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Tax Practice After the Tax Cuts and Jobs Act

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8

Cross-Border Acquisitions Following the Tax Cuts and Jobs Act

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I. INTRODUCTION

On December 22, 2017, President Trump signed H.R. 1, commonly known as the Tax Cuts and Jobs Act (the "TCJA"), into law. The TCJA represents the most significant overhaul of the U.S. tax code to be enacted in decades and has fundamentally altered the taxation of both individuals and businesses. While these reforms will impact many commercial transactions, one area in which the TCJA is expected to have material consequences is the structuring and negotiation of acquisitions of foreign target corporations by domestic acquirers. This paper seeks to provide a practical overview of certain tax considerations under the TCJA relevant to a domestic group's acquisition of a foreign corporation.

II. FINANCING FOREIGN ACQUISITIONS UNDER NEW.SECTION 163(j)

Under prior law, business interest expense was generally deductible by corporate taxpayers, subject to certain limitations. One key limitation was former Section 163(j) of the U.S. Internal Revenue Code of 1986, as amended (the "Code"),[1] which limited the deductibility of interest by certain corporations when interest was paid to a related party that was entirely or partially exempt from U.S. tax or to an unrelated party if the debt was guaranteed by a related party that was entirely or partially exempt from U.S. tax, subject to certain exceptions. The purpose of this limitation was to prevent "earnings stripping," or the reduction of taxable income of U.S. corporations in the form of interest deductions where the interest income was paid to a related U.S. tax-exempt entity or foreign person and therefore all or a portion of such interest income was not subject to U.S. tax. The limitation was targeted at thinly capitalized corporations, and therefore did not apply to U.S. corporations that could meet a debt-to-equity ratio safe harbor of 1.5 to 1 or for which net interest expense did not exceed 50% of adjusted taxable income plus any excess limitation carryforward. This limitation was generally not applicable in the context of leveraged acquisitions by domestic acquirers where the financing was provided by one or more third-party lenders.

The TCJA repealed this prior limitation and replaced it with a new regime which limits the deductibility of business interest expense regardless of whether it is paid to a related or unrelated person and whether or not that person is otherwise subject to U.S. tax. As amended by the TCJA,

1. Unless otherwise indicated, all "Section" or "§" references are to the Code.

Section 163(j) of the Code imposes a general limitation on the deduction of "business interest" equal to the sum of "business interest income" and 30% of "adjusted taxable income."[2] Certain small businesses,[3] real property trade or businesses that make an irrevocable election,[4] and certain regulated public utilities are exempt from this limitation.[5] The application of this limitation to partnerships is subject to special rules,[6] although this paper will focus on the application of Section 163(j) to corporations.

"Business interest" is any interest paid or accrued on debt allocable to a trade or business and does not include investment interest.[7] The 30% limitation on the deduction of business interest expense applies to the sum of "business interest income"[8] and "adjusted taxable income," which is taxable income computed without regard to (i) items not allocable to the business, (ii) business interest expense or income, (iii) net operating losses, (iv) the 20% pass-through deduction for individuals under

2. § 163(j)(1).
3. Taxpayers with average annual gross receipts of less than $25 million for the 3-taxable-year period ending with the taxable year which precedes the current taxable year under the rules of § 448(c) are not subject to the § 163(j) limitation. § 163(j)(3).
4. § 163(j)(7)(A)(ii), (j)(7)(B). Real property trade or businesses that elect to be exempt from these limitations must use a longer life for all nonresidential real property, residential rental property, and qualified improvement property. The irrevocable aspect of this election and potential tradeoff of longer depreciable lives raises questions for real property trade or businesses relating to the timing and desirability of making such an election, but these issues are outside the scope of this paper.
5. § 163(j)(7)(A)(iv).
6. § 163(j)(4).
7. § 163(j)(5). Investment interest means investment interest as defined in § 163(d), which includes gross income from property held for investment, the net gain attributable to the disposition of property held for investment over the net capital gain determined only by taking into account gains and losses from dispositions of property held for investment, and dividends from a domestic corporation or a foreign corporation eligible for treaty benefits or the stock of which is regularly traded on a United States established securities market. § 163(d)(4). Notably, the legislative history of § 163(j) provides that corporations have only business interest, not investment interest. H.R. REP. No. 115-466, at 386 n. 688 (2017) ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.").
8. Business interest income means the amount of interest includible in gross income which is allocable to a trade or business. § 163(j)(5).

