TEI's 76th Annual Conference

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Current Trends in M&A Taxation

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EMBRACING the CERTAINTY of CHANGE

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Agenda

1. Legislative Changes Impacting M&A
2. Special Purpose Acquisition Companies (SPACs)
3. NOLs
4. Other Considerations in M&A
5. Financing & Cross Border Aspects of M&A

Legislative Changes Impacting M&A

Significant Ways and Means Bill Provisions

- **Corporate Tax Rate Increase** - Replace 21% flat rate with a graduated rates with a maximum of 26.5% on income over $5 million. Applicable to taxable years beginning after December 31, 2021, with weighted average rate for fiscal years that include December 31, 2021.
  - Effects on M&A include increasing the incentive to structure transactions as taxable asset acquisitions, increasing the value of NOLs and other tax attributes
  - Also consider impact of capital gain rate changes on M&A
- **Section 163(j) Interest Expense Limitation Changes**
  - Carryforward limited to 5 years (absorption on FIFO basis).
    - Effects on M&A include increasing the potential cost/planning with respect to debt financing of acquisitions (together with existing change from EDITDA limit to EBIT limit in 2022).
  - Section 163(j) limits will apply at the partner or shareholder level for pass-through entities instead of at the entity level.
  - New Section 163(n) would limit the interest deduction of domestic corporations which are members of an international financial reporting group to 110% of the net interest expense for the group.
  - Applicable to taxable years beginning after December 31, 2021.

Significant Ways and Means Bill Provisions

- **Research and Experimentation Expenditures** – Delay effective date of the requirement to amortize research and development expenditures to taxable years beginning after December 31, 2025 (from December 31, 2021).
  - Effects on M&A include increasing the value of heavy R&D businesses
- **Section 165(g) Changes**
  - Section 165(g) modified to treat losses as realized on the day that the event establishing worthlessness occurs rather than the last day of the year.
  - Treat partnership indebtedness in the same manner as corporate indebtedness and losses on a worthless partnership interest as a sale of a partnership interest.
  - Applicable to taxable years beginning after December 31, 2021.

Significant Ways and Means Bill Provisions

- **Section 355 (Spin Off) Changes** - Amend Section 361 to limit the use of Spinco's securities to reduce Distributing's debt without recognizing gain to the basis of the assets contributed to Spinco (reduced by assumed liabilities and cash paid by Spinco to Distributing). This provision applies to transactions after the date of enactment.
  - Possible effects on M&A include reducing the ability to use spin offs to monetize the value of the distributed business.
- **Portfolio Interest Exemption** - In the case of an obligation issued by a corporation, any person who owns 10% or more of the total vote or value of the stock of such corporation is not eligible for the portfolio interest exemption. This amendment applies to obligations issued after the date of enactment.

Significant Ways and Means Bill Provisions

- **Limitation on Excessive Employee Remuneration** – Move up the effective date of the amendment to Section 162(m) to tax years after December 31, 2021 (from December 31, 2026) to expand the set of applicable employees of publicly held companies to include the eight most highly compensated officers other than the principal executive and principal financial officers for a taxable year.
- **S Corporation to Partnership Conversions** – Allow S corporations incorporated on or before May 13, 1996 to reorganize as partnerships in a tax-free transaction. Applicable to S corporations that completely liquidate and transfer substantially all assets and liabilities during the two-year period beginning on December 31, 2021.
  - Effects on M&A include increase in partnership acquisition structures, including Up-C IPOs and Up-SPACs

Significant Ways and Means Bill Provisions

- **Amend Section 1202 Exclusion** – Eliminate the 75% and 100% exclusions for Qualified Small Business Stock for any taxpayer (1) whose adjusted gross income (AGI) equals or exceeds $400,000; or (2) that is a trust or estate. In addition, for alternative minimum tax purposes, 7% of the excluded gain is an addback (i.e., tax preference item).
- Consider reaction of Ways and Means to addition of **Wyden Bill Partnership provisions** from the Senate**.**

Significant Ways and Means Bill Provisions (International)

- **GILTI Changes (generally, applicable to taxable years beginning after December 31, 2021)**
  - Section 250 Deduction – Reduce deduction for GILTI from 50% to 37.5% and, if the Section 250 deduction exceeds taxable income, the excess is allowed to increase the current year NOL.
  - Qualified Business Asset Investment (QBAI) Exemption – QBAI reduced from 10% to 5% (remains 10% in U.S. territories).
  - Country-by-Country – Calculated on a country-by-country basis.
  - Treatment of Foreign Losses – Country-specific net tested loss can be carried forward to succeeding tax year.
- **FDII (generally, applicable to taxable years beginning after December 31, 2021)**
  - Section 250 Deduction – Reduces the FDII deduction to from 37.5% to 21.875%, applicable to taxable years beginning after December 31, 2021.
- **BEAT (generally, applicable to taxable years beginning after December 31, 2021)**
  - Rate - Increase rate to 10% for tax years beginning after December 31, 2021, and before January 1, 2024, then 12.5% for tax years beginning before January 1, 2026, and 15% thereafter.
  - Multiple modifications to the determination of taxable income, including the treatment of payments to foreign parties that are included in COGS.

