Corporate Tax Update

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Agenda

I. IRS/Treasury Guidance, Including Section 385 Regulations
II. IRS PLR Process, Including Section 355 Spinoffs
III. Rev. Proc. 2018-12 re Continuity of Interest
IV. Consequence of Withdrawal of the Proposed No Net Value Regulations
V. Corporate M&A After the 2017 Tax Act
VI. Appendix
I. IRS/Treasury Guidance, Including Section 385 Regulations
Regulatory Guidance

- Executive Order 13771 (Jan. 30, 2017): for every new regulation issued, at least two prior regulations must be identified for elimination.

- Executive Order 13789 (Apr. 21, 2017) and Notice 2017-38, 2017-30 I.R.B. 147 (July 7, 2017): review of significant 2016 regulations, including regulations under Section 385 (debt/equity), Section 367 (outbound transfers), Section 337(d) (transfers to RICs and REITs) and five other regulations.

- October 2, 2017 “Second Report to the President on Identifying and Reducing Tax Regulatory Burdens.”

- April 12, 2018 Memorandum of Agreement between Treasury and OMB re Review of Tax Regulations.

- What corporate tax guidance is expected?
Section 385 Regulations

• Final and temporary related-party debt-equity regulations under Section 385 were issued on October 13, 2016.

• The regulations include rules (Reg. § 1.385-2) imposing documentation requirements for an instrument issued by a domestic corporation to a related corporation to be respected as debt.
  • The effective date of the documentation rules was delayed by Notice 2017-36 so now the rules apply to debt instruments issued on or after January 1, 2019.

• The regulations also include rules (Reg. § 1.385-3) recharacterizing as equity certain instruments issued by a domestic corporation to a related corporation in specified transactions.
  • The recharacterization rules are effective for debt instruments issued after April 4, 2016.

• For more information about the Section 385 regulations, see the Appendix.
Documentation Rules in Reg. § 1.385-2

• In general, Reg. § 1.385-2 imposed documentation requirements for an “expanded group interest” issued by a domestic corporation to be respected as debt.

• The following items had to be documented to establish that an instrument is debt:
  • An unconditional obligation to pay a sum certain;
  • Creditor’s rights;
  • A reasonable expectation of repayment; and
  • Actions evidencing a debtor-creditor relationship.
Proposed Withdrawal of the Documentation Regulations

• On September 21, Treasury/IRS issued proposed regulations to withdraw the Reg. § 1.385-2 documentation regulations.

• The proposed withdrawal will be effective upon finalization of the regulations, but taxpayers may rely on the proposed regulations in the interim.

• Treasury/IRS will continue to study the issues addressed by the documentation regulations.

• When that study is complete, Treasury/IRS may propose a modified version.

• Common law debt/equity principles remain in effect.
Overall Framework of the Recharacterization Rules in Reg. § 1.385-3

- Under Reg. § 1.385-3, subject to various exceptions, certain “covered debt instruments” issued by a covered member (a domestic corporation) to a member of the covered member’s “expanded group” will be treated as equity of the issuer, either at the time of issuance, or in a subsequent taxable year.
  - A covered debt instrument is a debt instrument issued after April, 4, 2016, that is not a “qualified dealer debt instrument” or an “excluded statutory or regulatory debt instrument”, and that is issued by a covered member (a domestic corporation) that is not an “excepted regulated financial company” or a “regulated insurance company.”
- Issuances of debt instruments subject to recharacterization under the “general rule” include:
  - Distributions of debt instruments;
  - Debt instruments issued in exchange for expanded group stock; and
  - Debt issuances issued in exchange of property in an asset reorganization, to the extent a shareholder of the target corporation that is a member of the issuer’s expanded group receives the covered debt instrument.
- There is also a “funding rule”, described on the next slide, that recharacterizes a debt instrument as equity.
- The recharacterization rules affect the deductibility of interest payments and have withholding tax implications.
Recharacterization Rules of Reg. § 1.385-3

• The recharacterization rules of Reg. § 1.385-3 are currently effective.

• Treasury/IRS are currently reassessing the recharacterization rules in light of the 2017 Tax Act. See the Appendix.
II. IRS PLR Process, Including Section 355 Spinoffs
Section 355

- D must own Section 368(c) control of C.
- Distributing (D) and Controlled (C) must each be engaged in a 5-year-old active trade or business (ATB). If either ATB was acquired within the last 5 years, it must have been acquired tax-free, or acquired from an affiliate of D or C.
- The spinoff must not be used principally as a device to distribute the E&P of D or C, such as by a post-spin sale of the stock of D or C.
- Generally, the distribution must be made predominantly to the historic shareholders of D. (No 50% purchases of D during the preceding 5 years (Section 355(d)). No 50% acquisitions of D or C as part of a plan involving the spin (Section 355(e)).
- Business purpose.
- Section 355(g). No cash rich splitoffs.
- Section 355(h). Generally no REIT spins.
Section 355 PLR Pilot Program

• On September 21, 2017, the IRS issued Rev. Proc. 2017-52, initiating a pilot program temporarily expanding the scope of private letter rulings available regarding the tax consequences of a distribution under Section 355 (including a Section 368(a)(1)(D)/Section 355 distribution).

• If the taxpayer submits proper documentation, description and analysis of legal issues, and numerous representations, then the taxpayer can receive a ruling regarding the tax consequences under Sections 312, 355, 357, 358, 361, 362(b), 362(e), 368(a)(1)(D), 368(b), 1032(a), 1223(1) and 1223(2).

• The pilot program will expire on March 21, 2019.

• Taxpayers can still obtain rulings only on “significant issues” as under prior ruling practice even if the transaction would qualify under the new pilot program.
IRS Statement re Section 355 Active Trade or Business Requirement

• As indicated earlier, in order for a spinoff to qualify for nonrecognition treatment under Section 355, one of the requirements is that Distributing and Controlled must each be engaged in a 5-year active trade or business (“ATB”).

