Tax Due Diligence in M&A Deals Under the TCJA

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In this article, Morin explains how changes made by the Tax Cuts and Jobs Act complicate the tax due diligence for merger and acquisition deals.

As a tax lawyer, my role in tax due diligence for merger and acquisition transactions often coincides with that of the accountants, who generally make an initial review of the target's tax returns and intercompany flows. I concurrently examine whether anything doesn't pass my "this looks as expected" test. This happy relationship has been somewhat upended because of the Tax Cuts and Jobs Act (P.L. 115-97). Now everyone is looking at the structure of the target and its operations as soon as possible, pondering what changes might need to be made to the purchase agreement because of the TCJA and what needs to be considered in integration once the target is acquired. A nonexclusive list of those exigencies is discussed in this article.

Broad Strokes

When conducting tax due diligence, it is worth asking targets for copies of any work papers, calculations, or estimates that they have prepared since passage of the TCJA. Similarly, sellers should be prepared for this question as well. Depending on the sellers, the target may have considered several possible scenarios that may be helpful to a potential buyer, such as any benefit of onshoring intellectual property to the United States or any new interest deduction limitations stemming from new section 163(j). Of course, targets with offshore corporate subsidiaries will (hopefully) have considered any changes to their structure under the new section 958(b) controlled foreign corporation attribution rules and any toll charges that may become due under section 965.

Intercompany Flows

It has always been necessary to ask a target about its intercompany flows, including which entities undertake sales and distribution functions, which entities undertake research and development or manufacturing functions, which hold IP or other assets, and how each is getting paid for its services. Is a cost-sharing arrangement or are distribution agreements in place? After the TCJA, these questions have become crucial because a host of new regimes could apply to these intercompany flows. These new regimes may necessitate post-acquisition integration corrections or remediation. In some cases, they may provide a tax benefit.

Suppose a buyer is considering the acquisition of an onshore corporate target with offshore subsidiaries. The target is a C corporation (that is, not a regulated investment company, a real estate investment trust, or an S corporation). Pre-TCJA, it would be helpful as a due diligence matter to understand how each offshore subsidiary is funded, what functions each performs and what transfer pricing or debt issues should be considered, as well as any subpart F exposure. Post-TCJA, those same questions apply, but so do many more. For example, does the target have average annual gross receipts of at least $500 million, such that it may be subject to the base erosion and antiabuse tax under new section 59A? If so, is the onshore corporate target taking deductions from payments, or shifting revenue, to its offshore affiliates? Are these deductions covered under the BEAT? This is particularly important in tax due diligence matters because the BEAT can apply retroactively (in other words, it can apply to tax credits generated before the BEAT became law). Is the target taking this into account or has it ignored this issue? If the target has ignored it, what is the resulting exposure? What, if anything, can be done in integration to avoid the BEAT issue? Considerations might include relieving any related-party debt with unrelated third-party debt to avoid the BEAT on associated deductible interest payments or otherwise restructuring payments so they are not being made to the offshore subsidiaries.

Hybrids

As with intercompany flows, it has always been necessary to identify hybrid entities in a target's structure. A seller should be able to point to any hybrid entities in its structure as well and the reason for their creation. Hybrids have often been a useful international tax planning tool, allowing opaque tax treatment in one jurisdiction and passthrough in another. Historically, identifying hybrids has helped guide analysis regarding potential use of (or the inability to use) income tax treaties covering intercompany payments, as well as potential non-U.S. anti-hybrid rule complications.

Thanks to the TCJA, we now have a new consideration in undertaking tax due diligence for a target that is a hybrid entity or has affiliates that are hybrid entities — new section 267A. This provision is similar in some respects to the OECD's Base Erosion and Profit Shifting Action Plan 2, which attempts to address timing mismatches of income and deductions in hybrid entities.

Section 267A as a general matter disallows deductions for "disqualified related party amounts" that are paid or accrued under a "hybrid transaction" or by, or to, a "hybrid entity." Disqualified related-party amounts means any royalty or interest payments paid or accrued to a related party to the extent that either (A) the amount is not included in the income of the related party under the tax law of the country of which the related party is a tax resident or is subject to tax, or (B) the related party receives a deduction for the amount under the tax laws of that country. Disqualified related-party amounts do not include any payments that are included in the gross income of a U.S. shareholder under subpart F. A related party includes any related person within the meaning of section 954(d)(3) as applied to these new hybrid rules. A hybrid transaction means any transaction, series of transactions, agreement, or instrument in which one or more payments are treated as interest or royalties for U.S. tax purposes but not for purposes of the tax law of the foreign country of which the recipient of the payment is resident for tax purposes or is subject to tax. A hybrid entity means any entity that is either (A) treated as fiscally transparent for U.S. tax purposes but not for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or (B) treated as fiscally transparent for purposes of the foreign tax law but not for U.S. tax purposes. The new code provisions do not further define "royalty," "fiscal transparency," or what it means to be "subject to tax," so clear determinations of these terms are not currently feasible.

