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Acquisition of Assets in Cross-Border Asset and Stock Deals

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In this article, the authors examine how the Tax Cuts and Jobs Act affected the general rules and dynamics for cross-border mergers and acquisitions involving controlled foreign corporations.

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Although cross-border mergers and acquisitions involving controlled foreign corporations have never been straightforward, before the enactment of the Tax Cuts and Jobs Act the general rules and dynamics were fairly well traversed and familiar to taxpayers and practitioners alike. The TCJA has changed the rules of the game, sometimes in unexpected ways. Although the carrot-and-stick approach of the TCJA's international tax provisions (for example, foreign-derived intangible income, global intangible low-taxed income, the base erosion and antiabuse tax) appears to encourage U.S. taxpayers to keep assets within or migrate them back to the United States, the incentives to do so may not be as effective or pronounced as one might expect. As a result, U.S. multinationals are faced with a complicated math problem in deciding when and how to involve CFCs in M&A deals. In this article, we explore some of the salient factors relevant to analyzing this problem, both in terms of deciding from where to sell and buy those assets, as well as some pre- and post-integration approaches that should be considered to make the math work.

Historic Approaches and Trends

Before delving into the current international tax landscape, it is helpful to understand how we got where we are. Historically (that is, pre-TCJA), the United States has had a "worldwide" tax system, whereby all income earned by a U.S. taxpayer, directly or indirectly, was subject to U.S. tax, with credits available to offset foreign tax burdens. (This general framework remains in place in the post-TCJA era.) Earnings of a CFC, however, typically were not subject to U.S. taxation unless and until repatriated. Like many international tax provisions, this general rule was subject to a significant exception — subpart F — which in turn was subject to numerous exceptions of its own. Thus, although some types of passive and mobile income could be subject to current subpart F taxation before repatriation, the various exceptions to subpart F allowed U.S. multinationals to continue to defer U.S. taxation on most of the earnings of their CFCs. As a result, it often made economic sense for U.S. multinationals to hold (or migrate) income-generating assets offshore to achieve a better global tax result and effective tax rate.

Repatriation of offshore earnings, however, was significantly more challenging, and usually could not be accomplished on a tax-efficient basis without creative tax planning. This so-called lockout effect created incentives for U.S. multinationals to finance acquisitions (both stock and asset deals) using previously untaxed CFC

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earnings (that is, acquiring stock or assets at the CFC level was often advantageous).

Against this backdrop, the pre-TCJA M&A math was not overly complicated in practice and tended to lean toward: (1) buying and selling between local-country entities to the greatest extent possible; (2) maximizing the use of previously untaxed CFC earnings to finance deals; and (3) above all, avoiding any transaction or pre-acquisition restructuring that would move previously untaxed earnings or assets onshore, unless a tax-efficient strategy was available to mitigate the associated tax costs.

Historically (and to this day), the threshold question in almost all M&A deals is whether to structure the transaction as an asset (or deemed asset) acquisition or a stock acquisition. Before enactment of the TCJA, the answer often turned on several factors, such as (1) whether the target assets were owned or held within or outside the United States, (2) whether they were tangible or intangible in nature, (3) whether they were held in corporate solution or through a passthrough vehicle, (4) the amount of built-in gain or loss in the target assets, and (5) the tax profile of the buyer. We focus here on CFC acquirers in the cross-border context.

In the purely domestic context, a seller generally preferred a stock sale because it would only be responsible for U.S. taxation on its shareholder-level gain and could avoid recognizing and incurring tax on any built-in gain in the target's assets. By contrast, an acquirer generally preferred an asset sale because it could obtain a stepped-up basis in the acquired assets. (An asset sale was also preferable for nontax reasons; for example, avoiding or limiting the assumption of any liabilities of the target.)

In the cross-border and foreign-to-foreign contexts, however, asset sales could be advantageous for both seller and buyer, particularly when a deal involved the acquisition of foreign assets owned or held by a CFC. An asset sale could generally be structured to avoid creating currently taxable subpart F income for its U.S. parent. As a result, the selling group could defer U.S. taxation on the proceeds from the sale until those earnings were repatriated to the United States. By contrast, a sale of the CFC itself, either by a U.S. shareholder of the CFC or by another related CFC, generally resulted in a current U.S. income inclusion for the selling group.

Cross-border asset sales were generally advantageous for CFC acquirers as well. As mentioned, an acquirer would usually obtain a stepped-up basis in the acquired assets, the resulting depreciation and amortization deductions from which could be used to offset other taxable income. Acquiring assets through a CFC offered several additional advantages that are not present in the domestic context. For example, previously untaxed CFC earnings could be used to finance the acquisition, alleviating the lockout effect. Moreover, asset sales could facilitate and simplify post-acquisition integration planning (particularly when the acquired assets included intangibles that would ultimately need to be incorporated into an existing cost-sharing arrangement), and in some circumstances minimize or eliminate corresponding withholding tax costs.