• Reg. § 1.355-3(b)(2)(ii) states that an ATB “ordinarily must include the collection of income and the payment of expenses.”

• What if a corporation is engaged in research and development but has collected no income or little income? Can these activities qualify as an ATB?
IRS Statement re Section 355 Active Trade or Business Requirement (cont’d)

• On September 25, the IRS issued a statement:
  • “The IRS has observed a significant rise in entrepreneurial ventures whose activities consist of research and development in lengthy phases. During these phases, the ventures often collect no income or negligible income but nonetheless incur significant financial expenditures and perform day-to-day operational and managerial functions that historically have evidenced an ‘active’ business. For instance, a venture in the pharmaceutical or technology field might engage in research to develop new products with the purpose of earning income in the future from sales or licenses. The venture might even forgo current income opportunities to obtain increased future income by developing products on its own. The nature and duration of the research phases [are] often dictated by regulatory agencies, which require complex review processes that can span multiple years and cost millions of dollars.”
The IRS is considering guidance to 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.

The IRS wants to develop standards in this area that would streamline the process. According to Bob Wellen, Associate Chief Counsel (Corporate), the standards need to be predictable, repeatable, fair and reasonable.
IRS Statement re Section 355 Active Trade or Business Requirement (cont’d)

• Per Bob Wellen, guideposts being considered include:
  • Regular, continuing research and related activities by a significant number of full-time management and operational employees;
  • Regular, continuing expenses for research and related activities;
  • Significant progress toward developing an income-producing product;
  • Holding out that the business is available to enter into an income-producing arrangement;
  • An actual offer or specific expression of interest made or received by the business to enter into an income-producing arrangement; and
  • Similarly situated businesses have entered into income-producing arrangements with research that has progressed to a similar level as the taxpayer’s research.

• Pending completion of the study, the IRS will entertain PLR requests regarding the ATB qualification of corporations that have not collected income.
Debt Allocation in Spinoffs: General Methods

• A spinoff is a way to separate core and non-core businesses.
• Generally, there are five methods by which value can be extracted from a non-core business in connection with the separation of core and non-core businesses:
  • Controlled Assumption of Liabilities: assumption of liabilities of the distributing corporation (D) by the controlled corporation (C);
  • Controlled Cash Distribution: distribution of C’s cash in exchange for assets transferred by D;
  • Controlled Securities Exchange: exchange of C securities (long-term debt) for D debt;
  • Controlled Stock Exchange: exchange of some C stock for D debt; or
  • Reverse Direction of Spinoff: leverage the non-core business and spin the core business (together with the proceeds from leveraging the non-core business).
• For more information about debt allocation in spinoffs, see the Appendix.
Rev. Proc. 2018-53 re Debt Allocation in a Spinoff

- On October 3, the IRS issued Rev. Proc. 2018-53, which provides procedures for taxpayers requesting PLRs regarding certain types of debt allocations in a Section 368(a)(1)(D)/Section 355 spinoff (a “Divisive Reorganization”).

- In a Divisive Reorganization, the distributing corporation (D) transfers property to a corporation it controls (C) in exchange for consideration. The consideration received by D (“§ 361 Consideration”) includes C stock and also may include money, debt obligations of C, and other property. C may also assume D liabilities.

- To complete the Divisive Reorganization, D distributes the C stock, and possibly other § 361 Consideration, to D’s shareholders. D may also distribute § 361 Consideration in satisfaction of D’s obligations to creditors.
Rev. Proc. 2018-53 re Debt Allocation in a Spinoff (cont’d)

• A taxpayer may request rulings that no gain or loss will be recognized to D upon: (1) C’s assumption of liability for an obligation of D (see Section 357(a)), or (2) D’s receipt of § 361 Consideration and D’s distribution of the § 361 Consideration to a D creditor in satisfaction of D’s debt obligation.

• The procedures in Rev. Proc. 2018-53 apply to a request for a ruling relating to: (1) an assumption by C of D debt, or (2) the satisfaction of D debt with § 361 Consideration.

• The IRS will continue to rule on similar transactions, such as distributions of § 361 Consideration to D’s shareholders, but the revenue procedure does not describe procedures for requesting such rulings.
Rev. Proc. 2018-53 re Debt Allocation in a Spinoff (cont’d)

• The basic principle of Rev. Proc. 2018-53 is that the IRS is generally comfortable that nonrecognition treatment should apply to an allocation of historic debt between D and C. This principle is reflected in the representations discussed below.

• In a request for rulings covered by Rev. Proc. 2018-53, the taxpayer should submit information that describes:
  1. The D debt that will be assumed or satisfied;
  2. The § 361 Consideration that will be distributed to D creditors in satisfaction of D debt; and
  3. The transactions that will implement C’s assumption of liability for D debt, or D’s receipt of § 361 Consideration and D’s distribution of § 361 Consideration to D creditors in satisfaction of D debt.
Rev. Proc. 2018-53 re Debt Allocation in a Spinoff (cont’d)

• The taxpayer should also submit information and analysis to establish that:
  1. Any assumption of D debt by C will be consideration received by D in the Divisive Reorganization; and
  2. Any distribution of § 361 Consideration by D to D’s creditors in satisfaction of D debt will be in connection with the plan of reorganization.

• In addition, the taxpayer should submit representations, as well as related information and analysis, discussed in the following slides.
Rev. Proc. 2018-53 re Debt Allocation in a Spinoff (cont’d)

• If the taxpayer cannot submit an applicable representation, the taxpayer should (1) explain why, and (2) should provide a rationale why the IRS should give a favorable ruling in the absence of the standard representation.