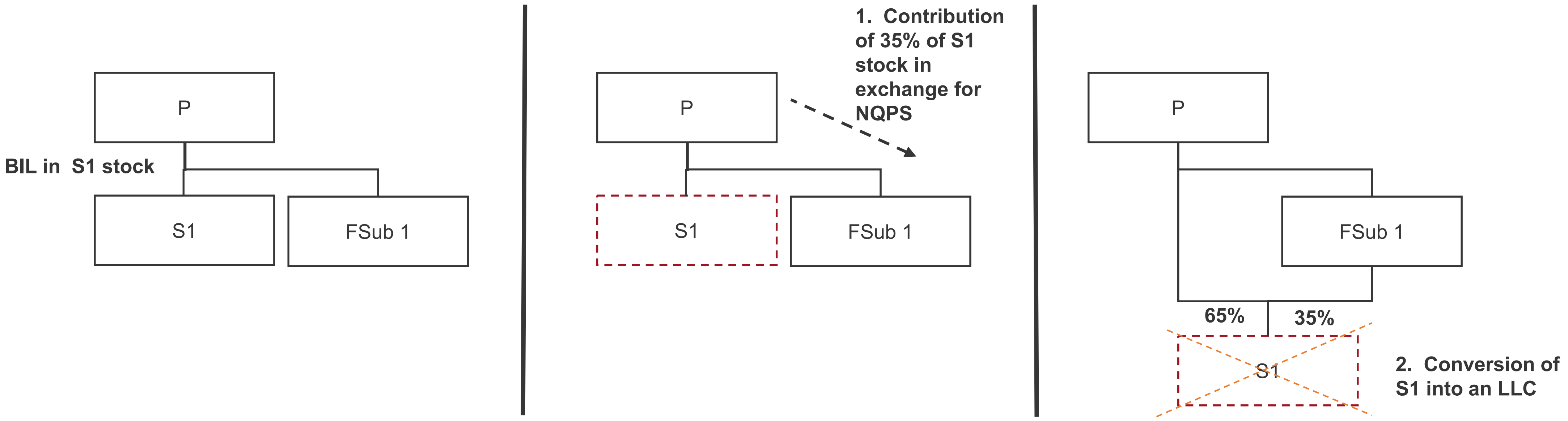
Significant Ways and Means Bill Provisions (International)

- **Various Subpart F and Foreign Tax Credit Changes, including**
  - FTC Limitation – FTC determined on a country-by-country basis.
  - FTC Carryovers – Excess FTCs carryforward period is reduced from 10 years to 5 years and the one-year carry back of excess FTCs is repealed.
- **CFC Dividends**
  - Section 245A DRD – Amend Section 245A so that the exemption applies to foreign portions of dividends received only from CFCs.
  - Extraordinary Dividends – Adds new Section 1059(g), which treats any CFC dividend from E&P earned while the foreign corporation was NOT a CFC as an extraordinary dividend, requiring a reduction in stock basis, without regard to the period the taxpayer held the stock.
- **CFC Year-End**
  - Section 898 – Repeals the provision that permits CFCs to have a year-end that permits a one-month deferral for its US shareholder.

Significant Ways and Means Bill Provisions

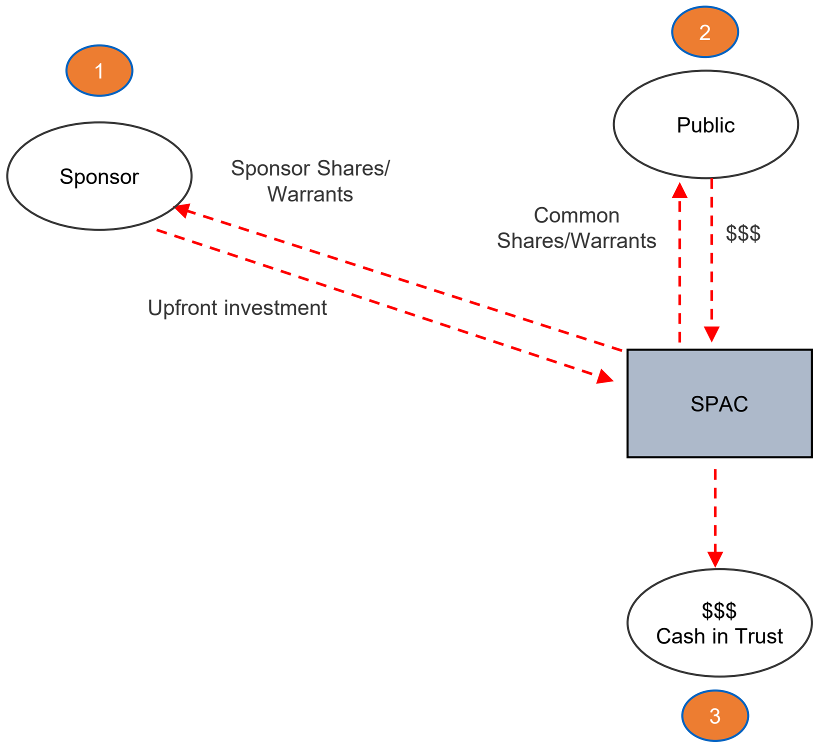
- **Section 267 Change for "Granite Trust" Transactions --**

