Corporate Tax: M&A Update

Moderator: Scott M. Levine, Partner, Jones Day

Panelists

Devon M. Bodoh, Partner, Weil Gotshal & Manges LLP

Kelly Madigan, Assistant Branch Chief, Branch 1, Associate Chief Counsel (Corporate), Internal Revenue Service

John J. Merrick, Senior Level Counsel, Associate Chief Counsel (International), Internal Revenue Service

Timothy Shuman, Partner, McDermott Will & Emery LLP

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Agenda

- Corporate M&A Issues Involving SPACs
- Public Section 304 Transactions
- International M&A Issues
  - Issues Relating to the Final and Proposed Foreign Tax Credit Regulations
  - Treas. Reg. section 1.245A-5 M&A Issues

Corporate M&A Issues Involving SPACs

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What is a SPAC?

- A Special Purpose Acquisition Company ("SPAC") is a blank-check company with no operations, formed for the sole purpose of raising equity capital through an initial public offering ("IPO") to acquire an operating business (a "business combination")
- Typically formed by well-known private equity/hedge fund sponsors relying on their reputation and experience to attract investors
- Significant portion of IPO proceeds are placed in a trust account and are used to fund expenses and the eventual business combination
  - Trust account may be interest bearing in certain circumstances
- Specified time period (typically 18-24 months) to complete the business combination following the IPO, otherwise the SPAC is liquidated and cash (plus interest, if any) is returned to shareholders

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Market Overview*

- SPACs generally date back to 1993 with the Securities and Exchange Commission's adoption of Rule 419 for blank-check company offerings
    - Evolved from the "blank-check" companies popular in the public markets during 1980s
    - David Nussbaum, Chairman of EarlyBirdCapital (successor of GKN Securities) is widely credited with the advent of "SPACs" and helped launch 13 offerings between 1993 and 1994**
- Over 200 SPACs have completed IPOs since 2000
- Popularity and size of offerings growing

* SEC Company Filings; http://www.spacdata.com/; Daniel S. Riemer, *Special Purpose Acquisition Companies: SPAC and SPAN, or Blank Check Redux?*, 85 Wash. U. L. Rev. 931 (2007), available at: http://openscholarship.wustl.edu/law_lawreview/vol85/iss4/5.

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Capital Structure: Publicly-held Securities

- SPACs typically raise capital by issuing “units” to public investors in an IPO
  - Each unit generally consists of one common share and warrants
    - The economics with respect to the warrants issued vary among SPAC offerings. In certain offerings, a unit consists of a half-warrant or a third-warrant instead of a full warrant.
    - Common shares and warrants trade separately (after an underwriter overallotment period)
    - Public warrants are exercisable and callable at a specified premium to issuance price
  - In connection with the business combination, common shares are redeemable at the holders’ option for their proportionate share of the funds in trust
  - Often, business combinations must receive majority shareholder approval and cannot be consummated if more than 30% of the public shareholders vote against the business combination and elect to exercise their redemption rights instead

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Capital Structure: Sponsors' Securities

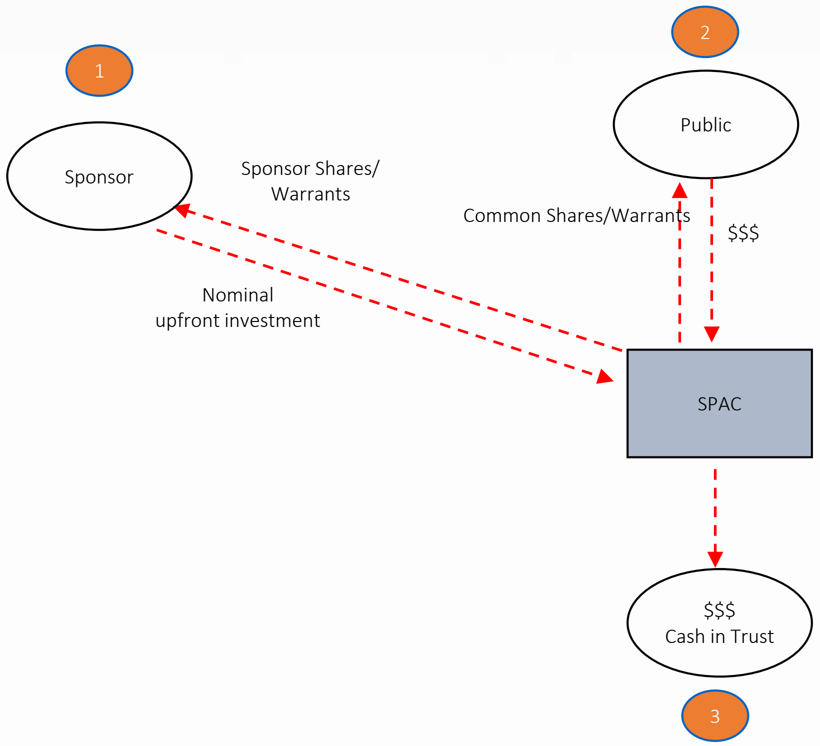
- Sponsors invest nominal capital up front for "Sponsor Shares" prior to the SPAC's IPO
  - Sponsor Shares have limited liquidity, as insiders typically cannot sell for a lock-up period (1-3 years following the business combination)
  - In certain deals, Sponsor Shares entitle Sponsors to control the board/elect directors prior to a business combination
  - Sponsors waive redemption rights afforded to public shareholders, agree to vote to approve business combination, waive rights to liquidating distributions from trust for failed business combination
- Sponsor Shares generally entitle holders to SPAC equity equal in value to 20% of post-IPO common shares (the "Sponsor Promote")
  - Largest SPAC ever ($4BN) did not issue any Sponsor Promote
  - Sponsor Promote may be economically "better" than typical private equity carried interest as it sometimes covers contributed capital and future appreciation
- "Sponsor warrants" are typically issued in a private placement concurrently with the IPO and are substantially similar to the public warrants
  - Unlike the public warrants, Sponsor warrants are typically not callable while still held by the initial holders
  - May be subject to a lock-up period