• The requested representations are summarized as follows:
  1. D is in substance the obligor of each D debt;
  2. No holder of D debt that will be assumed or satisfied is related to D or C;
  3. The holder of D debt that will be assumed or satisfied will not hold the debt for the benefit of D, C, or any related person (and there are additional representations if an intermediary will acquire pre-existing D debt from any person and such D debt will be satisfied with § 361 Consideration);
Rev. Proc. 2018-53 re Debt Allocation in a Spinoff (cont’d)

4. D incurred the D debt that will be assumed or satisfied (a) before the request for an relevant ruling is submitted and (b) no later than 60 days before the earliest of the following dates: (i) the date of the first public announcement of the Divisive Reorganization or a similar transaction, (ii) the date of the entry by D into a binding agreement to engage in the Divisive Reorganization or a similar transaction, and (iii) the date of approval of the Divisive Reorganization or a similar transaction by the D board of directors;

A. If D incurred or will incur any of the D debt that will be assumed or satisfied at a later time than the date above, the taxpayer should establish that the borrowing and the assumption or satisfaction of such D debt will result in an allocation of historic D debt between D and C or an exchange of historic D debt for D stock. As one example, the taxpayer may establish that the proceeds of the more recently incurred D debt were used to satisfy other D debt that was incurred no later the date above (cf. Rev. Rul. 79-258), or that the proceeds of the D debt assumed or satisfied were or will be used in C’s business.
5. The total D debt that will be assumed or satisfied does not exceed the historic average of D debt;

6. There are one or more substantial business reasons for any delay in satisfying D debt with § 361 Consideration beyond 30 days after the date of the first distribution of C stock to D’s shareholders (and submit the reasons), and all the D debt that will be satisfied with § 361 Consideration will be satisfied no later than 180 days after such distribution (and if satisfaction of any D debt with § 361 Consideration will occur more than 180 days after such first distribution, submit information and analysis to establish that the satisfaction will be in connection with the plan of reorganization);
7. D will not replace any D debt that will be assumed or satisfied with previously committed borrowing, other than borrowing in the ordinary course of business pursuant to a revolving credit agreement or similar arrangement.

• In addition, the taxpayer should submit information and analysis to establish that, under general principles of tax law, the transactions (including any exchange facilitated by an intermediary) should not be recast, recharacterized, or otherwise treated as one or more transactions that would not qualify under the relevant provisions of the Code.
III. Rev. Proc. 2018-12 re Continuity of Interest
Overview

• When certain conditions are satisfied, the Service will not challenge a taxpayer’s use of one of the valuation methods (the “Safe Harbor Valuation Methods”) and periods (“Measuring Periods”) described in Section 4 of Rev. Proc. 2018-12 to determine the value of publicly traded stock issued to shareholders of the target corporation in certain reorganizations.
To determine whether the continuity of interest ("COI") requirement is satisfied with respect to a reorganization, the value of the issuing corporation stock received by the target corporation shareholders is compared to the aggregate value of all consideration received by the shareholders of the target corporation.

- **Closing Date Rule:** Prior to 2011, the determination of whether the COI requirement is satisfied was based on the value of the issuing corporation stock “as of the effective date of the reorganization” (i.e., the closing date).

- **Signing Date Rule:** In 2011, Treasury and the Service issued final regulations that permitted taxpayers to value reorganization consideration (including the stock of the issuing corporation) as of the last business date (i.e., the pre-signing date) before the first date on which there was a binding contract to effect a potential reorganization for fixed consideration (i.e., the signing date).
Transactions to Which Rev. Proc. 2018-12 Applies

The Safe Harbor Valuation Methods and Measuring Periods described in Rev. Proc. 2018-12 apply to a transaction to which either the Signing Date Rule or the Closing Date Rule is applicable, provided:

• The shareholders of the target corporation receive stock of the issuing corporation as well as money, property, or both, in a transaction that would qualify as a Section 368(a)(1)(A), (B), (C) or (G) reorganization in the absence of the COI requirement;

• Shares of one or more classes of stock of the issued corporation received by target corporation shareholders are traded on a national securities exchange registered with the SEC (“Exchange Traded Stock”);

• All parties to the potential reorganization treat the transaction in a consistent manner;

• The transaction is effected pursuant to a contract that:
  • Evidences the parties’ agreement to:
    • The Safe Harbor Valuation Method and Measuring Period to be applied;
    • The national securities exchange and reporting source that will be used to determine the trading prices of the Exchange Traded Stock throughout the Measuring Period; and
    • Use of the value of each class of Exchange Traded Stock determined under the selected Safe Harbor Valuation Method and Measuring Period to determine the mix of consideration to be exchanged for stock of the target corporation; and
  • For transactions to which the Closing Date Rule applies, is binding no later than the beginning of the first trading day of the Measuring Period selected by the parties; and
  • The terms of the contract are fulfilled in all material respects at the closing date.
Safe Harbor Valuation Methods

• In a potential reorganization to which Rev. Proc. 2018-12 applies, the IRS will not challenge a taxpayer’s use of one of the following valuation methods to determine the value of Exchange Traded Stock received by shareholders of the target corporation:
  • Average of Daily Volume Weighted Average Prices;
  • Average of the Average High-Low Daily Prices; or
  • Average of the Daily Closing Prices.
A “Measuring Period” is a number of consecutive trading days on a specified exchange used in connection with a Safe Harbor Valuation Method.

- The measuring Period used to determine the value of each class of Exchange Traded stock must include at least 5 but no more than 35 consecutive trading days and must end no later than the closing date.

- For a transaction to which the Signing Date Rule is applicable, the Measuring Period must end no earlier than three trading days before the pre-signing date.

