

US Tax Issues for Foreign Acquirers of US Companies

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This article focuses on issues that the foreign acquirer of shares of a US company needs to know about. The article begins by focusing on structuring and planning issues inherent in the purchase of a US company's shares, such as holding companies, tax elections, debt financing and sandwich structures. It then discusses the issues a corporate attorney must consider when drafting representations, covenants and indemnities. Although some tax laws are detailed in this section, the focus is on the language of these provisions that the attorney must include to protect the foreign acquirer.

Suppose that a foreign acquirer is going to acquire shares of a US target from a seller in a taxable transaction. What type of US tax issues should the foreign acquirer consider? The purpose of this article is to describe the US international tax issues that the foreign acquirer may see when structuring the taxable acquisition of the US target's shares and to provide sample language to protect the foreign acquirer in the acquisition agreement.

Acquisition structuring

Purchase of shares or assets

For the purposes of this article, it will be assumed that the foreign acquirer is making a taxable purchase of the US target's shares. Other forms of acquisition include a taxable purchase of a US target's assets or a corporate

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reorganisation that is tax-free with respect to the acquisition of either shares or assets.¹

If the foreign acquirer purchases the shares of a US target, chances are the fair market value of the US target's shares (theoretically, the purchase price) is greater than the cost basis that the US target has in its individual assets.

The foreign acquirer can increase the US target's cost basis in its assets to fair market value, which increases the tax depreciation, by making a section 338(g) election. In effect, the transaction is treated as if the foreign acquirer makes a taxable asset purchase from the seller. Accordingly, the US target recognises gain on each of its assets and, if the US target is a corporation in the United States, there will generally be two levels of tax imposed – corporate income tax at the US target level and income tax at the shareholder level when the US target distributes the profits. The foreign acquirer, who may make a section 338(g) election without the consent of the seller, bears the tax cost of the election on the US target's return.²

The foreign acquirer's decision to make a section 338(g) election evaluates whether the net present value of the additional depreciation from the increased basis exceeds the tax cost.

In contrast to a section 338(g) election, the foreign acquirer may purchase the US target's shares and jointly make a section 338(h)(10) election with the seller.³ This is the best of both worlds, satisfying the seller's desire to sell shares and the foreign acquirer's desire to purchase assets. Accordingly, the only tax is on the sale of assets because the sale of shares is ignored for US tax purposes while the foreign acquirer acquires the US target's assets with a fair market value tax basis. However, because the seller incurs the economic aspects of the tax, the foreign acquirer and the seller may typically negotiate a gross up of the purchase price for the additional tax from this election.

Use of a US holding company

If the foreign acquirer owns the shares of multiple US subsidiaries, the foreign acquirer should consider having a US holding company own the shares of the US subsidiaries.

Use of a US holding company is a good structure if the foreign acquirer anticipates operating in the United States for a long time and does not anticipate selling any of its US subsidiaries. Through the use of a US holding

1 IRC s 368(a)(1).

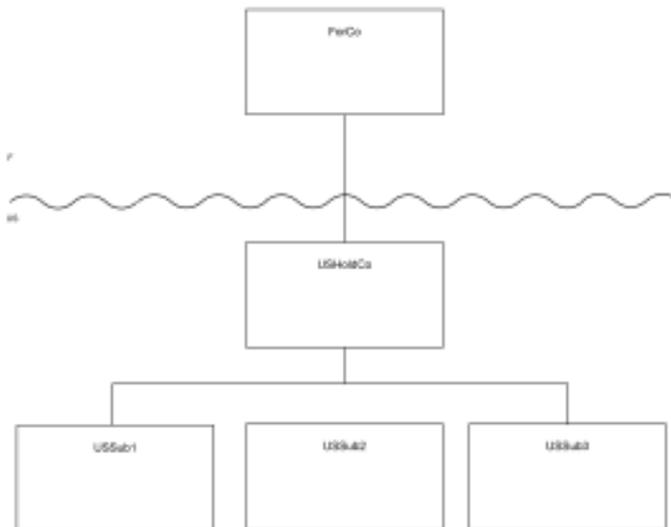
2 Although not as advantageous in recent years, a s 338(g) election is more beneficial for a foreign target of a US acquirer, which may not pay tax on the gain of the foreign target's assets.