Capital Structure: Additional Funds

- If additional cash is needed to finance a business combination (i.e., because IPO proceeds won't cover the price of the identified target), a SPAC may raise funds in a private issuance of additional equity
  - Such private issuances often take the form of a "private investment in public equity" (a "PIPE")
- A number of SPACs have raised additional funds by issuing equity-linked securities (such as forward-purchase contracts) whereby, in connection with a SPAC's IPO, investors agree to purchase SPAC common shares and warrants at the time of the SPAC's business combination

Basic SPAC Formation Tax Issues

Typical SPAC IPO Structure



Overview of Jurisdictional Considerations

- Sponsors in the market for targets based in the United States generally form a domestic SPAC (a “domestic-to-domestic” transaction)

- Sponsors in the market for foreign targets generally form a foreign SPAC (a “foreign-to-foreign” transaction)

- Difficult tax issues can arise if, for whatever reason, a domestic SPAC identifies a foreign target or a foreign SPAC identifies a domestic target

Non-US SPAC – Overview of PFIC rules

- Subject to the “start-up exception” and PFICs that are also CFCs (discussed later), a foreign corporation will be a PFIC if it “fails”:
  - the “Income Test”: 75% or more of its gross income is passive income; or
    - Note that even $1 of interest income earned on the IPO funds deposited in trust would “fail” the Income Test
  - the “Asset Test”: average value of its passive assets in a taxable year is 50% or more of the value of its total assets
    - Cash is considered a passive asset under the Asset Test
- Once a foreign corporation has “failed” one of the PFIC tests during a US shareholder’s holding period, the shares retain the PFIC “taint” with respect to such US shareholder, even if the corporation ceases to be a PFIC, unless the US shareholder makes a purging election (“once a PFIC always a PFIC”)
- SPACs own only cash prior to business combination, so foreign SPACs are PFICs unless (i) it doesn’t “fail” the Asset Test or Income Test in the year of its IPO (i.e., the business combination occurs in the year of the IPO) or (ii) the start-up exception applies

Consequences of PFIC Status

- Taxation to US shareholders on "excess distributions" (which include stock dispositions) at ordinary income rates and the imposition of an interest charge based on the shareholders' "deferred tax liability" (the "default regime")
- US shareholders may be able to elect out of the harsh default regime by making either a:
  - Section 1293* – Qualified Electing Fund election ("QEF election"); or
  - Section 1296 – Mark-to-market election
- Special rules under Section 367(b) apply to PFICs engaging in tax-free reorganizations under Section 368 (discussed later)
- Section 1291(f), Section 1298(a)(4) and regulations proposed under such Sections may apply to PFICs engaging in tax-free reorganizations (discussed later)

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Electing Out of the Default PFIC Regime

- QEF election
    - If a US shareholder makes a valid QEF election in the SPAC's first taxable year in which it would otherwise be a PFIC (or a subsequent taxable year if the shareholder makes a QEF election and a purging election), the SPAC will be a "pedigreed" QEF
    - Preserves character of income
        - US shareholder currently includes its pro rata share of the QEF's ordinary earnings as ordinary income and its pro rata share of net capital gain of the QEF as capital gain
        - Requires corresponding adjustments to stock basis
    - No deferred tax interest charge
    - According to proposed regulations, not available for options/warrants
    - Note that a shareholders' ability to make an effective QEF election is contingent upon, among other things, the provision by the PFIC of a "PFIC Information Statement"
    - Mark-to-market election
    - Available if the PFIC stock is "marketable" (i.e. regularly traded on a qualified exchange)
    - The US shareholder will be treated as if it sold its PFIC stock at the end of each year for its fair market value. Any gain realized will be taxable at ordinary income rates. Any loss realized will be deductible only to the extent of any prior year gains recognized by the shareholder under the MTM election regime
    - The deferred tax interest charge is avoided
    - Presumably not available for options/warrants, as regulations have not yet been issued

