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Peter A. Glicklich
Davies, Ward, Phillips & Vineberg LLP, New York

I. Acquisition by Foreign Country Buyer of U.S. Business From U.S. Sellers

Whether to buy stock or assets of a target company is a fundamental consideration in any acquisition of an incorporated business. The importance of this decision is heightened in the cross-border context, where ownership of a business in the United States can result in a foreign acquirer becoming subject to U.S. federal income taxes.

In addition to federal income taxes, the individual states of the United States and some localities also levy tax. Often state and local taxes are based on a taxpayer's income as calculated for federal income tax purposes. The discussion below focuses mainly on federal-level taxation, but some state tax consequences that do not necessarily follow the federal system are also described.

The following discussion first describes tax consequences of an all-cash purchase and later discusses consequences of providing shares or other consideration in connection with an acquisition. In all cases, and in all remaining questions, it is assumed that the target business represents both a trade or business and a permanent establishment (PE) in the United States.

In the United States, a taxable acquisition of a U.S. business can generally take the form of the purchase of the assets of the U.S. business from the corporation that owns them or the purchase of the stock of the corporation itself.

A. Taxable Asset Acquisition

In a taxable asset acquisition, the buyer takes a cost or fair market value basis in the assets acquired, which often represents a step-up in the bases where the assets have appreciated, and the buyer may be able to limit the liabilities assumed in the transaction, including undisclosed obligations that would affect the target corporation. For these reasons, U.S. buyers generally prefer to structure the acquisition of a U.S. business as an asset acquisition.

Like a U.S. buyer, an FC buyer should generally prefer an asset acquisition. However, an FC buyer's status as a foreign person creates the following issues:

- Purchasing assets is likely to cause the FC buyer to have a U.S. trade or business within the meaning of the Internal Revenue Code of 1986, as amended (the "Code"), in which case any income of the FC buyer that is effectively connected with the U.S. trade or business (ECI) would be subject to U.S. federal income tax on a net basis at graduated rates, much like the income of a U.S. person. If the FC buyer's country of residence has entered into a tax treaty with the United States, then the U.S. business is also likely to cause the FC buyer to have a PE in the United Sates, in which case the treaty will not protect the FC buyer from U.S. federal income taxation with respect to its profits from the business.
- The FC buyer will be required to report any ECI from the acquired U.S. business annually on a U.S. federal income tax return.
- The FC buyer may be subject to branch profits tax at a rate of 30% with respect to its earnings from its U.S. business (although the rate of the branch profits tax is often reduced or the tax eliminated by an applicable tax treaty).

Accordingly, the FC buyer is likely to make the acquisition through a U.S. acquisition vehicle. In this case, the income of the U.S. vehicle would be subject to U.S. federal income tax obligations and tax reporting requirements, and the FC buyer would be treated as receiving a dividend from the U.S. vehicle. Under the Code, a dividend paid from a U.S. corporation (such as the U.S. vehicle) to a foreign shareholder (such as the FC buyer) is generally subject to U.S. federal withholding tax at a 30% rate, which may be reduced (often to 15%, or 5% for significant holders of the target corporation's shares) if the foreign shareholder qualifies for the benefits of an applicable tax treaty.

In the case of an asset sale, the purchase price for the U.S. business must be allocated among the U.S. business's assets for U.S. federal tax purposes using the "residual method" prescribed by applicable Treasury Regulations. This methodology requires the purchase price to be analyzed through a waterfall consisting of seven asset classes, with the residual amount allocated to goodwill. The FC buyer's cost basis in the assets (as well as the amount and character of the seller's gain or loss on the transaction) is determined by the amounts allocated to each class of asset.

The purchase price allocation must be reported to the U.S. Internal Revenue Service (IRS) by both the buyer and the seller on Form 8594. Purchase agree-

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ments in the United States generally require the buyer and the seller to agree on the purchase price allocation and to report consistently on Form 8594. Because of differing costs and expenses, however, the allocations on the buyer's and the seller's Form 8594 are not likely to be exactly the same. A buyer and a seller that cannot agree on an allocation will occasionally base their Forms 8594 on different allocations, although this practice is not recommended.

The purchase price allocation forms the basis of the buyer's cost recovery deductions after the transaction. Assuming the value of the assets appreciated in the seller's hands, the buyer will enjoy increased depreciation and amortization deductions going forward. Purchase price allocated to certain intangibles, such as goodwill, and consideration for non-compete covenants can be amortized over a 15-year period.

Other assets may be depreciated or included in inventory—a buyer can typically choose its own inventory and cost recovery methods as well as its own taxable year (through the use of a newly created U.S. vehicle); these options s might not be available to a buyer of shares. Generally, U.S. tax rules limit the use of built-in or previously reported tax losses and credits.

The buyer's direct assumption of fixed liabilities of the seller in an asset acquisition is generally treated as additional consideration and increases the amount realized on the sale. Assumption of a future or contingent obligation, however, generally does not give rise to income or gain for the seller, and the buyer may be able to deduct expenses (or capitalize and amortize or depreciate a related asset) relating to future or contingent obligations.

