Here Be Dragons — and Opportunities:
The Uncharted Tax Waters of Your Company's or Your Client's First Foreign Acquisition

by Anna Derewenda

The increasing volume of mergers and acquisitions (M&A) in 2014 and 2015 has been a hot topic for commentators and analysts. Heightened levels of M&A activity made headlines in 2014 and reports indicate that the number of deals is expected to increase further in 2015.[1] The growing interest in acquisitions may reflect a strengthening US economy. This, coupled with the large amounts of cash reserves held by US companies, creates an amenable atmosphere for additional M&A activity for the remainder of 2015 and beyond.

This optimism extends to acquisitions by US companies of foreign entities (outbound acquisition). Currency exchange rates are another factor in cross-border acquisitions and the strength of the US dollar in 2015 has provided an additional level of benefits. A recent analysis by PricewaterhouseCoopers indicates that US investment in foreign markets has increased by 80 percent in the first half of 2015 (up to $139 billion from $89 billion in 2014).[2]

Expanding internationally can provide a US company with exciting new opportunities, including access to new customers and markets, as well as manufacturing and workforce opportunities. However, for a US company considering its first outbound acquisition, the process can seem quite daunting. Besides the new logistics and integration that will be required, the acquisition will likely require an analysis of US and foreign tax issues and rules that the US purchaser has not dealt with previously. This article provides an overview of and introduction to some of the tax issues and considerations that can potentially arise in the various stages of the outbound acquisition process, specifically in the context of a stock purchase.

Due Diligence

As is the case with all stock acquisitions, in order to complete tax due diligence it is important to understand not only the financial statements and tax filings of the target but also its legal structure and business operations. When pursuing a foreign target, this review, as well as all aspects of the purchase, must be completed while keeping two perspectives in mind: the non-US view and the US view. These considerations are relevant because while the purchaser must be aware of the potential foreign tax liabilities of the target, the operations and activities of the foreign company may result in US tax consequences to the US purchaser.

Due diligence should include a review of the foreign target's legal entity organization chart. An understanding of the target's investments will help provide a background for understanding the operations and intercompany transactions of the target and its affiliates, as well as information that will be necessary for structuring the acquisition.

Practitioners should understand each target company as a separate entity and also review its operations on a global scale. Among other items, due diligence includes understanding the target's intercompany agreements, financing, and location and volume of supply chains, manufacturing operations, distributors, sales agents, and employees. Reviewing these items will provide background for another important detail—intercompany payments, such as service fees, interest, dividends, and royalties.

Practitioners should also request copies of the foreign target's financial statements and foreign tax returns (including any supporting documentation) in order to understand the potential foreign tax exposures and tax balance sheet positions. The request should include items that may not yet be relevant to the US purchaser, such as value-added tax returns, tax rulings, and transfer pricing documentation. If the sellers are US persons and the target and/or its subsidiaries are (or have been) controlled foreign corporations (CFCs) or passive foreign investment corporations (PFICs), copies of any US tax information returns filed also should be requested.[3]

Obtaining these documents and details will help the buyer analyze the following aspects:

- *Type of entity:* As in the United States, each country has multiple options for organizing a business. In addition to confirming the local tax aspects of the chosen business entity, it will be important to know the foreign target's tax classification (or entity type) for structuring purposes, including the availability of check-the-box elections, as discussed further below.
- *Potential foreign tax exposures*: Tax liabilities may result not only from home country tax filings and positions, but also from other jurisdictions as a result of "permanent establishments" created through the target's activities in another country.
- *Withholding taxes*: Countries often impose withholding taxes on payments made outside their jurisdiction. These taxes are applied on a gross basis and the rates typically depend on the type of payment being made. For example, different withholding tax rates may apply to payments of royalties, interest, dividends, and for services. Understanding the applicable tax rates can be important for both due diligence and planning purposes because the rates can be quite high in some countries. However, if the recipient is eligible, the rate may be reduced under an applicable income tax treaty between the foreign country and the US.
- *Transfer pricing documentation*: Most countries have transfer pricing rules in place requiring that many payments made between affiliated companies are completed on an arm's length basis. Documentation and reporting may be required by the taxing authorities in the foreign country and in the US. In the absence of proper transfer pricing, the target and its affiliates may be under a higher risk of having their taxable income adjusted by the taxing authorities.
- *Tax rulings*: Some countries allow taxpayers relatively easy access to advance tax rulings whereby the taxpayer and the tax authority can agree to the tax consequences for proposed transactions. The tax authorities also can agree to the effective tax rate for a company's income taxes. Often these rulings are conditional on the substance in the entity (e.g., the number of individuals employed locally).
- *US anti-deferral regimes*: Where the foreign target will be a CFC or a PFIC in the hands of the US purchaser, the target's investments, operations, and transactions may result in the US purchaser being required to include the target's foreign profits in its US taxable income. Understanding the target's status is important

to know what post-closing risks may arise for the US purchaser after the acquisition.

- *Tax attributes*: Tax attributes should be analyzed from both foreign and US tax perspectives. For example, it may be necessary to understand the earnings and profits (E&P) of the target as well as the foreign tax paid by the foreign targets.[4] These attributes are calculated pursuant to US tax rules and may be different from earnings and tax pools calculated for foreign tax and financial statement purposes.[5] Therefore, where the seller is foreign, it is unlikely that such records have been kept. As discussed below, an election under Section 338 of the Internal Revenue Code (Section 338 Election) may be useful in purging these historical attributes for US tax purposes.