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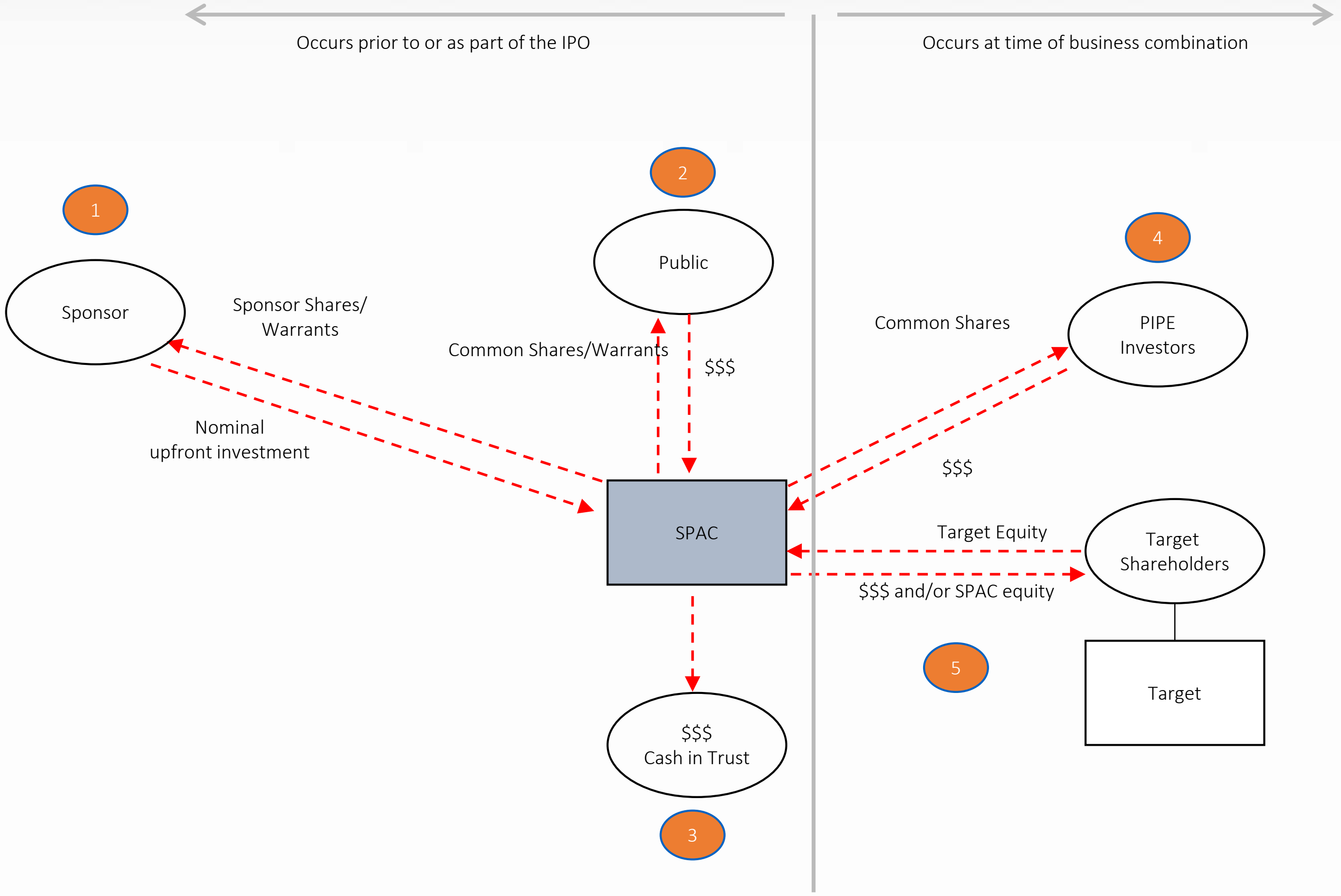
Start-up Exception to PFIC Status

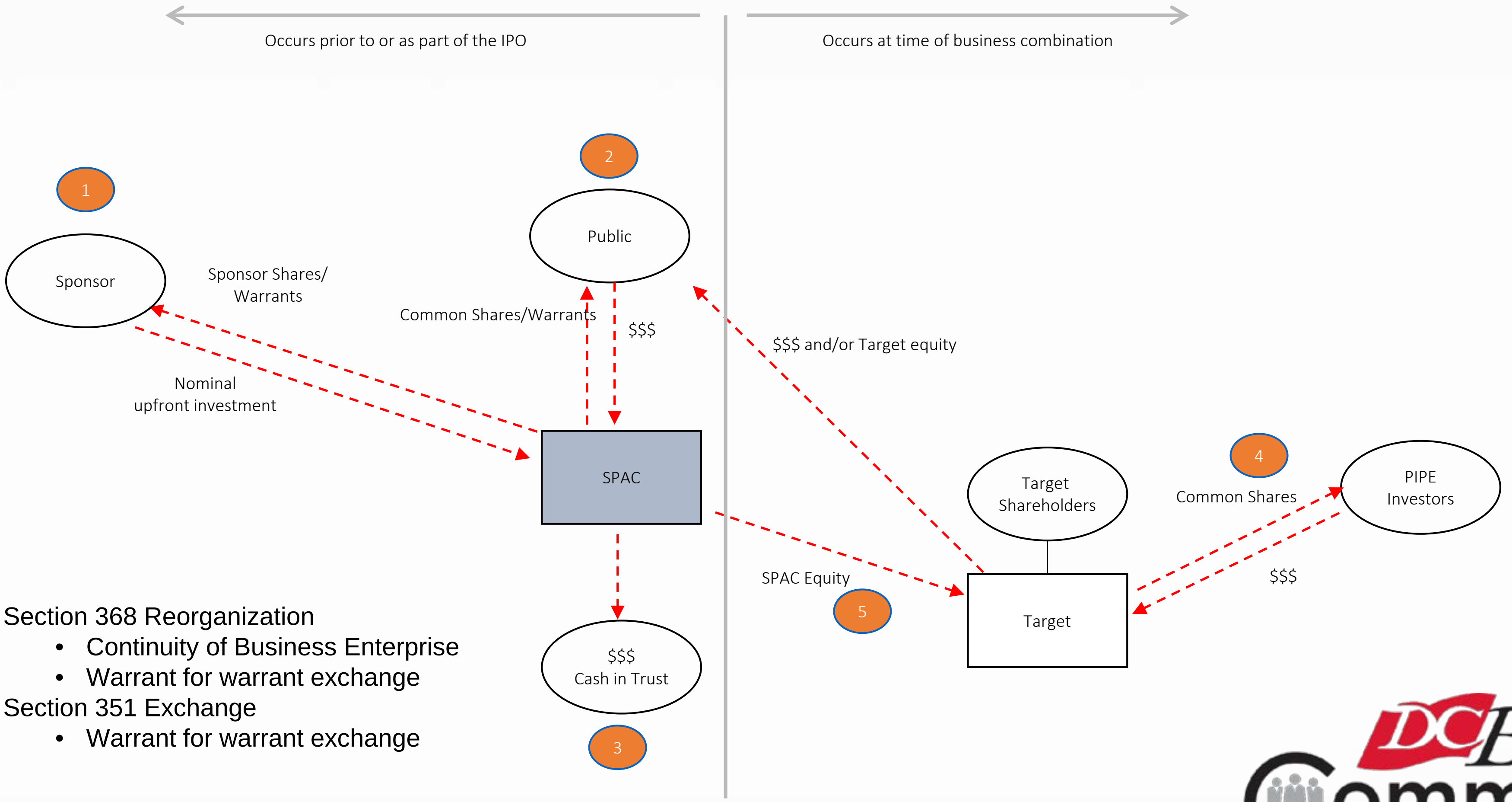
- Under the "start-up exception" in Section 1298(b)(2), a corporation is not a PFIC if:
  - in its "start-up year" (defined as the first taxable year it earns gross income), no predecessor corporation was a PFIC;
  - it establishes, to the satisfaction of the IRS, that it will not be a PFIC in either of the two succeeding years; and
  - it is not in fact a PFIC for either succeeding year
- What result if, in year 1, SPAC earns no income but "fails" the Asset Test?
  - If no income is earned prior to the business combination (i.e., because IPO funds are deposited in a non-interest bearing trust), the start-up exception is available
- What result if, in year 1, SPAC earns income but closes its business combination in the first quarter of year 2?
  - Year 1 will be SPAC's "start-up year"
  - The PFIC Asset Test tests asset composition on the last day of each quarter
  - Therefore, if the business combination closes before the last day of the second quarter of year 2, the SPAC would "pass" the Asset Test and Income Test in year 2, would not be a PFIC in year 2 and would satisfy the start-up exception (assuming it continues to own an active business and "passes" the PFIC tests in year 3)