B. Taxable Stock Acquisition

Sellers, on the other hand, generally prefer a stock acquisition because the amount of gain is often lower and is subject to capital gains rates, which are lower than ordinary rates in the case of sellers that are individuals or trusts. In addition, capital gains can be offset by a seller's capital losses. Moreover, the states do not generally tax a seller of stock, but do tax a seller of assets located in their jurisdiction. Non-tax reasons to prefer a stock acquisition over an asset acquisition generally include fewer third party consents, fewer filings with governmental agencies and fewer local transfer tax issues.

The buyer in a stock acquisition effectively succeeds to and bears the historical tax liabilities of the target corporation. Accordingly, stock purchase agreements generally include extensive representations, warranties, and indemnity provisions that seek to force sellers to cover a U.S. corporation's pre-closing tax liabilities.

Except as described further in I.C., below (in connection with an election under Section 338 of the Code), a target corporation's basis in its assets and its use of tax attributes are generally not affected by a stock sale.

C. Section 338: Stock Acquisitions Treated as Asset Acquisitions

If the buyer and seller agree to structure an acquisition of a U.S. business as a stock purchase, the buyer may be able to obtain a step-up in basis in the assets of the U.S. business by making an election under Section 338 of the Code. If this election is made, the buyer, the seller and the target corporation are treated as if the target had sold all of its assets in a taxable transaction and then liquidated. This has the effect of "pushing down" a basis adjustment into the target, but at the cost of triggering both corporate- and shareholder-level gain. As a result, such an election is generally made only where the target has losses or other tax attributes to shelter corporate-level gain.

A Section 338 election is only available if the buyer is a corporation and purchases 80% or more of the target's stock. A similar election has recently become available under Section 336(e), which does not require the buyer to be a corporation.

In a narrow category of cases, a joint election is available where the seller is filing a consolidated return with the target, or the target is an "S corporation." In those cases, involving a Section 338(h)(10) election, only one level of gain is reported (shareholder level gain is ignored). Contracts relating to such acquisitions carefully detail what elections are expected and who is to bear the cost of any error. Consistent allocation of consideration by the buyer and the seller in such a transaction is required by regulations and is generally reported jointly by the seller and the buyer.

D. Deductibility of Interest and Losses

Interest on acquisition indebtedness, like other indebtedness of a corporation, is generally deductible. The deductibility of interest is subject to many limitations under the Code and case law. Some of the most significant limitations are as follows:

- The party that is primarily liable with respect to the relevant debt can be redetermined, with the result that the original borrower is not respected as the party entitled to the interest deductions.
- Debt can be recharacterized as equity based on a multifactor court-based test. If such a recharacterization is successful, payments with respect to the resulting "equity" interest will be treated as nondeductible dividends that may be subject to different withholding tax and reporting rules.
- Recently issued regulations under Section 385 of the Code automatically treat debt between related parties as equity in certain circumstances, although this is subject to many exceptions and limitations. The provision also requires extensive documentation of inter-company debt.
- Section 267(a)(3) of the Code delays a deduction for interest paid to a related foreign person until the interest is actually paid.
- Section 163(j) of the Code, which addresses "earnings stripping" transactions, limits the deductibility of interest paid to a related lender where the lender does not include that interest in income and where the borrower's debt-to-equity ratio exceeds 1.5 to 1.

Other provisions limit the deductibility of interest on "applicable high-yield debt instruments" and convertible debt (and other debt if the interest is payable in equity).

Generally, the use of net operating losses (NOLs) by the target company after a stock acquisition will be limited under Sections 382-384 of the Code. The most significant of these limitations, Section 382, applies if the target corporation undergoes an "ownership shift," which generally occurs if a shareholder's interest in the corporation increases by 50 percentage points (including a new shareholder whose interest increases from 0% to 50% or more) over the course of a three-year period. The result of an ownership shift is that, after the ownership shift, the historic NOLs of the corporation cannot be used to offset more than a threshold amount of the corporation's income each year. The threshold is generally equal to the value of the corporation's assets at the time of the ownership shift multiplied by the "long-term tax-exempt rate" published by the IRS (2.04% for July 2017).

Losses can also be limited under Section 269 of the Code, which allows the IRS to disallow deductions (or other tax benefits) in situations where a person acquires control of a corporation with the principal purpose of obtaining such deductions. This provision applies both to direct acquisitions and tax-free transactions, which are discussed in more detail in I.F., below.

If a target corporation becomes a member of a group of affiliated corporations that join together in filing a consolidated tax return, applicable regulations may apply to limit deductions for the target corporation's NOLs or prevent the duplication of loss deductions.

E. Inversions

If an FC buyer acquires the stock of a U.S. corporation, the inversion rules under Section 7874 of the Code may apply if, after the acquisition, the former owners of the U.S. corporation own a threshold amount of the stock of the FC buyer, and the expanded affiliated group that includes the FC buyer does not have "substantial business activities" in the foreign country in which the FC buyer is organized.