Section 199A and (v) for taxable years beginning before January 1, 2022, depreciation and amortization.[9]

Any interest deduction disallowed under Section 163(j)(1) may be carried forward indefinitely.[10] These new limitations apply for tax years beginning after December 31, 2017, and there is no grandfathering for existing debt.

The availability of interest deductions is critical to the modeling of returns for leveraged buyouts and other debt-financed acquisitions, because a limitation on interest deductibility could increase tax costs and have a significant effect on available cash flow and valuation.[11] As described above, Section 163(j) may impose significant limitations on a U.S. borrower's ability to utilize interest deductions. In particular, a highly leveraged U.S. corporate group (particularly one with material non-interest taxable income and without significant available depreciation or amortization deductions) that under prior law relied on the tax shield generated by its interest expense to reduce or even eliminate its net taxable income may now be subject to an annual cash tax liability of at least 30% of its adjusted taxable income. Further, the reduction of the U.S. corporate tax rate decreases the tax benefit of domestic interest deductions that are permitted in a given taxable year under Section 163(j).[12]

Accordingly, it may be beneficial for corporate groups with both U.S. and non-U.S. operations to consider borrowing in non-U.S. jurisdictions or on-lending financing proceeds to non-U.S. jurisdictions in order to

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9. § 163(j)(6), (8). Unlike the House bill, the Senate amendment did not add back deductions for depreciation and amortization in the calculation of adjusted taxable income. The TCJA, which permits exclusion of depreciation and amortization deductions until taxable years beginning on or after January 1, 2022, is thus a taxpayer-favorable compromise because the add back of such deductions will increase a taxpayer's adjusted taxable income and result in a greater limitation. *See* H.R. REP. No. 115-466, at 392 (2017). Because there is no grandfathering for existing debt, when structuring acquisition financing today, borrowers should consider if they will be subject to a more restrictive limitation beginning in 2022 when depreciation and amortization deductions are no longer excluded from the calculation of adjusted taxable income.
10. § 163(j)(2). The business interest expense carryforward is a separate tax attribute and therefore not subject to the limitation on net operating loss carryforwards to 80% of taxable income imposed by the TCJA.
11. *See, e.g.,* Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts*, Section 1304 (2017) ("In a large LBO (or in any other acquisition financed by substantial borrowing), [the purchaser] must be vigilant to assure that some or all of its interest deductions are not disallowed.").
12. Under the TCJA, the maximum U.S. corporate income tax rate was reduced from 35% to 21%. § 11(b).

maximize the current utilization of interest deductions. By decreasing the net interest expense in the United States and increasing the net interest expense outside the United States, deductions that would have been unavailable in the United States as a result of Section 163(j) are now available to offset non-U.S. tax costs. This is especially tax-efficient when the non-U.S. subsidiary that is allocated net interest expense is taxed at a higher rate than the new U.S. corporate income tax rate of 21%. In addition, the TCJA enacted significant limitations on foreign tax credits, which provide another incentive to reduce incremental tax cost by borrowing in foreign jurisdictions.[13] However, to the extent that foreign interest deductions would be properly allocable to certain tested income of a controlled foreign corporation under Section 951A(c)(2), the deductions could increase the domestic parent's liability for global intangible low-taxed income (as discussed further below in Section IV).[14]

Consider the following simple example: assume a domestic corporation with annual adjusted taxable income of $100 purchases a foreign corporate target with financing from a third-party lender that generates $60 of annual net interest expense. If the domestic corporation is the sole borrower, the U.S. corporation's deduction for its interest expense will be limited to $30 annually and the remaining $30 will carry forward and potentially be utilized in future taxable years. In contrast, if the domestic corporation and foreign target corporation (or a foreign acquirer corporation) are co-obligors under the third-party credit facility and each is treated as primarily liable for 50% of the debt,[15] then the U.S. corporation will be entitled to deduct interest expense of $30 and the remainder will be available to be deducted by the foreign target corporation subject to any limitations in the foreign jurisdiction.[16]