De-SPACing Transactions

Typical SPAC Acquisition Structure



SPAC as a Target in the Acquisition Structure



- Section 368 Reorganization
  - Continuity of Business Enterprise
  - Warrant for warrant exchange
- Section 351 Exchange
  - Warrant for warrant exchange

Overview of Domestic-to-Domestic Transactions

- Tax considerations depend on whether a SPAC is acquiring a target for 100% cash, 100% SPAC equity or a mix of cash and SPAC equity

- A 100% cash purchase is a taxable acquisition

- If consideration is a mix of cash and stock, target sellers may expect the business combination to qualify as a tax-free reorganization under Section 368(a)

- Target sellers can achieve tax deferral in certain circumstances where target is a flow-through entity

Overview of Foreign-to-Foreign Transactions

- Since most SPACs have US persons as shareholders, there are many US tax considerations
- A foreign SPAC will likely manage “passive foreign investment company” (“PFIC”) status by satisfying certain exceptions
- Foreign SPACs are typically incorporated in the Cayman Islands or the British Virgin Islands. Immediately prior to a business combination, a foreign SPAC will typically migrate to the jurisdiction of its identified target
  - Migration transactions typically take the form of an F reorganization
  - Implicates the foreign-to-foreign reorganization rules in Section 367(b)
- If the foreign target has US sellers, they may desire to structure the business combination as a tax-free reorganization transaction
  - Implicates the potential gain recognition rules in Section 367(a)

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Domestic SPAC with a Foreign Target

- As discussed above, Sponsors seeking foreign targets typically set up foreign SPACs
- If a domestic SPAC happens to identify a foreign target, it would typically attempt to expatriate to the jurisdiction of the foreign target prior to the business combination
    - Note that simply maintaining a domestic SPAC operating the target as a foreign business would be tax-inefficient, as the foreign business would be a CFC (if organized as a corporation) or the SPAC would be subject to taxation in the foreign jurisdiction
- An expatriation transaction would typically be structured as a domestic-to-foreign F reorganization
    - The domestic SPAC is treated as transferring all of its assets to a newly-formed foreign SPAC in exchange for foreign SPAC stock which domestic SPAC distributes to its shareholders in complete liquidation. Domestic SPAC holders are treated as exchanging their domestic SPAC equity for foreign SPAC equity.
- In addition to Section 367(a), expatriations in this context implicate the anti-inversion rules contained in Section 7874 and accompanying regulations. These provisions in many circumstances prevent transactions proceeding in this manner
- "Substantial business activities" exception may apply to except from Section 7874 a Domestic SPAC combination with Foreign Target

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Foreign SPAC with Domestic Target, Generally

- Under Section 7874, an “inversion” occurs where a foreign corporation acquires substantially all of a domestic business whose former owners own 60% or more (by vote or value) of the foreign acquiring corporation after the transaction by reason of their ownership in the domestic business
- If former owners of the domestic business own 80% or more (by vote or value) of the foreign acquiring corporation, then the foreign corporation is treated as domestic for all US tax purposes
  - 60% and 80% tests are referred to herein as the “Ownership Tests”
  - Must follow special anti-inversion rules when calculating Ownership Tests, which can result in “tax” ownership that differs from actual ownership

Public Section 304 Transactions

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Section 304 - Summary

Section 304(a)(1) – Recap

- Section 304(a)(1) generally provides that, for section 302 purposes, "if one or more persons are in control of each of two corporations, and in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, then… such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock"
- "Property" does not include stock of the acquiring corporation

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Section 304 - Summary

Legislative History

- Section 302 predecessor enacted in 1939 Code "to prevent stockholders from drawing off accumulated corporate profits through the device of selling part of their stock to the corporation"
- Predecessor to section 304(a)(2) added in 1950 in response to taxpayer victory in *Wanamaker's Trust*, which "[H]as revealed a loophole through which this result can be accomplished without coming within the scope of section 115(g). Section 115(g) was held in that case to be applicable only where a corporation cancels or redeems its own stock. It was held not to be applicable when a subsidiary corporation purchased the stock of its parent corporation from the shareholders of the parent, even though the effect was, in fact, practically identical with that which would have resulted if the parent had itself purchased the stock."
- 1954 Code included section 304(a)(1) and (a)(2), with W&M explaining that where "the effect of the sale is in reality the distribution of a dividend, it will be taxed as such"