  For taxable liquidations under Section 331, if the corporate shareholder is related (e.g., owns more than 50%), the stock loss is deferred until the corporate shareholder disposes of substantially all of the assets received in the liquidation to an unrelated party.



Special Purpose Acquisition Companies (SPACs)

Typical SPAC IPO structure



Overview of jurisdictional considerations

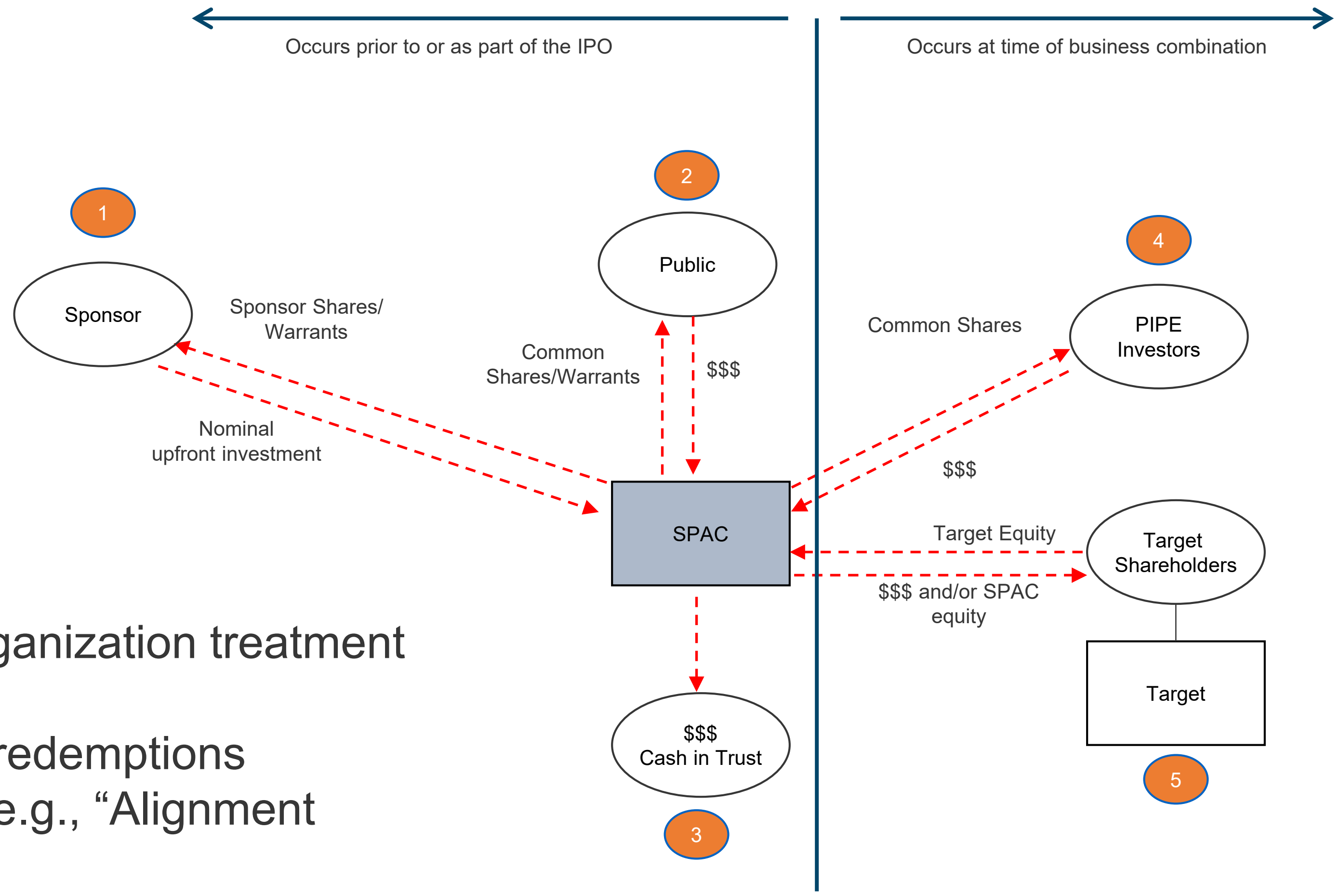
- Sponsors in the market for targets based in the United States generally form a domestic SPAC (a "domestic-to-domestic" transaction).. By comparison, Sponsors in the market for foreign targets generally form a foreign SPAC (a "foreign-to-foreign" transaction)
- Choice of jurisdiction for SPAC and the legal identity of the Target are highly relevant to the tax efficiency of the company post-de-SPAC
- But, the preferred organizational structure for the ultimate target corporation / business will not be known at the time of the SPAC formation and IPO because the de-SPAC target is still TBD
- But a common challenge is that the de-SPAC target will not have been identified at the time of the IPO – so, in some cases, the U.S. SPAC will end up pursuing a foreign target or a foreign SPAC will pursue a U.S. target