3 A s 338(h)(10) election requires the US target to be either an S corporation or part of a consolidated group. If the US target is neither of these, similar results may occur from a s 336(e) election.

company, all the US subsidiaries will be part of a consolidated return and losses from one entity may offset gains from another entity.⁴

On the other hand, double taxation results when a US holding company sells a US subsidiary's shares and distributes the proceeds. More specifically, if a US holding company sells the shares of its US subsidiary, the US holding company pays tax on the gain and has earnings and profits. A subsequent distribution of earnings and profits from the US holding company to the foreign acquirer will result in a dividend subject to withholding tax.

Case Study 1: ForCo, a foreign corporation, owns USHoldCo, which owns USSub1, USSub2 and USSub3, each of which owns US assets purchased for \$9m. USHoldCo sells the shares of USSub1 for \$10m for a \$1m gain. USHoldCo will pay tax of \$350,000 on this \$1m gain, leaving \$650,000 of earnings and profits. USHoldCo distributes the \$650,000 of earnings and profits as a dividend to ForCo. If a treaty does not apply, USHoldCo will be subject to tax of \$195,000 (at a 30 per cent rate) for a total tax cost of \$545,000.

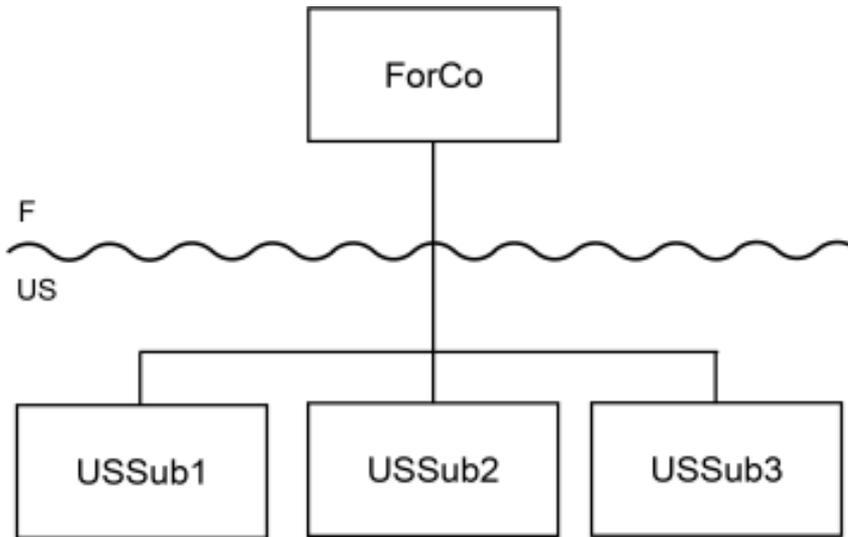


Direct ownership of a US subsidiary by the foreign acquirer without a US holding company is a good structure if the foreign acquirer anticipates selling the shares of the US subsidiary in the near future. Without a common US owner, the US target is not part of a consolidated return and losses from one US subsidiary in a particular year do not offset gains from another US subsidiary. However, the foreign acquirer can avoid US tax when merely selling the shares of a US subsidiary.⁵

4 IRC s 1502.

5 IRC s 865(a).

Case Study 2: ForCo owns USSub1, USSub2, and USSub3, each of which has recently purchased US assets for \$9m. ForCo sells the shares of USSub1 for \$10m, resulting in a \$1m gain. As long as USSub1 is not a US real property holding corporation,⁶ ForCo does not pay any US tax on the gain.