- For a transaction to which the Closing Date Rule is applicable, the Measuring Period must end no sooner than three trading days before the closing date.
Request for Private Letter Rulings

• Subject to the limitations of Rev. Proc. 2018-1 and Rev. Proc. 2018-3, the IRS will entertain requests for letter rulings regarding transactions and legal issues to which the safe harbor does not apply and regarding the applicability of the safe harbor.
IV. Consequence of Withdrawal of the Proposed No Net Value Regulations
No Net Value Regulations

• On March 10, 2005, IRS/Treasury issued proposed regulations that would have required an exchange of net value for a transaction to qualify as a reorganization under Section 368 (except under Section 368(a)(1)(E) or (F)).
  • Under the proposed regulations, the fair market value of the property of the target corporation had to exceed the liabilities and boot received, and the fair market value of the assets of the acquiring corporation had to exceed its liabilities immediately after the transaction.
  • Rules were also proposed for Section 332 liquidations and Section 351 transfers.
No Net Value Regulations (cont’d)

• On July 13, 2017, the proposed no net value regulations were withdrawn.

• The preamble states: “The Treasury Department and the IRS are of the view that current law is sufficient to ensure that the reorganization provisions and section 351 are used to accomplish readjustments of continuing interests in property held in modified corporate form.”

• What does this statement in the preamble mean? For a long time it has been uncertain whether a reorganization or a Section 351 transfer requires an exchange of net value. See Norman Scott, Inc. (T.C. 1967).
No Net Value Regulations (cont’d)

• On April 24, 2018, the Treasury Department issued a document entitled “Regulatory Reform Accomplishments Under President Trump’s Executive Orders”.

• Page 6 of this document states: “Removal of the proposed regulations [regarding no net value] provides certainty to corporate taxpayers that an exchange of net value is not required for many corporate transactions to be eligible for tax-free treatment.”

• Does this statement mean that an exchange of net value is not required for a reorganization? What about a Section 351 transfer? Presumably this statement is not intended to change the IRS’s longstanding position that a Section 332 liquidation or an upstream merger requires the transferor corporation to have net value? See Rev. Rul. 59-296 and Rev. Rul. 68-602.
V. Corporate M&A After the 2017 Tax Act
Some Relevant Provisions in the 2017 Tax Act

• Lower corporate tax rate
• Expensing
• Interest limitations
• Net operating loss limitations
• International provisions (a modified exemption system), including:
  • Tax on previously unrepatriated foreign earnings (Section 965)
  • 100% deduction for dividends received from 10%-owned foreign corporations (Section 245A)
  • Global Intangible Low-Taxed Income (GILTI) tax (Section 951A and Section 250)
  • Base Erosion and Anti-Abuse Tax (BEAT) (Section 59A)
  • Foreign-Derived Intangible Income (FDII) (Section 250)
  • Anti-inversion provisions
Types of Transactions

- Taxable versus tax-free transactions
- Financing considerations
- Outbound investments
- Inbound investments
- Spinoffs
Some Potential Effects of 2017 Tax Act

• Effect of lower corporate tax rate
• Effect on choice of entity
• Effect of denial of net interest deductions
• Effect of expensing
• Effect of changes to net operating loss rules
• Effect of changes in taxation of international operations
• Effect on financial accounting treatment
• Effect on state and local tax treatment
Some Potential Effects of 2017 Tax Act (cont’d)

• Higher or lower purchase price for transactions?
• More taxable acquisitions?
• Less leverage in acquisitions?
• Fewer spinoffs?
• Less bias for foreign acquisitions of U.S. targets?
Practical Effects of the 2017 Tax Act

• The enactment of the new law will require additions to the list of items that are subject to due diligence in an acquisition.

• The enactment of the new law will affect the covenants, representations and warranties in acquisition agreements.

• There are many important areas in which regulatory or other guidance will not be issued for quite some time, for example relating to the international provisions, leaving taxpayers and their advisors with uncertainty for tax and financial purposes.

• Due diligence and contractual provisions will have to take into account the many uncertainties in the new law.

• The parties will need to ascertain and allocate risk related to those uncertainties.
Rate Structure Changes

- C corporations: from 35% to 21% (permanent)
  - The lower rate reduces the tax on income
  - The lower rate reduces the value of deductions
  - Repeal of corporate alternative minimum tax
  - Dividends received deduction reset from 80% to 65% for 20%-owned corporations and from 70% to 50% for lesser ownership (roughly the same actual rates as before)
- Rate changes for cross-border activity:
  - 100% deduction for dividends received from 10%-owned foreign corporations
  - GILTI tax at 10.5% or more
  - FDII taxed at 13.125%
  - BEAT alternative tax at 10%
- Don’t forget state and local taxes
Rate Structure Changes (cont’d)

- Individuals: modest rate compression (individual changes through 2025)
- Pass-throughs and sole proprietorships: Section 199A 20% deduction against certain qualifying income (through 2025), potentially reducing the ordinary income tax rate from 37% to 29.6%
  - Investment income and foreign income do not qualify
  - Income from a specified service trade or business (such as law or accounting) is not eligible (unless the taxpayer’s income is below a threshold amount)
  - The deduction is limited by a percentage of W-2 wages and the unadjusted basis of qualified property (unless the taxpayer’s income is below a threshold amount)
- Proposed Section 199A regulations were issued on August 8, 2018.
Relative Rates for Businesses

• Whether there is an advantage to converting to C corporation status depends on a number of variables.

• The C corporation double tax burden can be higher than the pass-through tax burden if corporate earnings are distributed currently to shareholders, but not if earnings are retained for the long term.

• As a result of General Utilities repeal, a C corporation cannot dispose of assets without a corporate level tax.
Will Businesses Migrate into the C Corporation Regime?

• For many taxpayers, 21% is a beneficial tax rate if earnings are retained.
• Some benefits are available only to C corporations (e.g., the GILTI deduction).
• Need to remember the accumulated earnings tax, personal holding company tax, and the possibility of future tax rate changes.
Net Interest Limitation

• New Section 163(j) limits the interest deduction for the business interest of all taxpayers, including C corporations, that exceed a size threshold (Section 448(c) $25 million average gross receipts, aggregating related parties).