13. As discussed further below in Section III, no foreign tax credit is allowed with respect to amounts for which the taxpayer is eligible for the Section 245A dividends received deduction. § 245A(d)(1). Further, for United States shareholders that are corporations, with respect to certain global intangible low-taxed income (discussed further below in Section IV), foreign tax credits are calculated under a separate basket and limited to 80% of such income. § 960(d)(1).
14. § 951A(c)(2)(A)(ii).
15. Under U.S. law, as long as the co-obligors are jointly and severally liable, each is generally entitled to deduct all interest it actually paid during a taxable year absent other statutory limitation. *See, e.g.*, *Nelson v. Comm'r*, 281 F.2d 1, 5 (5th Cir. 1960). Accordingly, as long as the funds used to pay the interest are directly traceable to a U.S. co-obligor, such co-obligor is entitled to deduct the full amount of such interest payments with respect to the U.S. co-obligor, subject to the § 163 limitations.
16. Similar limitations apply under the U.K.'s Corporate Interest Restriction rules, which as of April 1, 2017 restrict U.K. interest deductions for a corporate group's net interest expense to the lesser of 30% of the U.K. tax EBITDA and a measure

A similar result can be achieved through the use of intercompany financing arrangements to push debt into the foreign target company.[17] For example, if the domestic corporation is the sole borrower under the third-party financing but then on-lends 50% of the debt proceeds to the foreign target corporation (or a foreign acquirer corporation), the U.S. corporation will have only $30 of net interest expense (which it will be permitted to deduct pursuant to Section 163(j)), because the $30 of interest income from the foreign target corporation will offset $30 of the interest expense.[18] Subject to any applicable limitations in the local jurisdiction, the foreign corporation will have $30 of available interest deductions resulting from payment of interest on the intercompany debt.[19] An arrangement in which both the domestic and foreign corporations are co-obligors (as described above) may produce a better result because it avoids the potential tax cost of paying interest cross-border.

Although debt financing has historically been more desirable than equity financing due to the tax benefit of interest deductions, the addition of Section 163(j) may increase the commercial desire to use preferred equity or similar financing arrangements when the tax benefit of debt financing has been reduced under Section 163(j) and it is not possible to use

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of the worldwide group's net external finance expense. *See* Pricewaterhouse Coopers, *UK introduces new corporation tax limitation on interest deductibility*, 1 (Mar. 2, 2017), available at https://www.pwc.com/us/en/tax-services/publications/insights/uk-introduces-new-limitation-on-interest-deductibility.html. Germany also has a similar limitation on deductibility up to 30% of EBITDA. *See* Pricewater houseCoopers, *Germany Corporate – Deductions* (Dec. 5, 2017), available at http://taxsummaries.pwc.com/ID/Germany-Corporate-Deductions. These limitations were based on the recommendations of Action 4 of the Base Erosion and Profit Shifting Project, which recommends a limitation on deductions of interest of between 10% to 30% of EBITDA. *See generally* OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update: Inclusive Framework on BEPS*, 29-30 (2017).

17. If debt were incurred in the foreign jurisdiction and on-lent to the United States, the interest payments would be subject to the Base Erosion Anti-Abuse Tax (the "BEAT"), which was added under the TCJA. § 59A. The BEAT is generally aimed at transactions with inverted structures involving a foreign parent above a U.S. subsidiary and is thus outside the scope of this paper. Nonetheless, the BEAT can apply to transactions between a U.S. parent and a foreign subsidiary, and its application should be considered.
18. This example assumes that the interest rate and other terms of the intercompany debt will mirror the terms of the third-party financing.
19. If the foreign jurisdiction imposes limitations on interest deductions for related party debt, it may be preferable for the domestic corporation to borrow directly because it will be able to carry forward its limitation and potentially use it in future taxable years.

interest deductions in the foreign jurisdiction. It is essential for multinational groups to consider and model the impact of these rules under different scenarios when evaluating new commercial opportunities and determining the most tax-efficient financing structures for a foreign acquisition.

III. REPATRIATION FROM FOREIGN CORPORATE SUBSIDIARIES

The TCJA fundamentally changed the U.S. system of international taxation. Under prior law, U.S. persons (including domestic corporations) were generally taxable on their worldwide income regardless of its source.[20] Under that regime, subject to certain exceptions, the earnings and profits of a foreign corporate subsidiary were generally not taxable to its domestic corporate parent unless those earnings were distributed to the parent entity.[21] However, a dividend from a foreign corporate subsidiary to its domestic corporate parent was subject to U.S. corporate income tax to the extent the dividend received exceeded available foreign tax credits resulting from taxes paid in a foreign jurisdiction. This incentivized domestic corporations that acquired foreign subsidiaries to keep earnings offshore to the extent feasible, rather than repatriate foreign earnings to the United States where they would be subject to U.S. corporate income tax (particularly given the then-applicable highest marginal federal corporate income tax rate of 35% was one of the highest in the world).[22]

The TCJA shifted away from this long-established system of world-wide taxation and replaced it with a partial territorial system where foreign earnings are generally taxed only in the foreign jurisdiction,

20. The double taxation of earnings by both the United States and a foreign jurisdiction resulting from worldwide taxation was mitigated through the use of foreign tax credits.