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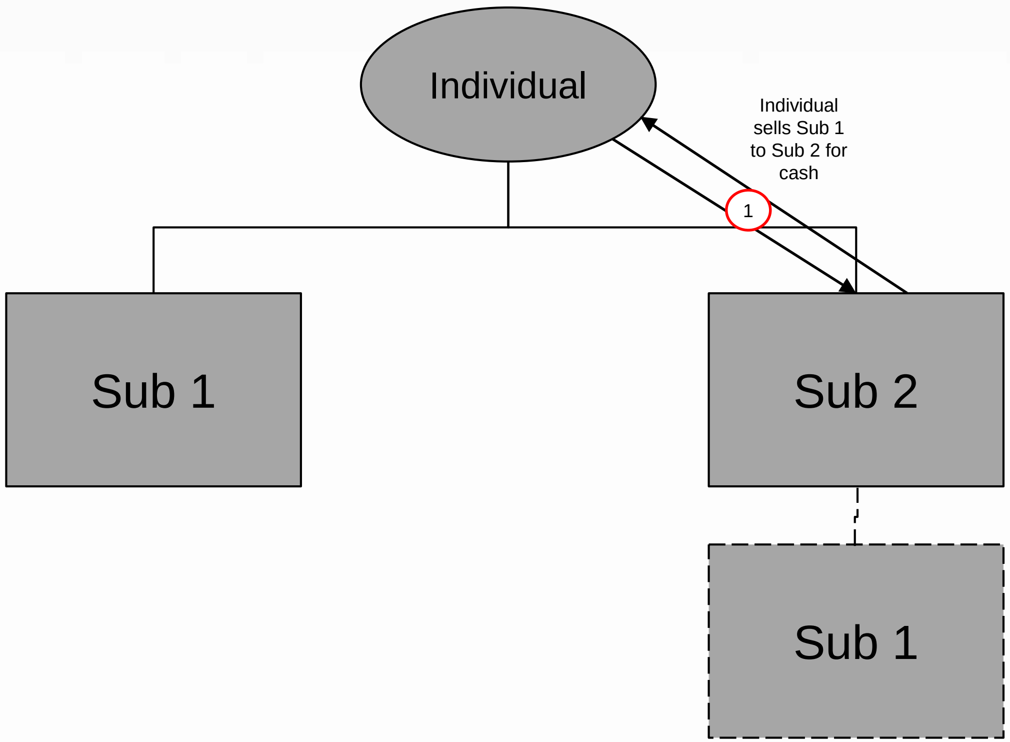
Section 304 - Summary



- Individual is in "control" of Sub 1 and Sub 2
- Cash paid by Sub 2 is "property"
- Result: Individual treated as receiving section 301 distribution, treated as a dividend from Sub 2 and Sub 1

Section 304(c) "Control"

Section 304(c) – When is the "control" requirement satisfied?

- Section 304(c) states that for purposes of Section 304 generally, "control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock..."
- Thus, section 304(c) effectively looks to whether one or more persons collectively own 50% of the vote or value of a corporation.
- The "control" analysis takes into account stock owned by any shareholder who (1) owns an interest in a target corporation (or "issuing corporation") whose stock is being sold in the transaction, (2) receives non-stock consideration in the transaction and (3) owns an interest in the purchasing corporation (or "acquiring corporation") after the transaction. Reg. § 1.304-5(b).
    - *No coordination among shareholders or minimum ownership of the issuing corporation is needed to count shareholders among the "control" group.*
- In measuring the ownership percentage of the acquiring corporation for a particular shareholder of the acquiring corporation, the acquiring corporation stock received by the shareholder as consideration in the transaction is taken into account in addition to any acquiring corporation stock owned by such shareholder prior to the transaction. Section 304(c)(2)(A).

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Application of Section 304(c) in Public M&A

Application of section 304(c) “control” test to public companies

- Need to identify whether target shareholders *as a group* control the acquiring corporation, regardless of level of ownership of target corporation
- *When* is “control” tested?
- How to identify shareholders of publicly traded companies?
  - 13G/13D/13F filings provide limited information
  - Detailed studies are available but only provide a snapshot in time and have limitations
- M&A transactions often involve significant shareholder overlap – e.g., because of index and industry-specific mutual funds and other institutional ownership
- How does IRS administratively apply these rules given limited facts?

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When is a Deemed Redemption a Section 301 Distribution?

Section 304(a)(1) – Testing Deemed Redemption for Dividend Equivalency

- Under section 304(b), whether a deemed distribution in redemption of stock results in a section 301 distribution or a section 302(a) sale or exchange is determined by reference to a stockholder's ownership of the target/issuing corporation (under section 304(b) constructive ownership rules).

- Compare a shareholder's ownership of the target corporation immediately before the transaction, and such shareholder's (constructive) ownership of the target corporation immediately after the transaction.

- In determining ownership for this purpose, constructive ownership rules apply – but no minimum amount of stock of the acquiring corporation is needed to be attributed ownership of the target corporation (by contrast, section 318(a)(2)(C) normally requires 50% stock ownership before constructive ownership applies)

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When is a Deemed Redemption a Section 301 Distribution (cont'd)?

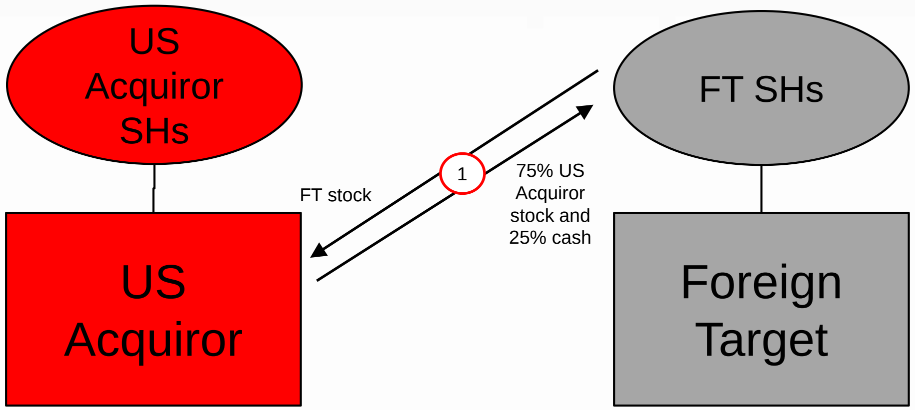
Section 304(a)(1) – Testing Deemed Redemption for Dividend Equivalency

- Although IRS rulings (Rev. Rul. 81-289) support the notion that *any* reduction in ownership by public shareholders in a widely held corporation makes a transaction exchange-equivalent instead of dividend-equivalent, what if there is *no* reduction (or an increase)?