Thin capitalisation See Addendum at end of article

Any debt financing of a foreign-owned US corporation must consider the thin capitalisation rule that is known in the United States as the anti-earnings-stripping provision. The anti-earnings stripping provision limits deductions for interest payments to foreign parents that are exempt from withholding tax. The anti-earnings stripping provision can limit interest deductions in all kinds of acquisitions due to the mechanical calculation as follows:⁷

- (1) The debt-to-equity ratio of the US target must exceed 1.5 to 1.⁸
- (2) The interest expense exceeds interest income for a net interest expense.
- (3) The US target must have an excess interest expense that equals the excess of the US corporation's net interest expense over 50 per cent of the US corporation's income before interest, tax, depreciation and amortisation.⁹

⁶ The sale of a US real property holding corporation (the net fair market value of real property exceeds half the value of the shares) would result in effectively connected income that is taxed in the United States. IRC s 897(c).

⁷ IRC s 163(j).

⁸ IRC s 163(j)(2)(A)(ii).

⁹ IRC s 163(j)(2)(B)(i) and (j)(6)(B).

- (4) The US target must pay interest to a related person that is exempt from US withholding tax.¹⁰
- (5) The interest expense is disallowed to the extent of the lower of either excess interest expense (3) or payments of interest to a related party that is exempt from US withholding tax (4).

Case Study 3: GerCo, a German company, acquires all the shares of USAco, a US corporation that derives all of its income from US business operations. In a recapitalisation, GerCo recharacterises equity in USAco as debt such that USAco's debt to equity ratio is 2 to 1 and USAco pays annual interest of \$20m that is exempt from withholding under the GermanUS Tax Treaty. The results from USAco's first year of operations are as follows:

Gross profit	\$60m
Other operating expenses	\$37m
Income (pre interest expense)	\$23m
Interest expense (paid to ItCo)	\$20m

An analysis of the deductibility of interest is as follows:

- (1) USAco's debt to equity ratio is 2 to 1, which exceeds 1.5 to 1.
- (2) USAco only has interest expense for a net interest expense of \$20m.
- (3) USAco's excess interest expense equals its interest expense of \$20m less 50 per cent of its income of \$23m, not accounting for interest. Therefore, the excess interest expense is \$8.5m ($\$20m - (50 \text{ per cent} \times \$23m)$).

¹⁰ IRC s 163(j)(3)(A).

- (4) USAco's entire amount of interest expense of \$20m is paid to a related party (GerCo) that is exempt from withholding due to the treaty.
- (5) USAco's disallowed interest deduction is \$8.5m, which is the lesser of excess interest expense (\$8.5m from (3)) or the \$20m of interest paid to a related party that does not pay US tax on the interest ((4)). Only \$11.5m of the interest is deductible by USAco.

Checking-the-box

The check-the-box regime allows the foreign acquirer to choose the type of entity desired for either the US target or the foreign acquirer for US tax purposes only.¹¹

Checking-the-box creates the opportunity to treat entities as disregarded (eg, a branch), as a partnership, or as a corporation. All entities except per se corporations, such as a C corporation in the United States, are eligible entities.¹²

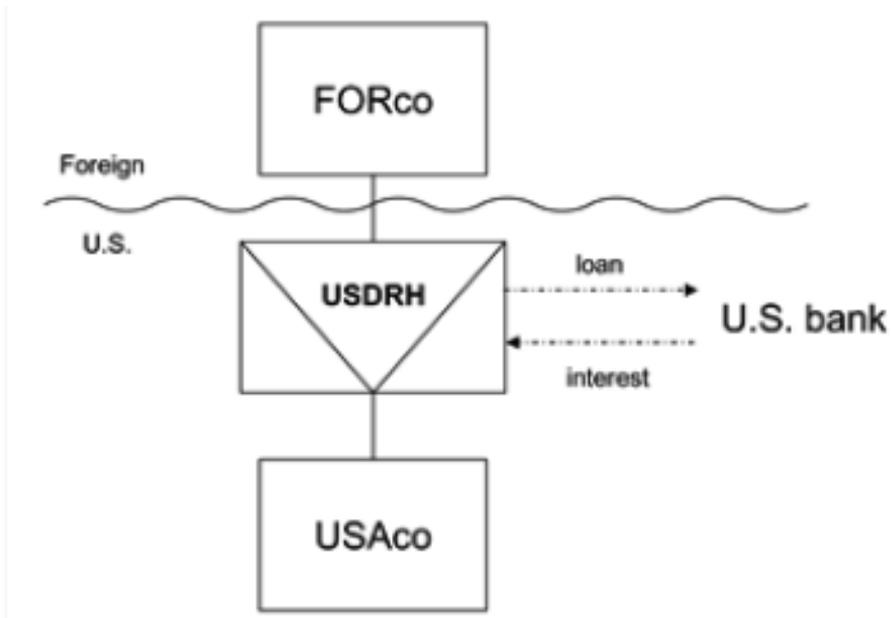
Taxpayers check the box by filing a Form 8832 within 12 months of the desired effective date or 75 days after the desired effective date.