21. The key exceptions to this rule under prior law were the "Subpart F" rules, which generally require United States shareholders of a controlled foreign corporation to pay current tax on their share of such corporation's dividends, interest, rents, royalties, purchases from or sales to a related party of goods when the goods are made for us outside the controlled foreign corporation's country of incorporation, and income from performing services for or on behalf of a related person, and the "passive foreign investment company" rules, which generally require U.S. persons who own shares of a company which has 75% or more passive income and/or 50% or more passive assets to choose between current taxation on such company's income or deferral of such income subject to deemed tax and interest. These rules are still applicable to certain U.S. persons.

22. Prior to the enactment of the TCJA, it was estimated that U.S. companies had stockpiled as much as $3.1 trillion offshore. Matthew Townsend and Laurie Meisler, *These Are the Biggest Overseas Cash Hoards Congress Wants to Tax*, Bloomberg (Nov. 2, 2017), available at https://www.bloomberg.com/graphics/2017-overseas-profits-tax/.

subject to certain exceptions. Despite the enactment of the TCJA, United States persons are still subject to the Subpart F and passive foreign investment company regimes.[23] Further, the TCJA removed the restriction in Section 958(b)(4) that prevented stock in a foreign corporation owned by a foreign person from being treated as constructively owned by a United States person. The TCJA also added several base erosion provisions, such as the BEAT and the tax on global intangible low-taxed income (discussed in Part IV), which are intended to ensure that income is subject to at least a minimum level of tax somewhere in the world.

In order to implement this new regime, the TCJA includes a "participation exemption" for foreign-source dividend income of domestic corporations. The new Section 245A provides a 100% deduction for the foreign-source portion of any dividend paid by a "specified 10-percent owned foreign corporation" to a domestic corporation which is a United States shareholder with respect to such foreign corporation.[24] A "specified 10-percent owned foreign corporation" is any foreign corporation (other than a passive foreign investment company) with respect to which any domestic corporation is a United States shareholder with respect to such corporation.[25] A "United States shareholder" for purposes of Section 245A is defined under Section 951(b) as a United States person who owns or is considered as owning by applying Section 958(b) 10% or more of the total combined voting power of all classes of stock entitled to vote or 10% or more of the total value of shares of all classes.[26] The foreign-source portion of a dividend is determined by comparing the ratio of the foreign corporation's undistributed foreign earnings to its total undistributed earnings.[27] Because the earnings are taxed only in the foreign

23. § 951(b).
24. § 245A(a). Notably, although U.S. individuals are subject to the § 965 transition tax, which generally imposes a mandatory repatriation of a United States shareholder's pro rata share of its foreign subsidiaries' undistributed earnings and profits, the § 245A deduction is available only to domestic corporations.
25. § 245A(b).
26. Under prior law, the definition of United States shareholder was limited to United States persons that owned 10% or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation. The TCJA expanded the definition of United States shareholder to United States persons that own 10% or more of the vote *and* value of all classes of stock the stock of the foreign corporation. § 951(b).
27. § 245A(c)(1). Undistributed earnings are earnings and profits as of the close of the taxable year without diminution by dividends distributed during the year. § 245A(c)(2). Undistributed foreign earnings are the portion of undistributed earnings which is neither attributable to income effectively connected with the conduct of a trade or business within the United States nor dividends received

jurisdiction, no foreign tax credit is allowed for foreign taxes paid with respect to a dividend for which a deduction is allowed under Section 245A.[28] Section 245A applies to distributions made (and for purposes of determining a taxpayer's foreign tax credit limitation under Section 904, deductions in taxable years beginning) after December 31, 2017.[29]

As a tradeoff for the TCJA's taxpayer-favorable addition of Section 245A, Section 965 imposes a one-time tax on a United States shareholder's pro rata share of the accumulated post-1986 earnings and profits of a "deferred foreign income corporation" for taxable years beginning before January 1, 2018.[30] A deferred foreign income corporation is any "specified foreign corporation" of the United States shareholder which has accumulated post-1986 deferred foreign income greater than zero.[31] United States shareholders are subject to this transition tax at a rate of 15.5% on their pro rata share of cash and liquid assets of the deferred foreign income corporation and 8% on all other earnings,[32] although there is an election available to pay the transition tax liability in increasing installments over eight years with no interest penalty.[33] Importantly, however, acquirers of foreign corporations that have pre-closing United

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directly or through a wholly owned foreign corporation from a domestic corporation at least 80% of the stock of which (by vote and value) is owned either directly or through a wholly owned foreign corporation (other than dividends from RICs or REITs). § 245A(c)(3).