General Post-TCJA Considerations

The TCJA purportedly transitioned the United States from a worldwide tax system to a territorial tax system. To do so, it instituted a carrot-and-stick approach to encourage U.S. taxpayers to keep their operations, assets, and sales in the United States. Much has been written about this approach, so we only briefly summarize it.

FDII (section 250) is the carrot; it aims to provide an incentive for U.S. multinationals to book and recognize worldwide income in the United States. To this end, domestic corporations are eligible for a reduced rate of taxation on qualifying income derived from sales, licenses, leases, or the provision of services to non-U.S. persons when the property or services involved are used or consumed outside the United States. However, this favorable tax treatment only applies to income over a notional 10 percent return on the depreciable tangible property used to generate the income — so-called qualified business asset investment. Income representing the return on assets is taxed at normal U.S. corporate tax rates. As a result, increasing QBAI held by a domestic corporation — one of the apparent underlying policies of the FDII rules —

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has the (surprising) effect of reducing the FDII benefit available to the corporation — an outcome that runs counter to the apparent policy of the rule. Against this backdrop, the math problem, from a tax benefit standpoint, appears to be:

Net benefit of [(cost of moving assets to the United States) + (FDII deduction)]	>	Net cost of [(cost (if any) of leaving assets outside the United States) + (no FDII deduction)]

GILTI (section 951A) is the companion provision to FDII — the stick[1] to FDII's carrot — and can be thought of as a current minimum tax on non-subpart F earnings of a CFC over a 10 percent deemed return on QBAI. Put another way, GILTI effectively imposes current U.S. taxation on CFC earnings that were historically (that is, pre-TCJA) eligible for deferral until repatriated. Although the FDII and GILTI rules share a common framework, they diverge in one very important respect: CFC earnings representing the 10 percent return on QBAI are not subject to GILTI or otherwise subject to U.S. taxation. Thus, increasing QBAI held by CFCs has the potential to increase the GILTI benefit[2] — an outcome that appears to run counter to the apparent policy of the FDII rules. Viewed through the lens of the GILTI rules, the math problem, from a tax benefit standpoint, thus appears to be:

Net benefit of [(moving assets to the United States) + (no GILTI)]	>	Net cost of [(not moving assets) + (GILTI)]

Although in theory it may be possible for a domestic corporation to avail itself of both the FDII and GILTI benefits, in practice many will be faced with the decision of planning into one regime or the other (particularly those domestic corporations with existing cost-sharing arrangements).[3] This only further complicates (and exacerbates) the math problem we have been discussing. That is, it cannot be universally said that [benefit of no GILTI] > [benefit of FDII deduction], or that [benefit of FDII deduction] > [benefit of no GILTI]. To that end, solving the math problem will depend on the end goal. If the goal is to maximize the FDII deduction, a domestic corporation will want to minimize the QBAI on its balance sheet. Doing so, however, could make it more challenging to generate FDII-eligible earnings in the first place. On the other hand, if the end goal is to minimize GILTI inclusions, a taxpayer will generally want to increase the QBAI on balance sheets of its CFCs.

Buy and Sell Side Considerations

We next turn to M&A deals. As discussed previously, all other things being equal, a buyer will generally prefer an asset deal because the associated benefit of receiving stepped-up basis in the acquired assets and the depreciation and amortization deductions that derive from them are often quite material.[4] Against this backdrop, should a domestic buyer "plan into" FDII? In other words, should a domestic acquirer directly acquire both U.S. and non-U.S. target revenue-generating assets (rather than, for instance, acquiring non-U.S. assets through a CFC) to maximize the amount of earnings eligible for the FDII deduction and to minimize GILTI exposure?

The economic benefit of such an approach is questionable, and in many cases the approach will simply be wrong. Viewed together, FDII and GILTI arguably create an incentive for U.S. multinationals to acquire and hold all target assets through CFCs. Doing so minimizes QBAI directly held by a domestic corporation, which can in turn increase the amount of earnings eligible for the FDII benefit. Thus, attempting to solve our math problem relying on the FDII equation — net benefit of [(cost of moving assets to United States) + (FDII deduction)] > net cost of [(cost of leaving assets outside United States) +

[1] BEAT and various anti-inversion provisions are other examples of sticks, although they are outside the scope of this discussion.

[2] However, increasing QBAI also has the effect of decreasing the foreign tax credit allowable for GILTI earnings, which can diminish the overall benefit of "planning into" a GILTI structure.

[3] *See* reg. section 1.482-7. Most cost-sharing arrangements are structured such that the U.S. participant has the exclusive right to sell into the United States and the foreign participant has the exclusive right to sell into some or all countries outside the United States.