Type of SPAC	Type of Acquisition Target	General Post-Acquisition Topco Structure
U.S. Corp	**U.S. Corp**	▪ U.S. Corporation
U.S. Corp	**U.S. Partnership** (or other flow-thru equivalent)	▪ U.S. Corporation, unless business eligible to operate in MLP format ▪ Seller may prefer an Up-C structure
U.S. Corp	**Foreign Corp**	▪ Foreign Corporation ▪ Subject to complying / addressing U.S. anti-inversion rules
Foreign Corp	**U.S. Corp**	▪ U.S. Corporation
Foreign Corp	**U.S. Partnership**	▪ U.S. Corporation (unless possibly PTP eligible) ▪ Seller may want an Up-C structure
Foreign Corp	**Foreign Entity / Business**	▪ Foreign Corporation

SPAC M&A – Follow Many Traditional Paths

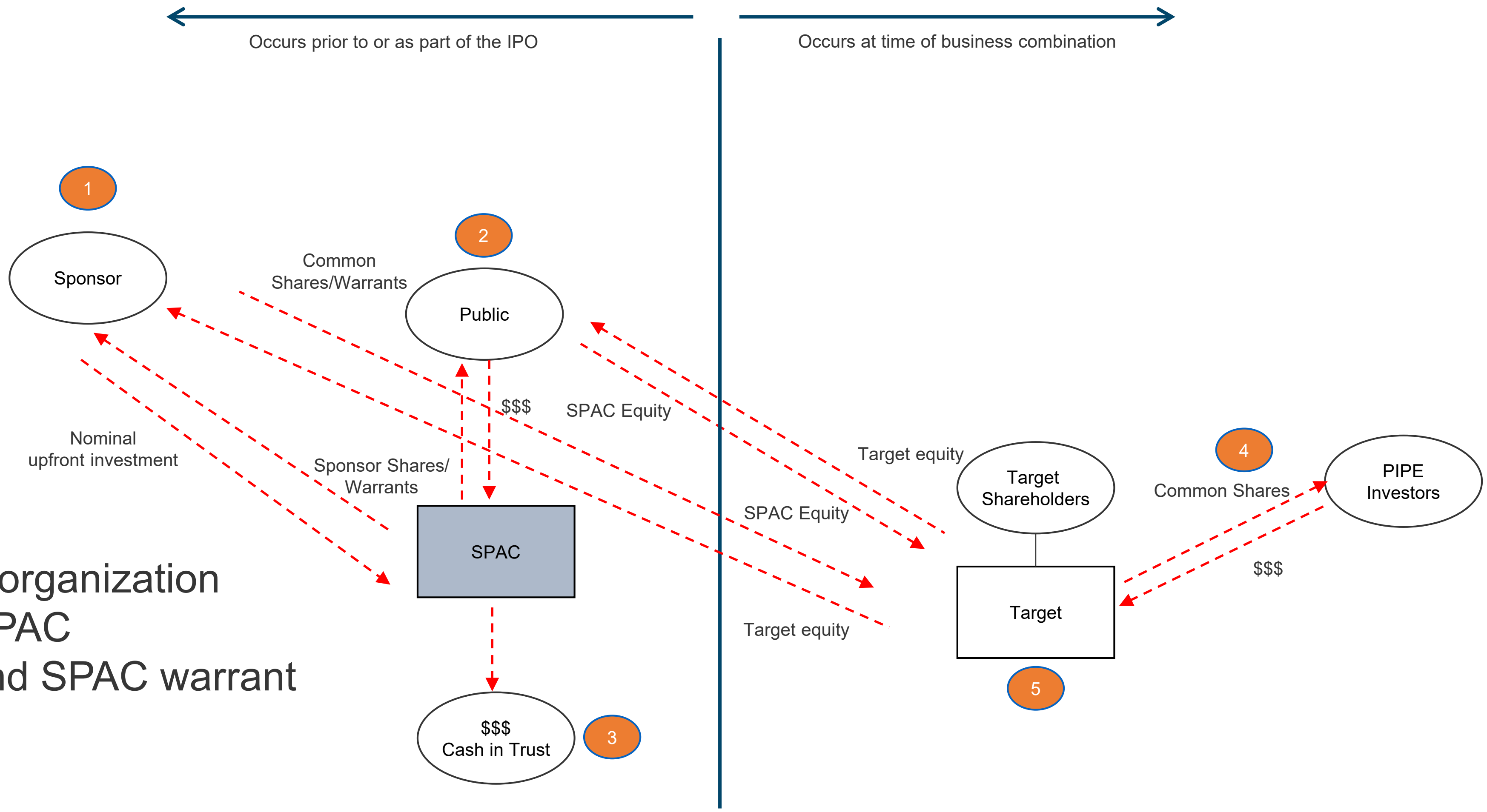
- **Most M&A structures that can be used in a typical M&A transaction can also be used in the context of the "de-SPAC" transaction**
- **Many de-SPAC transactions are designed to qualify for tax-free treatment – exactly what you'd expect since the Target often retains / receives a large equity stake and relatively little or no cash**
- **Three primary ways for the *Target* side to enjoy a non-taxable or tax-free transaction where the Target is a corporation**
  - Target formally acquires SPAC
  - SPAC acquires Target in ***a tax-free reorganization***
  - SPAC and Target combine in a ***Section 351 transaction***
- **SPAC side also prefers non-taxable or tax-free transaction from its perspective – SPAC shareholders and warrant holders do not receive any cash in the de-SPAC transaction (unless they exercise their redemption right)**
- **Numerous aspects of the U.S. tax laws may affect the abilty of the parties to achieve the intended and/or preferred tax treatment**
- **Cross-border transactions add additional complexity – sometimes, substantial complexity**