• The deductible business interest cannot exceed the sum of:
  • Business interest income,
  • 30% of adjusted taxable income, and
  • Floor plan financing interest.

• Adjusted taxable income is roughly EBITDA before 2022, and EBIT thereafter.

• No grandfathering – effective for taxable years beginning after 2017.
Net Interest Limitation (cont’d)

• Business interest that is disallowed under Section 163(j) is carried forward and treated as business interest paid or accrued in the succeeding taxable year.

• The interest limitation is applied at the partnership level.

• Business interest that is disallowed to a partnership is allocated to the partners and is treated as business interest paid or accrued by the partners in the succeeding taxable year.
Net Interest Limitation (cont’d)

• The limitation on the deductibility of net business interest expense may reduce the amount of leverage used in acquisitions.

• The limitation on the deductibility of net interest expense could affect where a multinational group of corporations places its indebtedness.
  – Because of the high former U.S. corporate tax rate (35%), it was generally advantageous for U.S. members of the worldwide group to do the borrowing.
  – Now that the U.S. corporate tax rate is 21%, the benefit of interest deductions is less.
Net Interest Limitation (cont’d)

- Would U.S. multinationals consider borrowing by foreign subsidiaries (rather than by U.S. members) in situations where the benefit of the deduction is greater because the foreign tax rate is greater than 21%?

- Would U.S. multinationals consider outbound loans to foreign subsidiaries to increase business interest income that can be offset by business interest deductions?
  - It would be necessary to determine the consequences of such a loan in the foreign country. For example, would the interest be subject to limitations on deductibility in the foreign country?
  
- Would U.S. multinationals consider increasing U.S. operations (as opposed to foreign operations) to increase adjusted taxable income so the limitation is higher?
Some Questions About New Section 163(j)

• There are many questions about new Section 163(j) that could affect acquisitions.
• Per Notice 2018-28, Section 163(j) regulations are not expected to include a general rule treating an affiliated group that does not file a consolidated return as a single taxpayer for purposes of Section 163(j).
• Per Notice 2018-28, the Section 163(j) limitation is applied at the level of the consolidated group. In other words, the consolidated group is treated as a single taxpayer.
• Intercompany obligations are disregarded for purposes of Section 163(j).
Some Unanswered Questions About New Section 163(j)

• There are numerous consolidated return issues under new Section 163(j).

• How is disallowed interest expense allocated in a consolidated group? What if some of the members engage in a business described in Section 163(j)(7) that is not subject to the Section 163(j) limitation (e.g., an electing real property trade or business)?

• If disallowed interest expense is allocated to a particular member, presumably there is no investment adjustment under Reg. § 1.1502-32, and P’s basis in the stock of S is higher.
Some Unanswered Questions About New Section 163(j) (cont’d)

• If a member of a consolidated group departs from a consolidated group, and the group has excess interest expense, is any of the excess interest expense allocated to the departing member? If excess interest expense is allocated to the departing member, how is it allocated?

• If a corporation with disallowed interest expense is acquired, presumably the disallowed interest expense carryover is subject to Section 382.

• If the disallowed interest expense carryover is not subject to Section 382, is it subject to the separate return limitation year (SRLY) rules?
Expensing

• The 2017 Tax Act expanded bonus depreciation in Section 168(k) from 50% to 100% (i.e., full expensing) for assets placed in service after September 27, 2017, through 2022. Expensing phases out 20% per year through 2026.
• Eligible property includes property with a recovery period of 20 years or less, and certain other property.
• Eligible property now includes used property.
• Eligible property generally does not include real estate or intangibles.
• Proposed regulations regarding Section 168(k) were issued on August 3, 2018.
• The 2017 Tax Act also increased the Section 179 expensing limits and broadened the eligible categories.
• Small business accounting methods were liberalized.
• The Section 199 Domestic Production Activities deduction was repealed.
Effect of Expensing on Transactions

• As previously noted, many assets, including used assets, are eligible for expensing, but various assets are not eligible, for example, generally real estate and intangibles.

• The availability of expensing might encourage parties to consider engaging in taxable asset acquisitions, including Section 338(h)(10) transactions, rather than tax-free acquisitions.

• The mix of eligible and ineligible assets in the target will be a relevant factor.
Effect of Expensing on the Purchaser

- In a taxable asset acquisition, the purchaser will be able to expense the eligible acquired assets (but not the ineligible assets, such as Section 197 intangibles).

- For a purchaser that is a C corporation, the benefit of expensing will be at a 21% rate, rather than at a 35% rate under prior law (excluding state and local taxes). For a purchaser that is not a C corporation, the benefit of expensing will be greater.

- Will the states conform and allow expensing? Many states previously opted out of bonus depreciation.
Effect of Expensing on the Seller

• In a taxable asset acquisition, the seller will recognize its gain (and loss) in all of its assets, including the assets that are not eligible for expensing by the purchaser.

• If some of the target’s assets have already been expensed, the seller’s gain with respect to those assets will be the amount realized without a basis offset.

• If the target’s assets still have basis, the benefit to the purchaser from expensing will exceed the detriment to the target from recognizing gain.

• If the seller is a C corporation, its gain will be taxed at a rate of 21%, rather than at a 35% rate under prior law (excluding state taxes). For a seller that is not a C corporation, the tax cost will be greater.
Effect of Expensing on Negotiations

- Will the purchaser pay a higher purchase price as a result of the benefit of expensing? But note the benefit is now at a lesser 21% rate.
- Will the seller will want a higher sales price as a result of the detriment of having greater gain with respect to expensed assets. But note that the detriment is now at a lesser 21% rate.
- The allocation of the purchase price might be somewhat more important by reason of the increased tax distinction between assets eligible for expensing and those assets that are ineligible.
- As under prior law, the seller and purchaser will negotiate allocations of purchase price and how to fill out Form 8594.
Expensing in a Consolidated Group

• X Corporation is the parent of a consolidated group. X transfers all of its stock in its subsidiary T Corporation to Newco and then, pursuant to a binding agreement, X sells the Newco stock to an unrelated corporation. X and Newco file a Section 338(h)(10) election for T.