Interest may be deductible against the income of both the US target and the foreign acquirer by checking-the-box to create a domestic reverse hybrid entity. A domestic reverse hybrid entity is treated as a corporation by the United States, but as a pass-through entity by the foreign country. A popular form of domestic reverse hybrid entity is a limited partnership for which the foreign acquirer has filed a Form 8832 that checks-the-box for US corporate tax status.

Case Study 4: ForCo, a corporation incorporated in country F, wants to acquire a US corporation, USAco. ForCo forms a domestic reverse hybrid entity ('USDRH'), which is a pass-through entity for country F tax purposes and a corporation for US tax purposes. USDRH borrows money from a US bank to which USDRH must pay interest and uses the funds borrowed to acquire the shares of USAco. For US tax purposes, USDRH and USAco file a consolidated return, which permits a deduction for the interest payment against the income of USAco. A double dip occurs because the pass-through nature of USDRH for country F tax purposes also permits ForCo to deduct the interest expense on ForCo's country F return.

11 Treas Reg s 301.7701-2.

12 Treas Reg s 301.7701-2(b). Per se corporations are the approximately 80 foreign entities that will always be treated as corporations for federal tax purposes.

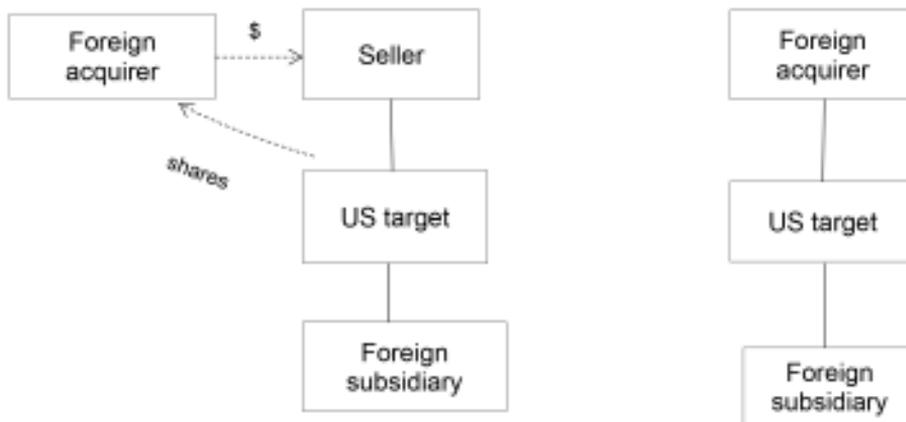


The attorney should consider three points with respect to a domestic reverse hybrid entity. First, US partnerships are preferable to US LLCs, which are often treated by foreign countries as corporations and not as pass-throughs.¹³ Secondly, to ensure that the aforementioned antiearnings stripping rules do not restrict the deductibility of interest, the attorney should ensure that the US target's debt-to-equity ratio does not exceed 1.5 to 1. Thirdly, the lender may be foreign or domestic, but cannot be related in any way to the foreign acquirer.