Typical SPAC acquisition structure



- Section 368 reorganization treatment to Target
- Tax treatment of redemptions
- Sponsor issues (e.g., “Alignment Shares”)
- Opinion practice

SPAC as a target in the acquisition structure



- Section 368 reorganization treatment to SPAC
- Section 351 and SPAC warrant holders

NOLs

§382 Background

- Limits a "loss corporation"
- That undergoes an "ownership change"
    - An ownership change occurs if immediately after an ***owner shift*** or an equity structure shift - The percentage ***by value*** of stock of the loss corporation owned by one or more
      5-percent shareholders has increased by more than ***50 percentage points*** over the lowest percentage ownership of such shareholders
- During a 3-year "testing period"
- From utilizing "pre-change losses" or other tax attributes
- Against "post-change" income

Equity Under §382

- What generally counts as "equity" when determining a §382 ownership change?
  - Common stock
  - Convertible preferred stock
  - Voting preferred stock
  - Can include non-stock equity instruments

Stock not Treated as Equity Under §382

- What generally does NOT count as "equity" when determining a §382 ownership change?
- Plain vanilla preferred stock (§1504(a)(4) stock)
  - Not entitled to vote
  - Not convertible
  - Limited and preferred as to dividends
  - Does not participate in corporate growth
  - Redemption and liquidation rights do not exceed issue price

PLR 202131005

Facts:

- Taxpayer issued units of Instrument I and Instrument II to Shareholder A for cash (Instrument II was not addressed).
- Instrument I (i) has no right to vote for any members of the board of directors, (ii) provides for (A) cumulative dividends at a fixed rate and (B) a liquidation right, and (iii) is perpetual and callable upon or after Date 3.
- Taxpayer expected to redeem Instrument I upon Date 3 at the time of issuance.
- The dividend rate as well as the redemption price can be increased as a result of certain limited actions by Taxpayer, and (ii) Taxpayer has the right to pay dividends at its election in common stock, neither were expected to occur as of the issue date.
- *The maximum number of units of Instrument I that can be transferred to carry out Action I is I% of units held by Shareholder A and J% of the units of Instrument I cannot be transferred to carry out Action I.*

Representations:

- At the issuance date, Taxpayer expected that it would be able to make all quarterly payments of dividends on Instrument I and redeem Instrument I on Date 3.
- The terms of Instrument I and Instrument II were established without Taxpayer giving any consideration to the possible application of section 382 at any point in time.