- For every shareholder, determine whether its ownership interest *in the target* has decreased – overlapping shareholders are key

- If transaction is dividend-equivalent as to a particular shareholder, treat as deemed section 351 exchange by shareholder, followed by deemed redemption by acquiring corporation of the stock just issued

Application of Section 304 in Public M&A – US Acquiror of Foreign Target



- Transaction is structured not to qualify as a reorganization
- Has US Acquiror made a "qualified stock purchase" for purposes of section 338?
  - Generally requires acquiring 80% of Foreign Target stock by vote and value in a non-carryover basis acquisition
  - Dividend-equivalent section 304 transaction results in deemed section 351 exchange, which is not a "purchase" for section 338 purposes
- Does US Acquiror need to withhold on cash consideration to non-US shareholders of Foreign Target?
  - 30% WHT absent treaty
  - E&P study likely needed
  - Potential capital markets implications of WHT
- Note: No withholding on US Acquiror's own stock because it is not "property" for section 304 purposes

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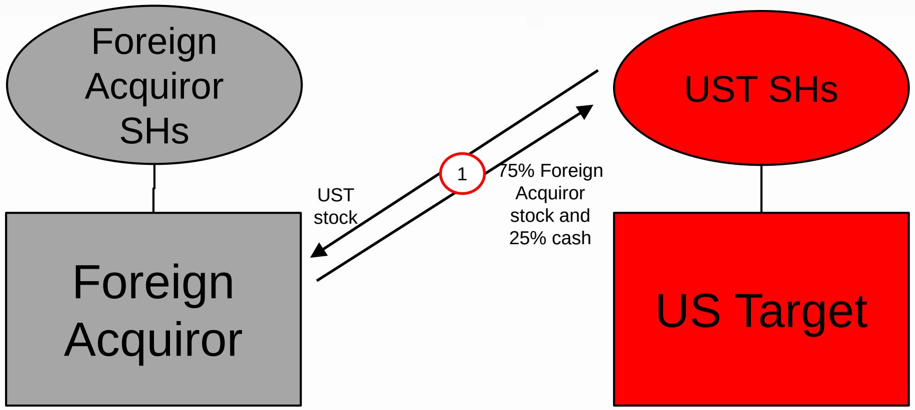
Application of Section 304 in Public M&A – Foreign Acquiror of US Target



- Transaction is structured not to qualify as a reorganization
- Does US Target need to withhold on cash consideration to non-US shareholders of US Target?
    - Section 304(b)(5) likely limits the Foreign Acquiror E&P taken into account; therefore, WHT is determined by reference to US Target E&P

Application of Section 304 in Public M&A

Does any of this make sense? What policy options are there for guidance?

- Change the way "control" is determined for publicly traded companies – simplified counting conventions
  - Only count significant shareholders (e.g., >5% owners or section 355(e)-like "controlling shareholders") or decision-makers (directors/officers)
  - Provide guidance on determining control (e.g., available sources of information such as SEC filings) – e.g., Reg. § 1.355-6(f) (reliance on SEC filings for section 355(d) filings absent actual knowledge to the contrary)
  - Provide guidance for time of counting (e.g., latest SEC filings as of the *signing date* or closest date to closing date)
- Extend section 302(b)(1) guidance (e.g., Rev. Rul. 81-289) to treat more fact patterns involving public shareholders as "not essentially equivalent to a dividend"
- Is Treasury/IRS open to guidance narrowing the application of section 304 in public M&A in light of changes in securities markets (more stock in street name) and administrability concerns?
  - See, e.g., Rev. Proc. 2011-35 (statistical sampling procedure following public "B" reorganization)

Foreign Tax Credit Issues in M&A

Nonresident Capital Gain Taxes
&
Tax Refund Issues

Recent Foreign Tax Credit Guidance

- On September 29, 2020, the IRS and Treasury released an unofficial advance copy of final regulations ("2020 Final Regulations") and proposed regulations ("2020 Proposed Regulations") relating to the determination of the foreign tax credit ("FTC").

- The 2020 Final Regulations and the 2020 Proposed Regulations were published in the Federal Register on November 12, 2020.

- The 2020 Proposed Regulations contain newly proposed and re-proposed guidance where the government materially revised their approach.

Recent FTC Guidance: What is a Creditable Tax?

- The 2020 Proposed Regulations, which would apply to taxable years beginning after finalization, revise 1983 final regulations issued addressing when a foreign tax will be treated as creditable for US purposes.
- The 2020 Proposed Regulations retain the framework of the current final section 901 and 903 regulations, requiring a foreign tax to meet the following requirements to qualify as a creditable foreign income tax:
  - Payment must be a tax: taxpayer does not receive specific economic benefit or subsidy because of the payment;
  - Tax must have a realization requirement under U.S. tax principles;
  - Gross receipts: tax must be imposed on actual gross receipts or on gross receipts computed under a method not likely to overstate them; and
  - Net income: tax must provide for a recovery of costs and expenses
- Otherwise creditable foreign taxes are not considered paid to the extent the amount is eligible to be refunded, credited, rebated, abated or forgiven.

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Recent FTC Guidance: What is a Creditable Tax?