28. § 245A(d)(1).
29. H.R. REP. No. 115-466, at 600 (2017). A domestic corporation is not permitted a dividends received deduction in respect of any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. The holding period requirement is treated as met only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the taxpayer is a United States shareholder with respect to such 10-percent owned foreign corporation at all times during the period. § 246(c)(5).
30. The tax is imposed on the greater of the accumulated post-1986 deferred foreign income as of November 2, 2017 or December 31, 2017. § 965(a).
31. Deferred foreign income is the post-1986 earnings and profits of a specified foreign corporation except to the extent such earnings are attributable to income effectively connected with the conduct of a trade or business within the United States or, in the case of a controlled foreign corporation, earnings that if distributed would be excluded from the gross income of the United States shareholder because the earnings were previously taxed under Section 959. § 965(d). A specified foreign corporation means any controlled foreign corporation and any other foreign corporation with respect to which one or more domestic corporations is a United States shareholder. § 965(e)(1).
32. § 965(c).
33. § 965(h).

States shareholders with transition tax liability do not need to allocate the transition tax contractually because the transition tax is borne by the selling United States shareholder and the acquirer thus does not bear the tax.[34]

In light of the TCJA's addition of Section 245A, domestic corporations acquiring a foreign corporate target may want to reevaluate the benefit of any preexisting intercompany arrangements for repatriation of foreign earnings, particularly the use of intercompany debt. The availability of the participation exemption may make repatriating cash from a foreign subsidiary in the form of interest payments to the domestic corporate parent (which would be subject to U.S. corporate income tax upon receipt) less attractive in comparison to dividends, unless there is an offsetting interest deduction from third-party borrowing. Further, because the TCJA did not repeal Section 956, repatriating by loaning money to a U.S. parent will be taxable under Section 956 if not repaid within thirty days, whereas a dividend to the U.S. parent would not be taxable under Section 956 and would be exempt under Section 245A.[35]

Notably, the Section 245A deduction does not apply to "hybrid dividends," which are defined as amounts received from a controlled foreign corporation (a "CFC") for which a deduction would otherwise be allowed under Section 245A and for which the CFC received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States.[36] The exception for hybrid dividends may implicate the efficiency of non-U.S. holding company structures commonly used in connection with acquisitions of foreign targets. For example, a typical arrangement involves a Luxembourg holding company issuing preferred equity certificates ("PECs") that are treated as debt for Luxembourg tax purposes but as equity for U.S. tax purposes.[37] Under such an arrangement, the

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34. The transition tax is relevant, however, to the acquisition of a U.S. corporation that owns foreign corporate subsidiaries. In that context, an acquirer may want to contractually provide that the seller bear the cost of any transition tax for which the U.S. target is liable.
35. Treas. Reg. § 1.956-2T(d)(2), Notice 88-108, 1988-2 C.B. 445.
36. § 245A(e)(1), (4).
37. *See generally* Oscar Grisales-Racini, *Cross-Border Hybrid Mismatch Arrangements in a Post-BEPS World: U.S. and EU Perspectives*, Bloomberg BNA (Jan. 26, 2017). Another common hybrid instrument used in Luxembourg holding company structures is the convertible preferred equity certificate, which is typically convertible at a fixed ratio and optionally redeemable at fair market value. Because the instrument is treated as debt in Luxembourg, a conversion is not treated as a dividend subject to withholding and could be eligible for a preferential dividend rates in the United States prior to enactment of the TCJA. *Id*.