Sandwich structures cause repatriation problems

Suppose the foreign acquirer purchases a US target that owns a foreign subsidiary. The end result of the transaction is that a US corporation – the US target – is sandwiched between the foreign acquirer and the foreign subsidiary.

¹³ Although there must be more than one owner for a partnership, the drawing does not display the second owner (typically, a one per cent owning LLC that ForCo wholly owns) in the interest of simplicity.



This structure is inherently tax inefficient. A dividend from the foreign subsidiary to the US target will incur tax at a top US corporate income tax rate of 35 per cent. Even if US target receives a deemed-paid foreign tax credit for the corporate income taxes paid by the foreign subsidiary,¹⁴ because the US corporate income tax rate is higher than most other countries, the US target will pay residual tax on the amount that the US corporate income tax rate of 35 per cent exceeds the foreign subsidiary's rate. Moreover, to the extent that the foreign acquirer seeks to repatriate the profits of the foreign subsidiary through the US target, the foreign acquirer may incur a US withholding tax that is not creditable in its foreign country.

There is not an easy resolution to this problem. The foreign acquirer may want to purchase the shares of the foreign subsidiary from the US target before purchasing the shares of the US target from the seller. As an alternative, the foreign acquirer may want to form a new foreign acquisition entity to buy the assets of the foreign subsidiary before purchasing the shares of the US target. Both of these options will include someone incurring US tax on any appreciation in the foreign subsidiary, which the foreign acquirer and the seller will have to negotiate.

Sandwich structures may cause income inclusions from loans

Investments of a controlled foreign corporation (CFC)¹⁵ may result in income to a related US corporation. This issue can arise from a sandwich

¹⁴ IRC s 902.

¹⁵ A foreign corporation is a controlled foreign corporation if ten per cent of the US shareholders own more than 50 per cent of the vote or value of the foreign corporation. IRC s 957(a).

structure whereby the foreign acquirer owns a US corporation that owns a CFC. Essentially, a CFC's investment in US property is equivalent to the CFC distributing a dividend to a US corporation.¹⁶

The many different income-resulting investments a CFC may have in US property include a loan from a CFC to its US corporation.¹⁷ The definition of a loan from a CFC to its US corporation includes securing a loan from a third party to a US corporation via a pledge of its CFC's shares or a guarantee by its CFC.¹⁸ However, an exception provides that a pledge of less than two-thirds of a CFC's shares do not constitute such a loan.¹⁹

Accordingly, a foreign acquirer should review the investments of a CFC to ensure that the CFC's value is not financing any loans incurred by a related US corporation.

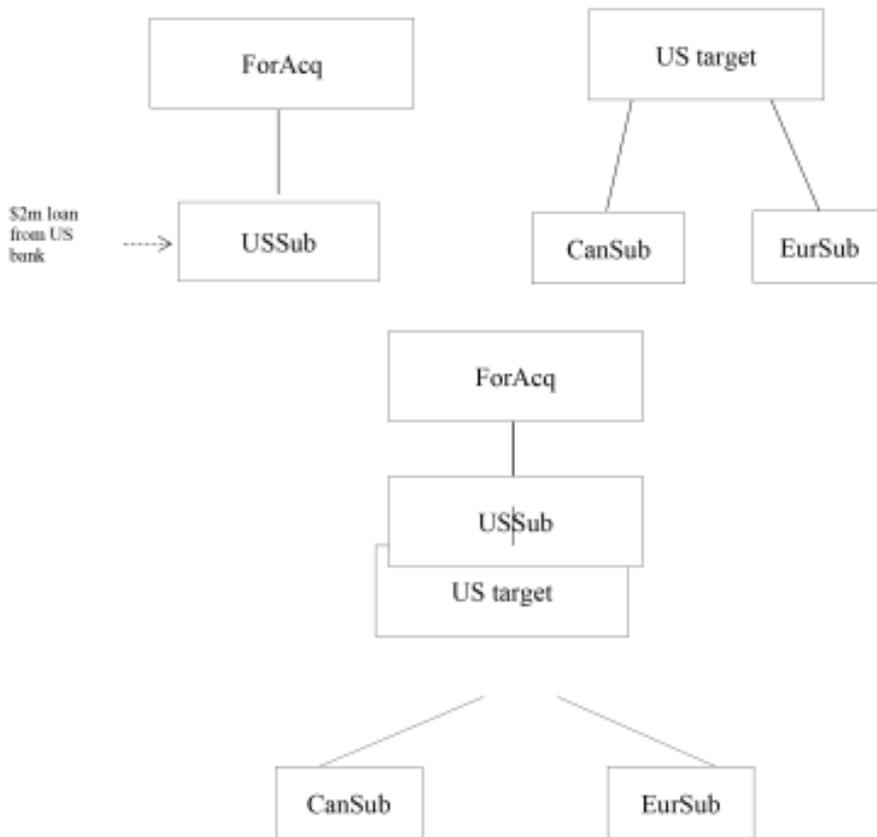
Case study 5: ForAcq is the foreign parent of USSub, a US subsidiary. USSub has a revolving line of credit with a US bank on which \$2m is currently outstanding. According to the revolving line of credit, all of USSub's shares of current and future subsidiaries are pledged as collateral for the revolving loan. USSub purchases the shares of a US target, which owns Canadian and European subsidiaries. Because the shares of the Canadian and European subsidiaries are now pledged for the revolving line of credit, USSub should have an income inclusion that is similar to a dividend.