- The 2020 Proposed Regulations retain the framework of the current final section 901 and 903 regulations, requiring a foreign tax to meet the following requirements to qualify as a creditable foreign income tax:
  - The realization requirement;
  - The gross receipts requirement; and
  - The net gain (renamed cost recovery) requirement

Proposed New Requirement: “Jurisdictional Nexus”

- FTCs historically limited to application against foreign income, war profits, excess profits, or “in-lieu-of” taxes.
- In recent years, Treasury has observed a trend of foreign nations “adopting a variety of novel extraterritorial taxes that diverge in significant respects from traditional norms of international taxing jurisdiction as reflected in the Internal Revenue Code.” 85 Fed. Reg. 42078, 72088.
- “To qualify as a creditable income tax, the foreign tax law must require a sufficient nexus between the foreign country and the taxpayer’s activities or investment of capital or other assets that give rise to the income being taxed.” 85 Fed. Reg. 42078, 72088.

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Proposed New Requirement: "Jurisdictional Nexus"

- To be a creditable foreign tax, there must be a sufficient ***jurisdictional nexus*** between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income subject to tax.
- Prop. Treas. Reg. § 1.901-2(c) provides that taxes on ***nonresidents*** must satisfy one of three tests:
  - Income subject to tax is attributable to nonresident's <u>activities</u> in the foreign country and not based, e.g., on location of customers;
  - Income is taxable because it arises from <u>sources</u> in the foreign country (foreign sourcing rules must be "reasonably similar" to US rules); *or*
  - Income is from sale or disposition of <u>property</u> that is real property located in foreign country or moveable property associated with a taxable presence.

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Proposed New Requirement: “Jurisdictional Nexus”

- Apparent focus is on extraterritorial tax regimes where income of a nonresident is taxed based on location of customers in the foreign country but may also apply to other tax regimes.

- Jurisdictional nexus requirement would apply to newly imposed digital services taxes in many jurisdictions (see, e.g., Austria, France, Hungary, Italy, Japan, Poland, South Korea, Spain, Turkey, and the UK).

- ***BUT***, as written, would likely also apply to jurisdictions with direct or indirect **nonresident** capital gains taxes (see, e.g., Argentina, Mexico, Peru, Saudi Arabia and Spain).

"Jurisdictional Nexus" and Capital Gains

- Income from sales or other dispositions of property by nonresidents that do not meet the activities requirement in proposed § 1.901–2(c)(1)(i) satisfy the jurisdictional nexus requirement only with respect to gains on the disposition of real property in the foreign country or movable property forming part of the business property of a taxable presence in the foreign country (or from interests in certain entities holding such property). *See* Prop. Treas. Reg. § 1.901-2(c)(iii).
- Treasury and the IRS believe that "[the above] rule is consistent with the fact that Federal income tax law generally does not tax gains of nonresidents that do not have a trade or business in the United States. See, for example, section 865(a)(2) and (e)(2); § 1.871–7(a)(1); see also U.S. Model Income Tax Convention (2016), Art. 13." 85 Fed. Reg. 42078, 72088.

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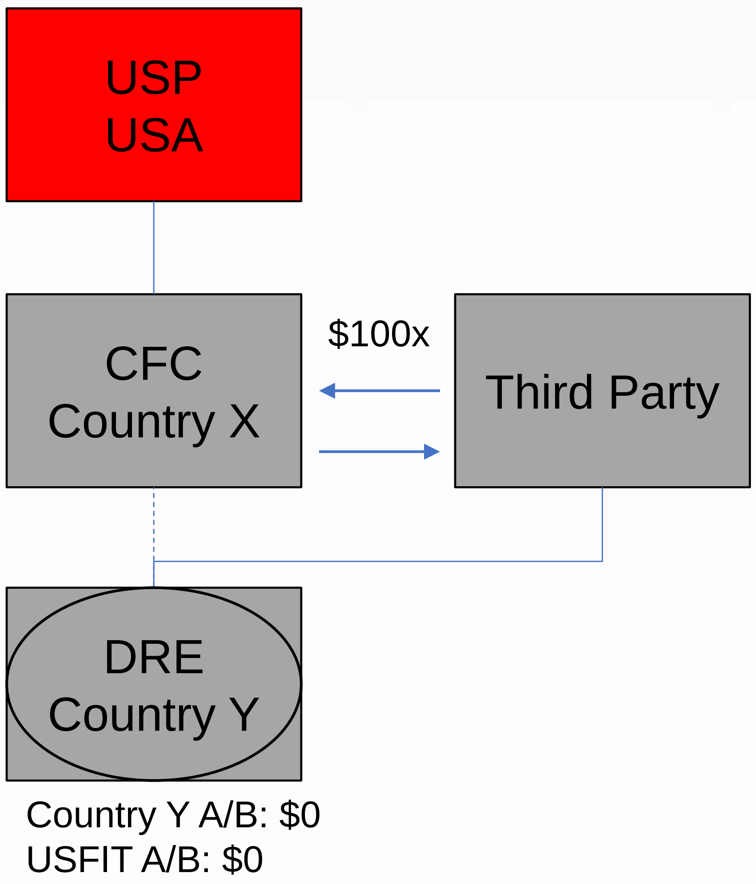
“Jurisdictional Nexus” Capital Gains Example



- USP wholly owns CFC in Country X, which wholly owns DRE in Country Y
- CFC sells DRE to a third party buyer for $100x
- As CFC is a nonresident, CFC is subject to Country Y’s nonresident capital gains tax on the sale
- Assumptions:
  - No Country Y real property in DRE
  - USFIT GILTI Effective Rate: 10.5%
  - Country Y’s nonresident Capital Gain Tax Rate: 20%
  - CFC is eligible for Country X’s 100% participation exemption on the sale of DRE
- Result: $30.50x tax on sale ($20x tax in Country Y + $10.50x tax in US). No U.S. FTC available under Prop. Treas. Reg. § 1.901-2(c)(iii).