If the former owners of the U.S. corporation own between 60% and 80% of the stock of the FC buyer after the acquisition, the expatriated entity must pay tax on its "inversion gain" for 10 years after the inversion. Inversion gain is generally any income from the transfer or licensing of property either in connection with the inversion or, if after the inversion, to a foreign related person. Inversion gain cannot be offset by tax attributes such as NOLs. If the former owners of the U.S. corporation own 80% or more of the stock of the FC buyer after the acquisition, the FC buyer is treated as a domestic corporation for all U.S. federal tax purposes after the acquisition.

F. Tax-Free Acquisitions

If stock is issued by an FC buyer as consideration for the target corporation's stock or assets instead of cash or other property, it may be possible to structure the acquisition so that the seller's gain is deferred for U.S. tax purposes under Section 368 of the Code, which defines several types of "reorganization" that do not result in immediate taxation of the seller. Generally, for a transaction to be a reorganization, at least 80% of the consideration in the transaction must consist of acquirer stock, although some types of reorganization prohibit the use of any consideration other than acquirer stock.

In a reorganization, there is no "step-up" in the basis of the target corporation's assets or stock. Instead, the basis of transferred property either carries over to the buyer or is replaced (known as "substituted basis") in the hands of the selling shareholder.

In a cross-border context, Section 367 of the Code generally disqualifies a transaction that would otherwise qualify as a tax-free reorganization under Section 368 by treating the foreign buyer as "not a corporation" for purposes of determining the amount of gain to be recognized on the transaction. There are several exceptions to Section 367, however, that may permit such a reorganization to remain tax-free.

One exception to Section 367 that could be available to an FC buyer with respect to the purchase of a U.S. business would be the exception for transfers of the stock or securities of a U.S. corporation to a foreign buyer. This exception would be available if: (1) the U.S. seller receives 50% or less of the FC buyer's stock in the sale; (2) U.S. persons who are officers or directors of the target corporation or hold 5% or more of the target corporation's stock do not own more than 50% of the FC buyer's stock; (3) the U.S. seller either holds less than 5% of the FC buyer's stock, or holds 5% or more of the FC buyer's stock and enters into a "gain recognition agreement" with the IRS; and (4) the FC buyer has been actively engaged in business for at least three years.

II. Acquisition From Foreign Sellers

A. Asset Sale

If the transaction is a sale of assets, a foreign seller will be subject to considerations similar to those to which a U.S. seller is subject. The Code includes provisions that treat gain of a foreign seller as taxable ECI if such gain results from a disposition of assets that had generated ECI previously. These provisions apply even after the cessation of the business that generated the ECI and with respect to assets that were removed from such an ECI-generating business within the previous ten years. Since it is assumed here that the U.S. business represents a PE for tax treaty purposes, a tax treaty will not protect a foreign seller's gain from ECI-generating assets from U.S. taxation.

The U.S. federal tax considerations for an FC buyer with respect to assets purchased from a foreign seller are generally the same as those described in I., above.

B. Stock Sale

If the transaction is a stock sale, a foreign seller will generally not be subject to tax on any gain realized on the sale. For U.S. federal income tax purposes, gain on the sale of personal property, such as stock, is generally sourced with reference to the residence of the seller. Therefore, gain on a foreign seller's disposition of stock is generally foreign-source income for the seller and is accordingly not taxable in the United States. This general rule does not apply in the case of a nonresident alien individual who is present in the United States for 183 days or more during a taxable year.

From the buyer's perspective, the U.S. federal tax considerations are the same as for a purchase of stock from sellers that are U.S. persons.

In general, the United States has agreed to refrain from imposing higher taxes on foreign sellers than on domestic sellers under the non-discrimination provisions of its tax treaties.

III. BEPS

Generally, the United States has declined to adopt the measures proposed by the OECD's BEPS actions, so BEPS is not likely to have a significant direct impact on the U.S. federal income taxation of stock and asset deals.

Some BEPS-inspired provisions, however, have been adopted by the Treasury Department in the latest version of the U.S. Model Tax Treaty. For example, the new provisions include restrictions relating to "triangular permanent establishments" and "special tax regimes" that are intended to combat treaty shopping in ways that are consistent with the OECD's recommendations. The changes are likely to limit the availability of tax treaties for buyers and sellers of U.S. businesses.

The United States has enacted rules similar to the BEPS actions on interest deductions and hybrid entities that may reduce the availability of certain tax benefits to foreign buyers.

IV. Non-Tax Factors

Tax representations, warranties and indemnities generally play a larger role in a stock deal, because the tax liabilities of the target corporation remain liabilities of the target corporation after the transaction. Asset deals, on the other hand, often simply include an indemnity for taxes of the selling corporation and pre-closing taxes that relate to the purchased business. Since so few pre-closing taxes can be assessed against the purchaser in an asset deal, this simplified indemnity is adequate for a purchase of business assets.

The availability of insurance for representations and warranties and the rise of alternative dispute resolution mechanisms, which are sometimes used for disputes that might give rise to an indemnification claim but have not yet arisen, have become important considerations in the cross-border context.

Buyers and sellers of a U.S. business have the flexibility to designate the applicable law in the sales contract. Delaware and New York are the jurisdictions most often specified in U.S.-based transactions. In cross-border transactions, it is the author's experience that either U.K. or New York law is standard in multi-jurisdiction asset or stock acquisitions.