[4] Additional considerations may result in an asset sale preference, such as section 168(k) as amended by the TCJA, which allows immediate expensing of the cost of some qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. This benefit would be most applicable to deals in which the target assets include a material amount of tangible property.

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(no FDII deduction)] — may be oversimplistic in many cases.

Even with the previously discussed dynamics in mind, it is not entirely clear that our GILTI equation — net benefit of [(moving assets to the United States) + (no GILTI)] > net cost of [(not moving assets) + (GILTI)] — makes any more sense, economically speaking. Although increasing QBAI reduces GILTI, it also reduces the foreign tax credits available to offset foreign taxes incurred regarding GILTI. The loss of those credits can in some cases produce a worse overall tax outcome, despite the general reduction in GILTI.

Other Post-TCJA Challenges

For the reasons discussed, although surprising given legislative intent, the framework of the GILTI and FDII rules creates an incentive to hold assets outside the United States (that is, in CFCs). Moreover, the enactment of (new) section 245A and the significant narrowing of section 956 by Treasury and the IRS have eliminated many of the obstacles that used to prevent taxpayers from holding U.S. assets through CFCs. Nevertheless, the question remains: Are these changes and incentives collectively meaningful enough to encourage U.S. multinationals to hold U.S. assets through CFCs? Perhaps. However, there are numerous challenges that taxpayers will need to carefully consider.

First, ownership by a CFC of tangible assets located in the United States has the potential to create a taxable presence for the CFC there. This has several important implications. First, any income effectively connected with (or attributable to, in the case of a permanent establishment) the taxable presence will be subject to current U.S. taxation at normal U.S. corporate income tax rates (now 21 percent). Moreover, under the so-called force of attraction rules, any U.S.-source income of the CFC will also be subject to current U.S. taxation, regardless of whether it is effectively connected with (or attributable to) the activities or operations creating the taxable presence.

Second, assuming the CFC is considered to have a U.S. taxable presence, earnings generated from the U.S. property will not be eligible for the preferential GILTI and FDII tax rates (10.5 percent and 13.125 percent, respectively). Effectively connected income is explicitly excluded from the definitions of tested income (GILTI) and deduction-eligible income (FDII).

Third, the new participation exemption under section 245A is not available for earnings of a CFC representing ECI.

Fourth, even if a taxpayer is able to successfully navigate those obstacles, it must still contend with withholding taxes that could apply to payments for use of or access to the tangible property. Rental income received from property located in the United States constitutes U.S.-source income subject to withholding. Moreover, income for the use of that property from a related party would in most cases constitute currently taxable subpart F income in the hands of the CFC unless an exception applies.

Against this backdrop, owning or holding U.S. tangible assets through a CFC may prove to be challenging, and perhaps more importantly, any potential GILTI benefit resulting from increased CFC-owned QBAI could very well be offset by the additional U.S. taxation resulting from one or more of the potential taxes previously discussed.

Nevertheless, might there still be a benefit to holding U.S. intangible assets through CFCs? Although basis associated with intangibles typically will not create or provide a QBAI benefit under the GILTI rules, amortization deductions available regarding that basis can reduce both subpart F income and GILTI (provided that antiabuse provisions do not apply). Moreover, unlike tangible assets, mere ownership or possession of U.S. intangible assets by CFCs typically does not create a U.S. taxable presence for a CFC (or a foreign corporation more generally).

At the same time, however, the withholding tax and subpart F considerations previously discussed continue to apply — that is, royalties and payments for use or access to intangible property are often subject to U.S. withholding tax. Moreover, royalties received from related parties typically give rise to subpart F income. Royalties received from unrelated parties typically do as well, unless the licenser is directly and actively engaged in the creation and development of the intangibles or actively engaged in marketing the intangibles or products derived from them. These

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additional tax costs, standing alone or in combination, may offset any amortization deduction benefit associated with CFC ownership of U.S. intangible assets.

Concluding Remarks

Has the carrot-and-stick approach been successful in encouraging U.S. multinationals to acquire and hold assets through domestic corporations? The jury is still out. However, preliminary indications suggest that the TCJA has not changed the historic buy-side and sell-side dynamics of M&A deals — at least not materially.[5] Nevertheless, it is possible that we are still in the midst of a (long and arduous) transition period in which taxpayers must work through important M&A decisions such as where to buy, sell, and hold assets. For now, taxpayers are advised to pause before concluding that onshoring assets — or not — truly makes economic or tax sense. ■

[5] *See, e.g.*, Thomas Horst, "Preliminary Estimates of the Likely Actual Revenue Effects of the TCJA's Provisions," *Tax Notes Int'l*, Sept. 16, 2019, p. 1153; and Congressional Research Service, "Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)" (Aug. 23, 2019).

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