To address this tax due diligence issue (to the extent it can be addressed in light of present uncertainties), a buyer needs to know the full tax status of cross-border flows among affiliated entities, including the U.S. and non-U.S. tax treatment of all of an onshore target's offshore affiliates to whom the target is paying interest or royalties (bearing in mind that royalties are not clearly defined for purposes of section 267A), as well as the timing of income inclusions and deductions associated with them from U.S. and local perspectives. The buyer then needs to ask whether these provisions cause any such payments to result in an income and deduction mismatch that may be captured under section 267A. That section results in a permanent disallowance of the interest or royalty deduction that would otherwise apply, so it is not to be taken lightly if amounts are material and may have to be corrected if feasible in integration.

Controlled Foreign Corporations

Pre-TCJA, when acquiring a target with offshore entities in its structure and substantial U.S. ownership, CFCs were generally recognized relatively quickly. Ensuing tax due diligence after this initial identification might have included questions about the target's IRS Forms 5471 or estimates of subpart F exposure. After the TCJA, CFCs trigger a host of new issues and are not as easily identified as they may previously have been.

Importantly, the target may not appreciate that it has CFCs under the new TCJA rules. Historically, a U.S. shareholder of a CFC included U.S. persons who owned 10 percent or more of the voting power of the CFC. This definition led (sometimes questionably, from an antiabuse perspective) to issuances of limited or nonvoting stock to U.S. persons to avoid triggering CFC status of a foreign corporation. In a first hurdle to identifying CFCs, the post-TCJA CFC rules take into account U.S. persons who own not only 10 percent or more of voting power of the CFC but also U.S. persons who own 10 percent or more of the value of the CFC. A buyer needs to question any CFC determinations that a target or seller has made in consideration of this revised definition, particularly if those CFCs have issued nonvoting stock to U.S. persons.

In a second hurdle, the TCJA repealed section 958(b)(4), which had stated that so-called downward attribution does not apply in determining whether a U.S. person owned stock of a foreign corporation for CFC purposes. Because of the repeal, the stock of a foreign corporation that is owned by a foreign person can be attributed to a U.S. person under the rules of section 318 when determining whether the U.S. person is a U.S. shareholder of the foreign corporation. Thus, under the revised attribution rules for U.S. shareholders of CFCs, a target or seller that previously concluded that it had no CFCs in its structure may now be incorrect when applying the revised attribution rules.

If there are CFCs in the target's structure that are now recognized under the TCJA and the materialization of which the seller did not appreciate, exposure to subpart F and the global intangible low-taxed income may occur. If the seller did not realize it had these new CFCs in the target structure because of these changes in law, the seller very likely will not have considered any such exposures, leaving a potentially material tax liability for the buyer and worsening any existing negative tax consequences in the structure.

All new and existing CFCs might trigger subpart F exposure, as we knew before the TCJA. After the TCJA, these CFCs may now also trigger GILTI issues. This new tax requires each U.S. shareholder of a CFC to include in gross income for each tax year its proportionate share of the CFC's GILTI. The new regime is similar in operation in many ways to subpart F, although it includes not only passive income but also active business income. Thus, while a seller may have structured the operations of a target or its subsidiaries to avoid or reduce the burden of subpart F inclusions, similar planning may not have taken GILTI inclusions into account.

Transition Tax

The TCJA introduced new section 965, which provides a one-time tax on some accumulated earnings and profits held in corporate form offshore. A buyer needs to ask any U.S. target company that it is considering acquiring how this transition tax has been addressed. Has the target calculated the exposure? Has the target made (or will it make) an election to spread out the transition tax liability over eight years, as allowable under section 965(h)?

Depending on the business deal, the buyer may assume a target's transition tax liability, including any related installment payments. If so, the buyer should be mindful that proposed regulations under section 965 require the buyer and seller in some cases to enter into an agreement with the IRS to maintain the installment payment arrangement.

Importantly, one area where diligence seems to be lacking is in reviewing any potentially abusive (or deemed abusive) actions undertaken by the target or its affiliates to reduce the transition tax. Some antiabuse rules are included in new section 965(o) and in proposed reg. section 1.965-4(b) through (e) that apply to disregard some transactions that are entered into after November 2, 2017, with a principal purpose of causing a reduction in a section 958(a) inclusion amount or aggregate foreign cash position or an increase in deemed paid foreign income taxes as a result of a section 965(a) inclusion (which are referred to as changes in the section 965 element). These disregarded transactions further include changes in a relevant foreign corporation's method of accounting for a tax year that ends in 2017 or 2018, as well as entity classification elections that are effective on or after November 2, 2017, regardless of the principal purpose of the change, if it would also result in a change in the section 965 element. To assess any associated exposure, a buyer should ask for disclosure of any transaction that a seller or target may have undertaken that could be captured under these provisions.

Conclusion

Tax due diligence is more complicated now than it was before enactment of the TCJA. Buyers should consider revamping their due diligence questionnaires and inquiries to consider the new issues I've discussed and others that may apply because of the TCJA. Work with sellers as early in the deal process as possible to make sure they are aware of these issues and have the time and resources to answer the due diligence questions. And best of luck navigating the TCJA due diligence waters. ■