• Can the qualifying assets of T be expensed under Section 168(k)?

• If yes, can the deduction be taken in the X consolidated group return?
Net Operating Loss Carryovers

• As a result of the 2017 Tax Act, carrybacks of net operating losses (NOLs) arising in tax years ending after December 31, 2017, generally are not permitted.
• NOLs can be carried forward. Unlike prior law, they do not expire.
• A post-2017 NOL can offset only 80% of taxable income in any year.
• There is a separate carryforward for interest that is disallowed under Section 163(j).
• Section 382 and SRLY limitations apply to NOL carryovers.
Effect of NOL Carryover Limitations

• After a stock acquisition or a tax-free asset acquisition, corporations will not be able to carry back NOLs.

• In general, the loss carryback waiver in Reg. § 1.1502-21(b)(3) will no longer be relevant.

• Use of NOLs going forward will be subject to the 80% of taxable income limitation, which reduces the value of the NOLs to an acquirer.

• On the other hand, the fact that NOLs will no longer expire might have some value, but remember that Section 382 and SRLY applies, and the long-term tax-exempt rate is quite low (around 2%).
Section 382(h) and Notice 2018-30

• Section 382 generally provides that, after an ownership change (O/C), the amount of taxable income of a loss corporation for any post-change year that may be offset by pre-change losses shall not exceed the Section 382 limitation.

• Section 382(h) provides rules for the treatment of built-in gain and loss with respect to assets owned by the loss corporation at the time of its O/C.
  • If, at the time of an O/C, a loss corporation has a net unrealized built-in gain (NUBIG), any recognized built-in gain (RBIG) for a taxable year within the 5-year recognition period following the O/C increases the Section 382 limitation for that year, but not above the amount of the NUBIG.
  • Similarly, if a loss corporation has a net unrealized built-in loss (NUBIL), any recognized built-in loss (RBIL) for a taxable year within the 5-year recognition period is treated as a pre-change loss subject to the Section 382 limitation, but not above the amount of the NUBIL.
Section 382(h) and Notice 2018-30 (cont’d)

• Notice 2003-65 provides two alternative safe harbor approaches to determine RBIG and RBIL: the “338 approach” and the “1374 approach”.

• The 338 approach treats as RBIG an amount equal to the excess of the cost recovery deduction that would have been allowable with respect to an asset had an election under Section 338 been made over the loss corporation’s actual allowable cost recovery deduction.

• The 338 approach and the 1374 approach treat as RBIL an amount equal to the excess of the loss corporation’s actual allowable cost recovery deduction over the cost recovery deduction that would have been allowable with respect to an asset had an election under Section 338 been made.
Section 382(h) and Notice 2018-30 (cont’d)

• Section 168(k), as amended by the 2017 Tax Act, permits 100% expensing.
• Section 168(k) would affect the application of the Notice 2003-65 safe harbors. The additional first-year depreciation would increase RBIG and reduce RBIL in the first year of the recognition period, by increasing the cost recovery deduction had an election under Section 338 been made. It could also affect total RBIG and RBIL over the 5-year recognition period.
Section 382(h) and Notice 2018-30 (cont’d)

• Section 382(h) is intended to be a rough estimate of income or expense occurring after the O/C that is attributable to the pre-change period.

• Notice 2018-30 states that Section 168(k) is an investment incentive and there is no indication in the 2017 Tax Act or its legislative history that the amendments to Section 168(k) were intended to reflect an estimate of income or expense generated by an asset during any particular time.
Section 382(h) and Notice 2018-30 (cont’d)

- Notice 2018-30 modifies the two safe harbor approaches under Notice 2003-65 for determining RBIG and RBIL, providing that the hypothetical cost recovery deduction that would have been allowable had an election under Section 338 been made (or had the asset been purchased at fair market value under the 1374 approach) are determined without regard to Section 168(k).

- Notice 2018-30 is effective for O/Cs that occur after May 8, 2018.
Cross-Border Changes: Outbound Investment

• Section 965 imposes a transition tax on the unrepatriated earnings of foreign subsidiaries. The rate is 15.5% for cash/8% for non-cash and can be paid eight in installments.
• Section 245A provides a 100% deduction for distributions of foreign earnings not taxed currently under subpart F or GILTI.
• Section 951A imposes a current GILTI tax on foreign earnings in excess of a specified return on tangible assets, with a partial offsetting deduction under Section 250.
• Only vestiges remain of the former deferral system for taxing outbound investment.
• The Section 367(a) exception for outbound transfers of businesses was repealed.
• The foreign tax credit baskets were revised.
• Section 250 provides a FDII deduction as an incentive to earn certain types of income in the United States rather than abroad.
Acquisition of a Foreign Corporation

- The 2017 Tax Act will have important effects on the economics of an acquisition of a foreign corporation by a U.S. corporation.
- If the foreign target was subject to the Section 965 tax on unrepatriated foreign earnings, an acquirer will need to perform due diligence to ensure that the target paid the correct amount of tax or the amount of deferred tax was calculated correctly.
- Furthermore, the expected returns from an acquisition are likely to be different than under old law.
- For example, the interest limitation of new Section 163(j) could affect the level of debt financing the acquisition.
- The effect of the GILTI tax will affect returns on the investment.
- The calculations under new law will be made harder because of the uncertainties in the new law.
Acquisition of a Foreign Corporation (cont’d)

- Under old law, active earnings of a foreign subsidiary were not subject to immediate tax, and tax was deferred until dividends were paid to the U.S. parent. Dividends could be offset by foreign tax credits, or payment of dividends could be deferred indefinitely.