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Refunds and FTCs

- Issues may arise when the taxpayer that pays a foreign tax is not owned by such taxpayer at the time such tax is refunded.
- The 2020 Final Regulations provide that even if, at the time of a foreign tax redetermination, the person with the legal right to a refund is a different person than the person that had legal liability for the tax in the year to which the redetermined tax relates (the ''original taxpayer''), the original taxpayer is treated as receiving the refund in the year to which the refunded tax relates. Treas. Reg. § 1.905–3(b)(3).
- Thus, the original taxpayer must reduce its foreign taxes for FTC purposes even when the refund was received and retained by another taxpayer.

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Refunds and FTCs: M&A Negotiation Point

- When negotiating tax provisions of an M&A agreement, tax refunds may or may be returned by the buyer/target to the seller. Under Treas. Reg. § 1.905–3(b)(3), the buyer's/target's retention of a tax refund from a pre-closing period is more costly than under prior law.
- If buyer/target retain refund, USP of seller still must amend relevant year return and reduce its foreign taxes (and correspondingly, its available FTCs).
- What if buyer/target does not notify seller of post-closing refund? Is there a duty to inquire? Perhaps similar to section 958(b)(4) repeal don't ask, don't tell approach of Rev. Proc. 2019-40?

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Final Section 245A Regulations

Extraordinary Reductions

Extraordinary Reduction Amount

- The ineligible amount includes 100% of the ER amount [Reg. 1.245A-5(b)(2)(ii)].

- If an extraordinary reduction occurs, the ER amount, with respect to a dividend received by a controlling section 245A shareholder of a CFC, is equal to the lesser of:
  - The amount of the dividend; and
  - The sum of the 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 Reduction

- An ER occurs if either:
  - The controlling section 245A shareholder transfers, directly or indirectly, CFC stock representing more than 10 percent (value) of the CFC stock owned, directly or indirectly, as of the beginning of the CFC's tax year (and at least 5 percent of the total by value) (10% transfer event); or
  - As a result of one or more transactions, the controlling section 245A shareholder's ownership in the CFC as of two dates is reduced by more than 10 percent (value) and at least 5 percent of the total value (10% dilution event).
- The following exceptions apply:
  - E and F reorganizations are not 10% transfer events [Reg. 1.245A-5(e)(2)(i)(A)(1)].
  - Transactions pursuant to which the CFC's taxable year ends (e.g., section 332 liquidations; A, C and D reorganizations), so long as the section 245A shareholder directly or indirectly owns the stock on the last day of the year, are not 10% transfer events [Reg. 1.245A-5(e)(2)(i)(C)].
  - If the controlling shareholder makes an election to close the CFC's tax year for all purposes of the Code as of the end of the date on which the extraordinary reduction occurs, no amount is considered an ER amount [Reg. 1.245A-5(e)(3)(i)].

Pre-Reduction Pro Rata Share

- The pre-reduction pro rata share of a controlling section 245A shareholder with respect to a CFC is:
  - The shareholder's pro rata share of the CFC's subpart F income or tested income, determined based on the shareholder's direct or indirect ownership immediately before the ER;
  - Without regard to section 951(a)(2)(B) and Reg. 1.951-1(b)(1)(ii);
  - But only to the extent that such subpart F income or tested income is not included in the controlling section 245A shareholder's pro rata share of the CFC's subpart F income or tested income.
- This amount is reduced to the extent U.S. tax residents' pro rata shares of subpart F income or tested income is increased as a result of a transfer of stock of the CFC by the controlling section 245A shareholder or an issuance of stock by the CFC.

Prior Extraordinary Reduction Amount

- A prior ER amount is the sum of the ER amounts of each prior dividend received by the section 245A shareholder from the CFC during the taxable year; *plus*
- A prior dividend received by the section 245A shareholder to the extent that the dividend was not eligible for the section 245A deduction by reason of section 245A(e) or the holding period requirement of section 246 not being satisfied (but would have been an ER amount); *plus*
- The portion of a prior dividend received from the CFC by an upper-tier CFC that was included in the section 245A shareholder's income by reason of section 245A(e) (but would have been an ER amount); *plus*
- The portion of a prior dividend received from the CFC by an upper-tier CFC during the taxable year that is a tiered ER amount and that is included in the income of the section 245A shareholder by reason of section 951(a).

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Elective Exception to Close CFC's Taxable Year

- If each controlling section 245A shareholder elects to close the CFC's tax year for all purposes of the Code as of the end of the date on which the ER occurred.
- Then no amount is considered either an ER amount or tiered ER amount.
- For purposes of applying this rule, a controlling section 245A shareholder is treated as owning the same amount of stock it owned immediately before the ER (except for purposes of determining the shareholders that must enter into a binding commitment).
- Consequence of closing the year is generally to cause US shareholders of the CFC to include subpart F income and tested income that accrues prior to the ER.
- Foreign taxes are allocated:
  - To the pre-reduction year and the post-reduction year;
  - Based on the respective portions of the taxable income of the CFC attributable to the periods; and
  - Under the principles of Treas. Reg. 1.1502-76(b); which is
  - Consistent with the treatment of mid-year transfers of disregarded entities under Treas. Reg. 1.901-2(f)(4).
- Election is made with the original tax return of each controlling section 245A shareholder, subject to a transition rule for ERs that occurred before the publishing of the regulations.
- To make the election, all controlling section 245A shareholders and each other US tax resident that is a US shareholder of the CFC must enter into a binding commitment to close the CFC's year.

ER Rule: Making the election to close CFC's year
Treas. Reg. §1.245A-5(e)(3)

- Summary of requirements to make election to close the year of a CFC:
  - An extraordinary reduction occurs with respect to a CFC;
  - There would be an extraordinary reduction amount (or tiered extraordinary reduction amount);
  - All controlling Section 245A shareholders / certain U.S. tax residents elect and enter into a binding commitment to close the year (includes both sellers <u>and</u> buyers); and
  - Consistency requirements are observed (multiple ERs / multiple CFCs).

- How is binding agreement condition satisfied when there is one controlling section 245A shareholder before the sale, and no controlling section 245A shareholders after sale?
  - Binding commitment requirement?
  - Election statement requirement?

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