16 IRC ss 951(a)(1)(B) and 956(a). The US target must include in gross income some of its pro rata share of the CFC's current-year investment in US property to the extent the CFC has undistributed earnings that have not yet been taxed to the US target.

17 IRC s 956(c)(1)(C). There are exceptions for obligations of unrelated US corporations, obligations of the United States, deposits with a US bank, obligations that arise from regular business transactions to the extent such amounts are ordinary and necessary, certain deposits of cash or securities made or received by a securities or commodities dealer and obligations to US persons who are not related.

18 IRC s 956(d).

19 Treas Reg s 1.956-2(c).



Accordingly, ForAcq will need to modify the terms of its line of credit so that the pledges of shares of CFCs are limited to 66 per cent.

USE OF NET OPERATING LOSSES (NOLs)

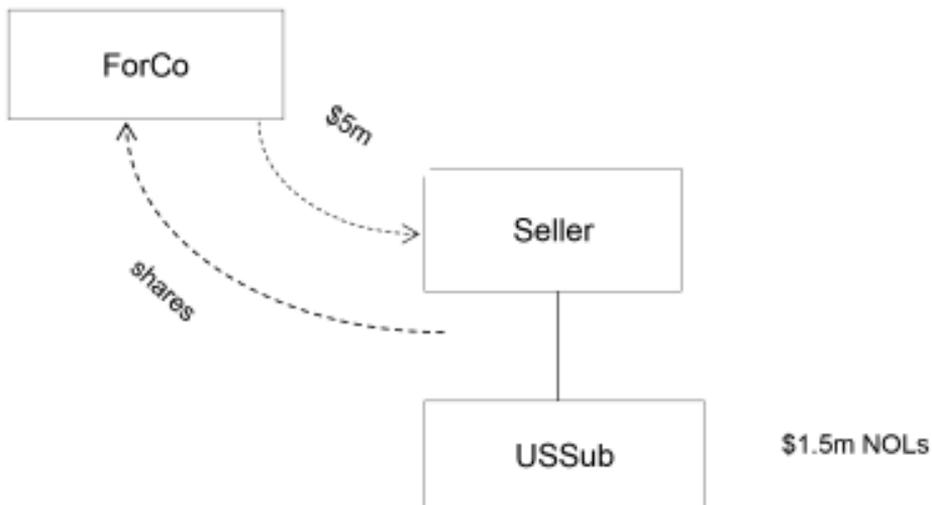
US taxpayers can carry back NOLs two years and carry forward NOLs 20 years. However, section 382 prevents the marketability and trafficking of US corporations that have significant NOLs. Without section 382, the foreign acquirer could have its US subsidiary purchase the US target and use the US target's net operating losses against its US subsidiary's income in a consolidated tax return.