Luxembourg holding company can deduct interest paid or accrued and the U.S. parent would not be subject to withholding tax on interest payments, while the accrual on the PECs will not be currently taxable in the United States (which it would be if the PECs were treated as debt for U.S. tax purposes) until a dividend is paid to the U.S. parent.[38] Under the TCJA, however, to the extent the dividends on PECs are eligible for an interest deduction in Luxembourg, the dividends will be treated as hybrid dividends that are ineligible for deduction under Section 245A. The exception for hybrid dividends creates a tradeoff for the use of PECs in that payments on the PECs may not be entitled to a Section 245A deduction to the extent eligible for an interest deduction in Luxembourg, but will be subject to Luxembourg withholding if treated as non-deductible dividend payments from a Luxembourg tax perspective. In light of the TCJA's addition of Section 245A, taxpayers may want to reconsider the efficiency of typical non-U.S. holding company structures, such as the use of Luxembourg holding companies and PECs.

IV. ACQUISITIONS OF FOREIGN TARGETS BY DOMESTIC CORPORATIONS UNDER THE GILTI REGIME

In connection with the shift to a partial territorial system and the implementation of an exemption for dividends from 10% owned foreign corporate subsidiaries, the TCJA imposes a number of new restrictions intended to prevent the erosion of the U.S. tax base. One such base erosion measure is a new tax on "global intangible low-taxed income" (commonly known as "GILTI") for United States shareholders of CFCs.[39] The GILTI regime is intended to prevent U.S. taxpayers from moving investments and operations into corporate subsidiaries in low- or no-tax foreign jurisdictions and then repatriating the earnings tax-free under the new participation exemption system (as discussed in Part III above), therefore avoiding tax on those earnings entirely. The new Section 951A ensures that United States shareholders are paying a sufficient amount of tax somewhere in the world by subjecting United States shareholders to a current tax (similar to the Subpart F regime) on their earnings from intangible property.

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38. *Id.*
39. For purposes of § 951A, a United States shareholder is treated as a United States shareholder only if such person owns stock within the meaning of § 958(a) of a CFC, which requires direct or indirect ownership (proportionate ownership through a foreign corporation, partnership, trust or estate), on the last day of the taxable year of the foreign corporation on which such corporation is a CFC. § 951A(e)(2).

GILTI for a United States shareholder in a given taxable year is determined on an aggregate basis for all of the CFCs with respect to which it is a United States shareholder, based on a complex formula equal to the excess of its "net CFC tested income" over its "net deemed tangible income return" for such taxable year.[40] This formula is intended to approximate earnings on intangible assets by calculating income from CFCs other than a deemed reasonable return on tangible assets.

A United States shareholder's "net CFC tested income" is equal to the excess of the aggregate of such shareholder's pro rata share of the tested income of each CFC with respect to which such shareholder is a United States shareholder over the aggregate of such shareholder's pro rata share of the tested loss of each such CFC.[41] The tested income or loss of each CFC is the income and deductions of the CFC other than with respect to (i) income effectively connected with the conduct of a U.S. trade or business, (ii) Subpart F income, (iii) income that is subject to a foreign income tax rate greater than 90% of the maximum U.S. corporate income tax rate, (iv) dividends received from related persons, and (v) certain foreign oil and gas income.[42]

A United States shareholder's "net deemed tangible income return" equals the excess of 10% of the aggregate of such shareholder's pro rata share of the "qualified business asset investment" of each CFC over the amount of interest expense taken into account in calculating such shareholder's net CFC tested income to the extent the interest income attributable to such expense is not taken into account in determining such shareholder's net CFC tested income.[43] Qualified business asset investment is the average of the aggregate adjusted bases in tangible property used in the trade or business of a CFC or for which a Section 167 depreciation deduction is available.[44]

Similar to Subpart F income, GILTI requires any person who is a United States shareholder of a CFC for any taxable year to include its pro rata share of GILTI in its gross income for such taxable year on a current basis. United States shareholders that are corporations are entitled to a

40. § 951A(b)(1).
41. § 951A(c)(1).
42. § 951A(c)(2).
43. § 951A(b)(2).
44. § 951A(d)(1), (2).

deduction under the new Section 250 of the Code which results in a lower minimum effective tax rate on GILTI of 10.5%.[45]

The new tax on GILTI is a relevant consideration for any U.S. corporation acquiring a foreign target corporation. From a diligence perspective, a domestic acquirer will want to thoroughly understand the foreign target's asset composition in order to model any potential GILTI impact and determine the most tax-efficient structure for any acquired intellectual property or other intangible assets.