Rulings:

- J% of the units of Instrument I will not constitute stock within the meaning of either section 382(k)(6)(A) or Treas. Reg. §1.382-2T(f)(18).
- I% of the units of Instrument I will constitute stock within the meaning of section 382(k)(6)(A).

Application of §382 to CFCs

- §951A provides that a U.S. shareholder of any Controlled Foreign Corporation (CFC) is required to include its pro rata share of GILTI in it's annual reportable Gross Income.
- §1.951-2(a)(1) - the gross income of a foreign corporation for any taxable year shall be determined by treating such foreign corporation as a domestic corporation
    - Does the CFC meet the definition of a "loss corporation"?

§382(e)(3)

- §382(e)(3) states that the value of a foreign corporation which is a loss corporation only takes into account those items which are effectively connected with the conduct of a U.S. trade or business.
- How does section 382(e)(3) apply if no ECI but GILTI?
- If a CFC doesn't have ECI, does section 382(e)(3) mean that the section 382 limitation is zero in the absence of regulations?
- Potentially impacted attributes
    - CFC section 163(j) BIE carryovers
    - CFC NUBIL
    - CFC NUBIG

§165(i)

- On March 13, 2020, the COVID pandemic was declared an "emergency" under the Robert T. Stafford Disaster Relief and Emergency Assistance Act and each state received a disaster declaration beginning on January 20, 2020 and moving forward
- Under §165(i), any loss occurring in a disaster area and attributable to a federally declared disaster warranting assistance by the federal government may, at the election of the taxpayer, be taken into account for *the taxable year immediately preceding the taxable year in which the disaster occurred*
- Certain losses attributable to COVID-19 after March 13, 2020 may be claimed in 2020 but accelerated back to 2019
- The CARES Act provided for a five year carryback (absent election) for NOLs arising in tax years beginning after December 31, 2017 but before January 1, 2021
- Is §165(i) intended to apply to worthless stock deductions if the worthlessness was attributable to the impact of COVID-19?
- How do you take into non-US operations?

Other Considerations In M&A

Practical Concerns

- Opinions v. rulings in M&A transactions
- Continued importance of financial statements
- Strategic v. financial buyers
- Rep & Warranty Insurance – Specific tax risks?

§1202

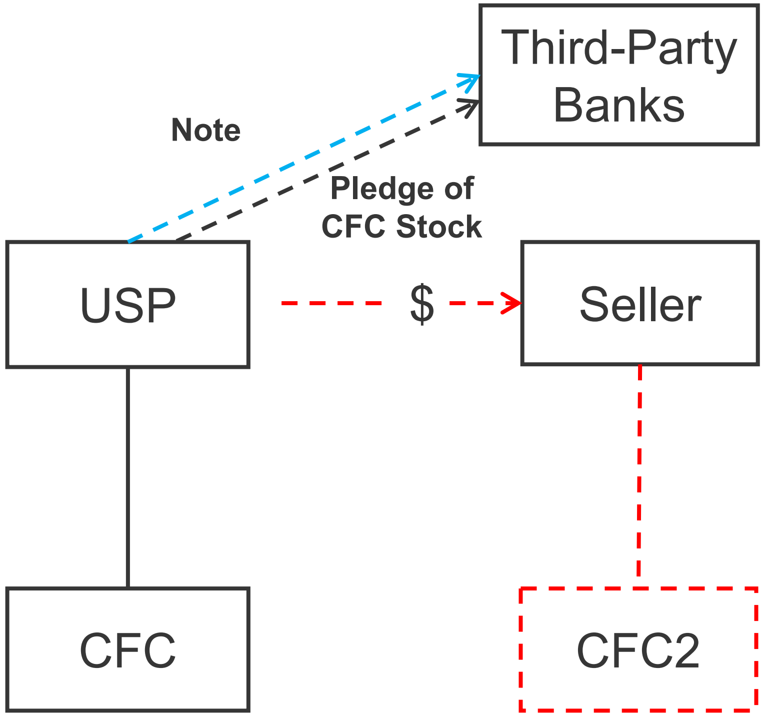
- Individual's sale of "Qualified Small Business Stock" is excluded from gain for federal income tax purposes if held for more than 5 years for issuances after 2015
  - Exclusion is limited to $10M or 10x shareholder's adjusted basis
  - Must be an original issuance (can rollover - §1045)
- Must be a domestic C corporation with aggregate gross assets of less than $50M
  - What if C corporation owns a CFC?
- Active trade or business test (at least 80% of value is from a qualified active trade or business) at all times
- Legislation would limit gain exclusion to 50% and include the gain in AMT for sales after September 13, 2021 for taxpayers with $400,000 or more of AGI