Section 382 triggers NOL limitations when the ownership of the US target changes by at least 50 per cent of the shareholders owning five per cent or more of the US target's shares.²⁰ Consequently, a purchase of all the shares of the US target by either the foreign parent or a US subsidiary of the foreign parent should trigger the NOL limitations.

²⁰ The purchase may occur over a three-year period. IRC s 382.

More specifically, section 382 limits the annual use of NOLs to an amount equal to the IRS's published long-term tax-exempt rate times the purchase price of the US target's shares. Failure of the foreign acquirer to consider this potential limitation could significantly increase the future tax liability of the US target.

Case Study 6: ForCo purchases USSub for \$10m. Although USSub has an NOL of \$1.5m, ForCo believes that better management will turn around the business such that USSub will earn \$1m during the taxable year. Because there has been more than a 50 per cent ownership change by five per cent of the shareholders (100 per cent of ownership has changed), USSub will not be able to eliminate its anticipated taxable income of \$1m through the use of the NOL. Instead, if we assume that the long-term tax-exempt interest rate is five per cent, USSub will only be able to deduct \$250,000 of the NOL (\$5m at five per cent) to reduce the pre-tax income to \$750,000.



If the US target has both built-in gain assets that the foreign acquirer does not want to retain and NOLs, the foreign acquirer should have the seller sell the built-in gain assets before the transaction. Accordingly, the US target would be able to use the NOL against the unwanted assets. Waiting to dispose of the unwanted built-in gain assets until after the transaction would result in gain for which section 382 would limit the use of NOLs.

SECTION 385 REGULATIONS AND ANTI-INVERSION RULES

Two of the more notorious pieces of guidance the IRS has promulgated in recent years deal with the characterisation of debt versus equity under the section 385 regulations and the continual pronouncements regarding anti-inversion rules that try to bolster section 7874.

The section 385 regulations can recharacterise some debt of a US subsidiary to a foreign parent as equity. More specifically, the regulations say that the debt used in an acquisition with expanded group shares could be recharacterised as equity. However, in the simple inbound acquisition described herein, it is doubtful that the section 385 regulations would ever be applicable.²¹ For more complex acquisitions, the section 385 regulations may be traps for the unwary.

Similarly, section 7874 deals with corporate inversions, whereby the US parent of a multinational group becomes a subsidiary of or is merged into a foreign parent.²²

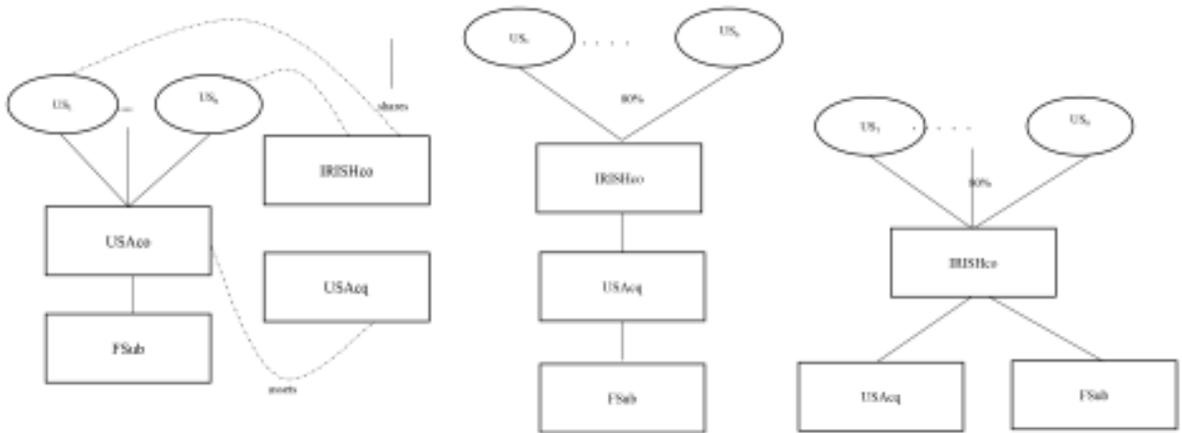
If section 7874 applies to an inversion, the foreign parent will be recharacterised as a US corporation that is subject to tax on its worldwide income. Recharacterised as a US corporation, any of its foreign subsidiaries remain CFCs that are subject to the US taxing jurisdiction.