Structuring the transaction

The structure of the transaction will depend on many factors, including the identity of the buyer and the purchaser, whether the target is publicly traded or privately held, and whether an asset or stock purchase is contemplated. The structure can be simple, such as the making of one of the elections listed below, or more complicated involving multiple entities and steps or even implicating the much discussed "inversion" rules.[6]

- *Use of a newly formed acquisition company:* An acquisition company, either foreign or US may be useful for an additional layer of legal protection, where an asset purchase is contemplated and in planning for financing, post-closing ownership, operations and transactions.
- *Section 338 Election:* A Section 338 Election will serve to treat a stock purchase as an asset acquisition for US federal income tax purposes.[7] A fictional transaction is deemed to occur whereby "old" target sells all of its assets to "new" target.[8] This has the effect of eliminating the historic US tax attributes of the target and therefore may be useful where the E&P and foreign tax credit pool of the target is not known or is unreliable. Furthermore, the election may have the benefit of stepping up the tax basis of assets, resulting in increased depreciation and amortization deductions that may serve to reduce the future E&P of the entity. It should be noted that this election is effective *only* for US tax purposes and has no effect on the tax attributes as calculated for foreign tax purposes. Thus, for example, a Section 338 Election may eliminate a historic deficit in E&P for US tax purposes, but carryforward losses may continue to exist for foreign tax purposes.

  A Section 338(g) election may be made for a foreign target if all the requirements for making such an election are met.[9] There are various considerations that must be analyzed in conjunction with the making of this election. The election may have an effect on the future tax credits available to the US purchaser or the character of distributions made from the target.[10] In addition, the identity of the seller will be relevant. Where the seller is a US person, additional tax may result to them on the sale of their shares because the election may recharacterize their gain. Indemnification of the seller for incremental taxes may be negotiated as part of the purchase and included in the share purchase agreement.
- *Check-the- box election*: The US tax rules provide that a taxpayer may elect to treat domestic and foreign business entities as corporate (opaque) or as flow-through (transparent) entities.[11] In certain circumstances, it may be useful to treat the foreign target as a flow-through entity. Such an election may be useful where the foreign target is projected to create losses, when deferral of US taxation on foreign income is not possible due to anti-deferral regimes, or where access to additional US foreign tax credits may result.

  The check-the-box election is generally available for foreign entities unless they are on a list of entities known as "per se corporations."[12] An election cannot be made to treat such entities as flow-through entities. Therefore, it is important to understand the foreign target's structure to determine whether a conversion to an eligible entity will be required. Such conversions can often be completed in a tax neutral matter, but it may take several weeks or even months, resulting in "tax leakage" while the foreign target remains a corporation and upon the check-the-box election itself.
- *Financing of the acquisition*: Acquisition of the foreign target may be financed by the cash held in the US purchaser's reserves or through third-party financing. To the extent that bank financing is necessary, the determination should be made as to whether it should be obtained by the US purchaser or a foreign acquisition company. Although generally driven by non-tax factors, financing of the acquisition must be carefully analyzed from a tax perspective.

  For example, banks frequently require collateral for loans by US purchasers. This requirement can extend to a pledge of the newly purchased foreign assets or shares. Such a pledge can result in a deemed dividend to the US purchaser in the amount of the loan.[13] The same consequences can result if the foreign subsidiary guarantees the

US purchaser's loan.[14] Therefore, care must be taken to ensure that the financing is properly negotiated to avoid substantial tax consequences to the purchaser.

Conclusion

Although the acquisition of the US company's first foreign target can seem like a daunting process, it can provide significant opportunities for growth of the company. Coordination with reliable and knowledgeable co-counsel in the local jurisdiction(s) will be vital in the process, ensuring that issues are properly addressed and negotiations adequately memorialized in the purchase agreement. With the assistance of experienced US and local counsel, the burdens on you and your company can be greatly alleviated.

Kyle Wingfield contributed to this article.

Endnotes:

1 http://www.pwc.com/us/en/press-releases/2015/pwc-deals-mid-year-outlook-press-release.jhtml based on data provided by Thomson Reuters; http://www2.deloitte.com/content/dam/Deloitte/us/Documents/mergers-acqisitions/us-ma-trends15-042115.pdf.

2 http://www.pwc.com/us/en/press-releases/2015/pwc-deals-mid-year-outlook-press-release.jhtml.

3 A CFC is a foreign corporation that is owned more than 50% by US shareholders. I.R.C. § 957(a). For this purpose, a US shareholder is a US person that owns 10% or more of the shares of the foreign corporation. I.R.C. § 951(b). Where the foreign corporation is a CFC, the US shareholder may be subject to the "Subpart F" anti-deferral regime requiring inclusion of the CFC's profits in the shareholder's US taxable income.

The PFIC regime is also an anti-deferral regime, but has no ownership threshold. A foreign corporation will be treated as a PFIC if the level of its "passive" income and assets meets a certain threshold. I.R.C. § 1297. A US person owning an interest in a PFIC may be subject to additional taxation on distributions from and sales of the PFIC stock. I.R.C. § 1291.

In both cases, additional return reporting will likely be required for the U.S. shareholder.

4 A US shareholder's taxable income under US anti-deferral regimes often depends on the E&P of the foreign company. However, double-taxation of the income may be alleviated in certain circumstances through credits available in the U.S. for foreign taxes paid on that income. I.R.C. §§ 901, 902.

5 I.R.C. § 964(a).

6 *See* I.R.C. § 7874.

7 I.R.C. § 338(a).

8 *Id.*

9 *See generally* I.R.C. § 338 and the regulations thereunder.

10 *See, e.g.,* I.R.C. § 901(m).

11 Treas. Reg. § 301.7701-3.

12 Treas. Reg. § 301.7701-2,-3.

13 *See* I.R.C. § 956; Treas. Reg. § 956-2(c).

14 *Id.*

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