- Under the 2017 Tax Act, not only is there current taxation of subpart F income, but also current taxation of GILTI. The tax rate on GILTI is at a reduced rate of 10.5%, although actually in some cases at a higher effective rate. In other words, the new law imposes immediate tax on a much broader portion of foreign earnings.
Acquisition of a Foreign Corporation (cont’d)

• To the extent a foreign subsidiary has income that is not subject to subpart F or the GILTI tax, such income will not be subject to U.S. tax and can be distributed to the U.S. parent tax-free under the new Section 245A 100% deduction for dividends paid by a 10%-owned foreign subsidiary.

• When a U.S. corporation sells the stock of a foreign subsidiary, the gain up to the Section 1248 amount will be eligible for the 100% dividends received deduction, but gain in excess of the Section 1248 amount will be taxed at a 21% rate.

• Under old law, the sale of assets by a foreign subsidiary did not result in subpart F income or other recognition. However, under new law the foreign subsidiary’s sale of its assets could result in GILTI subject to current tax at a 10.5% or higher rate.

• Consequently, the changes in law could affect the structure of the disposition of a foreign subsidiary.
Cross-Border Changes: Inbound Investment

• The 2017 Tax Act will also have important effects on the economics of an acquisition of a U.S. corporation by a foreign corporation.
• Under prior law, a foreign acquirer in a low-tax jurisdiction had an advantage over a U.S. acquirer because the foreign acquirer could lend to the U.S. target and thus could engage in earnings stripping that a U.S. acquirer could not do. Old Section 163(j) did not impose a significant limitation.
• The 2017 Tax Act diminishes the ability to do earnings stripping by two principal measures.
  • First, as discussed before, new Section 163(j) imposes limitations on interest deductions.
  • Second, Section 59A imposes the BEAT, which is a 10% minimum tax computed by adding back deductible payments to foreign related parties.
Acquisition of a U.S. Corporation

• As indicated previously, the BEAT creates an alternative tax base by adding back outbound deductible payments, such as interest or royalties, made to a foreign related party. (Note that the add-back occurs whether the parent of the group is foreign or domestic.)

• Payments for amounts that result in a reduction of cost of goods sold (e.g., for inventory) are not added back.

• The limitation on interest deductions and the BEAT could significantly reduce the advantage a potential foreign acquirer of a U.S. target has over a potential U.S. acquirer.
Effect of 2017 Tax Act on Spinoffs

- One of the requirements for a spinoff is that the transaction cannot be used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both.
- The Section 367 regulations include complicated rules, including for spinoffs, to ensure that earnings and profits of CFCs will remain subject to eventual U.S. taxation.
- The 2017 Tax Act changes the international rules so that CFC earnings are subject to U.S. tax immediately as subpart F income or GILTI, or are not subject to U.S. tax at all.
- As a result of the 2017 Tax Act, do the Section 367 regulations need to be revisited?
- Can a spinoff where a foreign subsidiary (FD) distributes the stock of its subsidiary to FD’s U.S. parent present a potential for dividend avoidance under the new international tax system?
Concluding Comments

• Will the 2017 Tax Act facilitate acquisitions?
• The lower corporate tax rate will reduce tax on income, but will also reduce the value of tax deductions.
• The limitation on interest deductions will affect the use of leverage in acquisitions.
• Expensing may reduce the cost to a purchaser of assets.
• The international changes will affect the cost of an acquisition of a foreign target by a U.S. acquirer.
• The international changes will reduce the advantage a foreign acquirer has with respect to a U.S. target.
• The 2017 Tax Act is unlikely to affect the desirability of a spinoff.
VI. Appendix
More Information About the Section 385 Regulations
Overall Framework of the Recharacterization Rules in Reg. § 1.385-3

- Under Reg. § 1.385-3, subject to various exceptions, certain “covered debt instruments” issued by a covered member (a domestic corporation) to a member of the covered member’s “expanded group” will be treated as equity of the issuer, either at the time of issuance, or in a subsequent taxable year.
  - A covered debt instrument is a debt instrument issued after April, 4, 2016, that is not a “qualified dealer debt instrument” or an “excluded statutory or regulatory debt instrument”, and that is issued by a covered member (a domestic corporation) that is not an “excepted regulated financial company” or a “regulated insurance company.”
- Issuances of debt instruments subject to recharacterization under the “general rule” include:
  - Distributions of debt instruments;
  - Debt instruments issued in exchange for expanded group stock; and
  - Debt issuances issued in exchange of property in an asset reorganization, to the extent a shareholder of the target corporation that is a member of the issuer’s expanded group receives the covered debt instrument.
- There is also a “funding rule”, described on the next slide, that recharacterizes a debt instrument as equity.
- The recharacterization rules affect the deductibility of interest payments and have withholding tax implications.
Funding Rule of Reg. § 1.385-3

- Subject to various exceptions (such as a “qualified short-term debt instrument”), a debt instrument is also recharacterized as stock to the extent that it is issued by a corporation (funded member) and treated as funding a distribution or acquisition.

- The distributions or acquisitions subject to the “funding rule” include (with exceptions for each category):
  - A distribution of cash or other property by the funded member to a member of its expanded group;
  - An acquisition of expanded group stock by the funded member from another member of the funded member’s expanded group in exchange for cash or other property; or
  - An acquisition of property by the funded member in an asset reorganization, to the extent that shareholders of the target corporation that is another member of the funded member’s expanded group receive boot in the reorganization.
Per Se Funding Rule

• The funding rules have a non-rebuttable presumption, under which a covered debt instrument is treated as stock if it is issued within three years before the date of the distribution or acquisition by the covered member or within three years after the date of the distribution or acquisition (i.e., a six-year period in total).