It may be necessary to include contractual language allocating any GILTI cost for the taxable year in which the acquisition occurs between the buyer and seller. Because GILTI (like Subpart F income generally) is included in the income of any United States shareholders that own stock in the CFC on the last day of the foreign corporation's taxable year, in the absence of any contractual provision a domestic corporation that acquires a CFC will include in its income GILTI attributable to the entire taxable year (including the portion prior to when it acquired the CFC). Unless it is possible to close the CFC's tax year in connection with the acquisition, this would not be addressed by a standard pre-closing tax indemnity because (i) the GILTI inclusion occurs in the post-closing tax period and (ii) the tax would not be a tax of the foreign target or its subsidiaries. Therefore, a domestic corporation acquiring a CFC that is expected to generate GILTI in the year of the acquisition may want to consider contractually allocating GILTI between the pre- and post-closing tax periods for purposes of any tax indemnities or otherwise adjusting the purchase price for the expected GILTI inclusion attributable to earnings during the seller's period of ownership.[46] If the foreign target is not a CFC prior to closing, a seller may not want to bear any GILTI cost because the GILTI cost is incurred solely due to the foreign target becoming a CFC as a result of the transaction.

Section 951A of the Code may also create an additional incentive for domestic acquirers to make a Section 338(g) election in certain circumstances. Domestic acquirers conducting a stock acquisition of a foreign corporate target entity should carefully consider making a

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45. This lower minimum effective tax rate of 10.5% will increase to 13.125% due to a reduction in the deduction for GILTI under § 250 from 50% to 37.5% for tax years beginning after December 31, 2025. § 250(a)(3).
46. Similar considerations existed for domestic acquirers of CFCs with regard to Subpart F income prior to the implementation of GILTI. It is not uncommon for domestic acquirers to contractually allocate Subpart F income between the pre- and post-closing tax periods or otherwise adjust the purchase price for any Subpart F cost attributable to pre-closing earnings.

Section 338(g) election when so electing would cause a step-up in basis of tangible, depreciable assets, which include any tangible property used in the production of tested income, used in a trade or business of the CFC, and with respect to which a deduction is allowable under Section 167.[47] Achieving a step-up in the tax basis of these assets will increase the net deemed tangible income return and therefore decrease GILTI. Further, any step-up of intangible assets that are amortizable may permit greater amortization deductions, thereby reducing net CFC tested income. In addition, making a Section 338(g) election with respect to the acquisition will close the taxable year of the foreign corporate target (thus avoiding the need to take into account pre-acquisition GILTI in negotiating the acquisition contract, as discussed above). Alternatively, if feasible, domestic acquirers may also prefer to structure acquisitions by purchasing assets of the foreign target rather than purchasing foreign target stock. Assuming the buyer forms a new CFC to purchase a foreign target's assets, an asset purchase will achieve the same results as a Section 338(g) election and will reduce GILTI when the target has depreciable or amortizable assets.

From a seller's perspective, however, a Section 338(g) election will increase CFC net tested income and generate GILTI when the entity is a CFC prior to close and has a seller that is a U.S. person. In addition, the Section 338(g) election may increase the seller's earnings and profits and the potential for exempt dividends under Section 245A. However, the deemed asset sale as a result of the Section 338(g) election will cleanse the foreign target's earnings and profits since the election treats the foreign target as a new corporation for U.S. federal income tax purposes.[48] The elimination of earnings and profits may decrease the acquirer's potential for exempt dividends under Section 245A because distributions in excess of the CFC's earnings and profits and the acquirer's basis will be treated as returns of capital, which are not eligible for exemption under Section 245A. Acquirers must carefully diligence foreign targets to ensure the most tax efficient acquisition structure.

47. § 951A(d)(1), (2). Acquisition agreements typically require the parties to agree upon a purchase price allocation. There may be an incentive for the buyer to negotiate for a greater allocation of the purchase price to tangible, depreciable assets to achieve a greater step-up in basis and increase the buyer's pro rata share of qualified business asset investment in order to reduce GILTI liability.

48. § 338(a)(2).

V. CONCLUSION

The TCJA introduces significant new complexities as well as new tax planning opportunities for a domestic group's acquisition of a foreign target. In particular, the Section 163(j) limitation on interest deductibility, the Section 245A deduction for certain foreign-source dividends, and the new GILTI regime may require reevaluation of typical methods of structuring foreign target acquisitions and repatriation of foreign earnings. It is essential for domestic groups and their tax advisers to understand these complexities in order to determine which acquisition and financing structure is most tax efficient given the particular circumstances of the transaction.

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