Financing & Cross Border Aspects of M&A

International Tax Considerations for M&A Transactions

- Anti-Inversion Provisions / Direction of Merger
- US “Participation” Exemption for Earnings
- FDII / GILTI + QBAI / BEAT
- Shrinking FTC
- Local Country Tax Considerations
- Treaty Considerations
- CFC

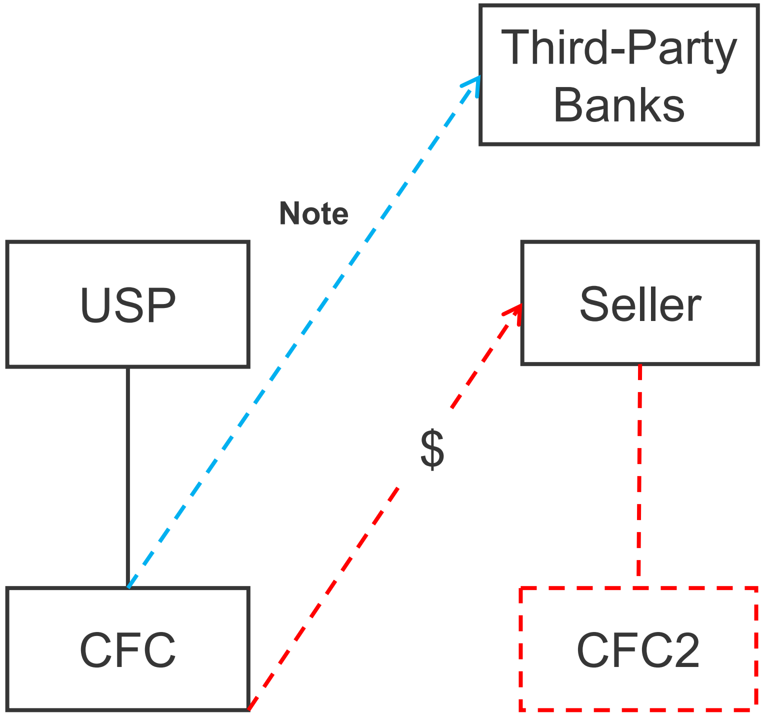
Third-Party Financing Considerations



- **Interest Expense Limitation** – New Section 163(j) caps interest expense to 30% of EBITDA (EBIT in 2022)
  - Applies to third-party debt as well as intercompany debt
  - Very broad and also limits deductions for payments or accruals that are economically equivalent to interest such as OID, repurchase premium, and unstated interest on deferred consideration
  - Section 163(j) limitation is determined at the consolidated group level

- **Credit Support from CFCs and Section 956**
  - Under Section 956, certain guarantees from and pledges of CFC assets or stock triggered deemed Section 956 inclusions
    - Effective safe harbor for pledge of less than 66.67% of top-tier foreign subsidiary voting stock
  - Under prior law, a deemed dividend under Section 956 was ineligible for a DRD
  - Final regulations issued in May 2019, however, limit the application of Section 956 significantly
  - The regulations generally provide that the amount otherwise determined under Section 956 is reduced to the extent the US shareholder would have been allowed a deduction under Section 245A had the US shareholder received an actual distribution from the CFC equal to the amount determined under Section 956.

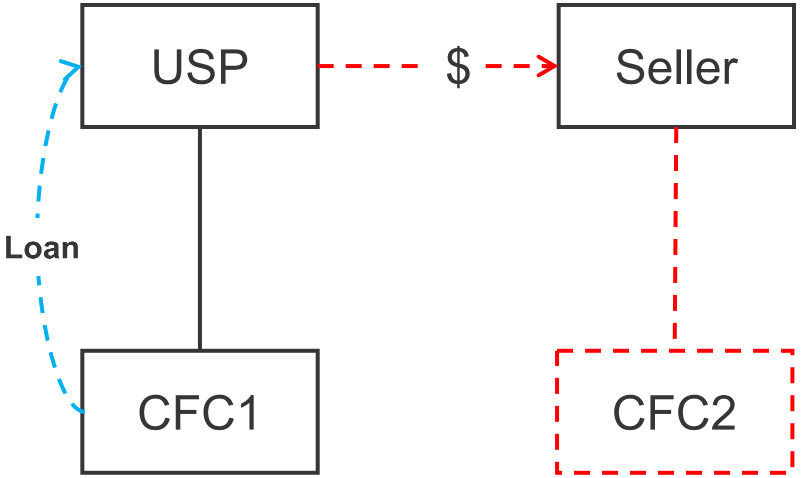
Third-Party Financing Considerations (Continued)