• This presumption is non-rebuttable. Motive is irrelevant (i.e., the debt is stock under this per se rule).
Rules Limited to Issuers that are Domestic Corporations

• The final regulations do not apply to debt issued by foreign issuers.
• The final regulations narrow the rules to focus primarily on cross-border earnings stripping.
Debt Between Affiliated U.S. Corporations

• Debt between members of a consolidated group is generally not subject to the rules.
• However, the rules do apply to debt between non-consolidated U.S. members of an expanded group, subject to exceptions.
Scope of Rules for Multinationals with a U.S. Parent

• Section 956 loans (a loan by a CFC to its U.S. parent)
• Trade payables owed by U.S group members to foreign affiliates
Scope of Rules for Multinationals with a Foreign Parent

• Long-term inbound lending
• Short-term funding/cash pooling for U.S. group members where a foreign group member is the lender
• Trade payables owed by U.S. group members to foreign affiliates
October 2, 2017 Report re Tax Regulatory Burdens

- On October 2, 2017, the Treasury Department issued a “Second Report to the President on Identifying and Reducing Tax Regulatory Burdens” pursuant to E.O. 12789.
- In that report, Treasury recommends that the Section 385 regulations be revoked in substantial part.
- The report recommends revoking the Section 385 documentation regulations as issued.
- The report recommends retaining the recharacterization rules, including the funding rule, until tax reform occurs.
Regarding the documentation rules of Reg. § 1.385-2, the Report states that “Treasury and the IRS now agree with commenters that some requirements of the documentation regulations departed substantially from current practice and would have compelled corporations to build expensive new systems to satisfy the numerous tests required by the regulations.”

“Treasury and the IRS are considering a proposal to revoke the documentation regulations as issued. Treasury and the IRS are actively considering the development of revised documentation rules that would be substantially simplified and streamlined in a manner that will lessen their burden on U.S. corporations, while requiring sufficient legal documentation and other information for tax administration purposes.”

In particular, consideration is being given to the requirement to document a reasonable expectation of ability to repay indebtedness.

In addition, the treatment of ordinary trade payables will be reexamined.

The new proposed rules would have a prospective effective date.
October 2, 2017 Report re Tax Regulatory Burdens (cont’d)

- Regarding the recharacterization rules of Reg. § 1.385-3, the Report states: “The distribution regulations address inversions and takeovers of U.S. corporations by limiting the ability of corporations to generate additional interest deductions without new investment in the United States. In recent years, earnings-stripping by foreign-parented multinational corporations, as well as corporate inversions whereby U.S. corporations become foreign corporations and engage in earnings stripping, frequently as a tax artifice, have put U.S. corporations at a competitive disadvantage compared to their foreign peers. Treasury is committed to the Administration’s goals of leveling the playing field for U.S. businesses, so that they may compete freely and fairly in the global economy, and implementing tax rules that reduce the distortion of capital and ownership decisions through earnings stripping and similar practices.”
October 2, 2017 Report re Tax Regulatory Burdens (cont’d)

• Regarding the recharacterization rules of Reg. § 1.385-3, the Report further states: “Commenters have criticized the complexity and breadth of the distribution rules. They have criticized in particular the funding rule .... Treasury understands that the distribution rules are a blunt instrument for accomplishing their tax policy objectives, and continues to consider how the distribution rules might be made more targeted and compliance with the regulations less onerous. At the same time, Treasury continues to believe firmly in maintaining safeguards against earnings-stripping and diminishing incentives for inversions and foreign takeovers.”
October 2, 2017 Report re Tax Regulatory Burdens (cont’d)

- Regarding the recharacterization rules of Reg. § 1.385-3, the Report continues: “Treasury has consistently affirmed that legislative changes can most effectively address the distortions and base erosion caused by excessive earnings stripping, as well as the general tax incentives for U.S. companies to engage in inversions. Treasury is actively working with Congress on fundamental tax reform that should prevent base erosion and fix the structural deficiencies in the current U.S. tax system. Tax reform is expected to obviate the need for the distribution regulations and make it possible for these regulations to be revoked.”
October 2, 2017 Report re Tax Regulatory Burdens (cont’d)

• Regarding the recharacterization rules of Reg. § 1.385-3, the Report concludes: “In the meantime, after careful consideration, Treasury believes that proposing to revoke the existing distribution regulations before enactment of fundamental tax reform, could make existing problems worse. If legislation does not entirely eliminate the need for the distribution regulations, Treasury will reassess the distribution rules and Treasury and the IRS may then propose more streamlined and targeted regulations.”

• Now that a major tax bill has been enacted addressing base erosion concerns, what is the status of the reconsideration of the Section 385 regulations?
More Information About Financing in Spinoffs
Spinoff: Controlled Assumption of Liabilities

Non-core assets and liabilities

1. D distributes C stock

C stock

2. D distributes C stock to D shareholders

See Section 357(b) and 357(c) limitations on C’s assumption of liabilities.
Spinoff: Controlled Cash Distribution

D distributes C stock to D shareholders and the cash to D shareholders or creditors

See Section 361(b)(3) limitation that D will recognize gain if the cash is distributed to creditors and the cash exceeds the contributed asset basis plus liabilities assumed by C.
Spinoff: Controlled Securities Exchange

1. Non-core assets

2. D distributes C stock to D shareholders and C securities to D creditors

See proposed legislation to treat the securities like cash for purposes of the Section 361(b)(3) limitation on distributions to creditors mentioned on the previous slide.
Spinoff: Controlled Stock Exchange

D distributes C stock to D shareholders and D creditors

D cannot distribute more than 20% of the C stock to D creditors without disqualifying the distribution under Section 355.
Spinoff: Reverse Direction of Spin-Off

1. The lender provides a loan.

2. Core assets and cash are given to C stock.

3. D distributes C stock (core business) to D shareholders.