business segments. Segment 1 was a historic business. The other segments were expansions.

Distributing contributed segment 4 to Controlled and distributed the stock of Controlled pro rata to its shareholders.

Following the distribution, Controlled would continue to provide services to Distributing, but once Controlled ceased providing such services to Distributing, “Controlled may not generate revenue, but it will continue to seek to generate future revenue. . .”

As part of the proposed transaction and immediately following the distribution of Controlled, Controlled will issue shares of Controlled Common Stock to one or more investors in exchange for cash, which will be retained for use in Controlled’s operation of segment 4.

Service ruled that Section 355 applied to the transaction.