- **CFC Group Election**
  - Under the general Section 163(j) rules, the interest limitation applies to each CFC individually
  - This could lead to mismatch issues for inter-CFC debt. For example, interest expense paid by one CFC could be limited, while the interest income of the second CFC could result in taxable income
  - Proposed regulations address this issue by allowing taxpayers to irrevocably elect certain CFCs to be treated as a group for purposes of calculating the 163(j) limitation
  - Benefits of this election include:
    - Netting of interest income and expense between CFC group members
    - Roll-up of certain "excess taxable income" of lower-tier CFCs to upper-tier CFCs
  - Only certain CFCs may make the election (e.g., "applicable," 80% owned CFCs, no ECI)

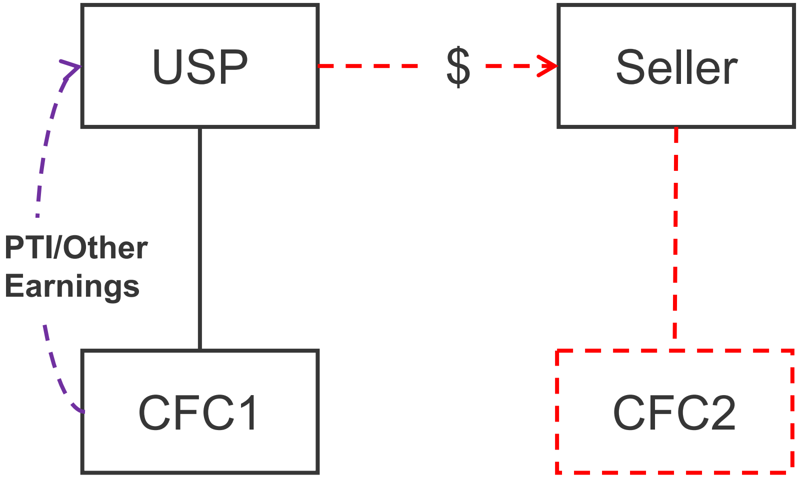
- **New Incentives for Section 163(j) Application at CFC Level**
  - Consider foreign country interest deduction availability if approaching Section 163(j) limitations in US group
  - With 21% tax rate, benefit of interest deduction may be worth more at CFC level for local law purposes (especially if taxpayer has excess FTCs in the GILTI basket)

Intercompany Financing Considerations



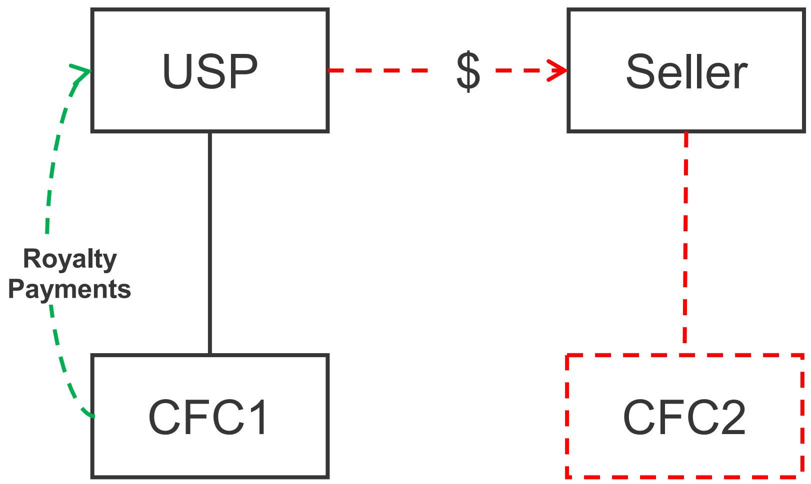
- **The TCJA limits the ability to use intercompany leverage in a tax-efficient manner**
- **BEAT** – Interest expense may be subject to BEAT, even though interest payment is includable under Subpart F (no relief in BEAT regulations)
- **163(j) –** Interest expense deduction is capped at 30% of EBITDA (EBIT starting in 2022)
- **Other Potential Issues:**
  - Anti-hybrid rules under Section 267A (but CFC exception may apply)
  - Section 956 less of a concern

Financing With Foreign Earnings



- Under prior law, distribution of non-Subpart F foreign earnings could potentially accelerate otherwise deferred taxes
- After the TCJA, distribution of PTI and other foreign earnings can provide a potential financing alternative
  - PTI pools from Section 965 transition tax, GILTI, Subpart F
  - Section 245A DRD
  - Consider 986 foreign exchange issues
  - Consider local law restrictions and withholding taxes on distributions
    - Withholding taxes may be creditable under Section 960(b).

Financing With Royalties



- Royalty stream from migrating IP into the US can provide another potential source of acquisition financing
- Other potential benefits
  - FDII eligible
  - Less GILTI and Subpart F inclusions
  - Fewer BEAT payments
- But, once IP is in the US, it is more difficult now to reverse the decision

Questions? / Thank you!