Case Study 7: USAco, a publicly-held US C corporation, owns FSub, a controlled foreign corporation. IRISHco forms a US acquisition corporation, USAcq. In a taxable transaction, USAco's shareholders receive both cash and 80 per cent of the shares of IRISHco for the assets. The resulting structure has the former USAco shareholders now owning 80 per cent of the shares of IRISHco. USAcq, which now operates the business of the former USAco, now owns FSub and transfers FSub's shares to IRISHco.

21 The Treasury Department is currently considering repeal of these regulations.

22 IRC s 7874. To recharacterise the new foreign parent as a US corporation, (a) US shareholders own 80 per cent or more of the shares of the foreign corporation as a result of the inversion transaction, (b) the US corporation becomes a subsidiary of a foreign corporation or transfers substantially all of its property to a foreign corporation and, (c) the group does not have substantial business activities in the foreign corporation's country of incorporation compared to the total worldwide business activities of the group. If the ownership is less than 80 per cent, but at least 60 per cent, the new foreign parent will not be treated as a US corporation, but the US shareholders will not be able to use any resulting foreign tax credits or net operating losses.

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Under the anti-inversion rules, IRISHco is treated as if it were a US corporation that will incur tax on its worldwide income. Moreover, FSub remains a CFC and its income may be Subpart F income to IRISHco, which is a US shareholder.

The attorney for the foreign acquirer should ensure that any acquisition structure does not fall under the anti-inversion rules.

Planning for exits

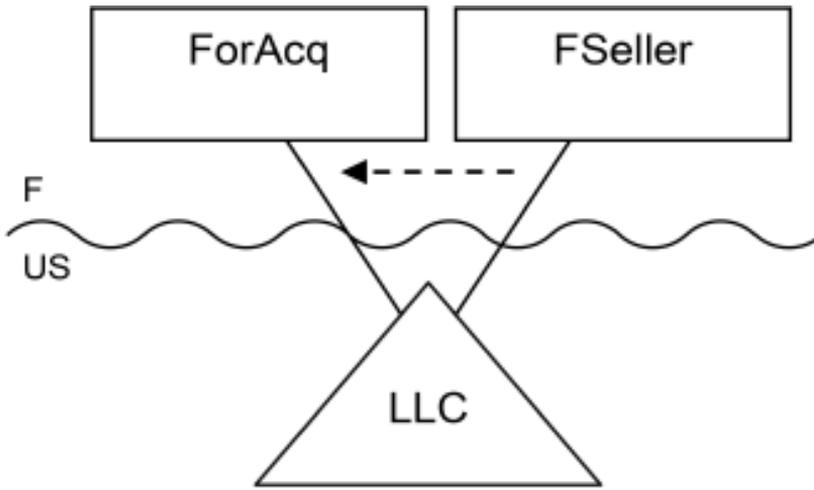
A foreign owner of an LLC should check-the-box to elect corporate tax status for the LLC before sale. Without checking-the-box, the tax obligations of continuing operations of either entity will be similar. A C corporation will incur US corporate income tax and a withholding tax on dividends. An LLC will result in the foreign corporation incurring the US corporate income tax and the branch profits tax on any repatriation.

However, the sale of a C corporation's share is preferable to the sale of LLC interests. A foreign seller's sale of an LLC will result in taxable income from any gain on the sold assets.²³ In contrast, a foreign seller's sale of a C corporation's shares will not result in taxable income.²⁴

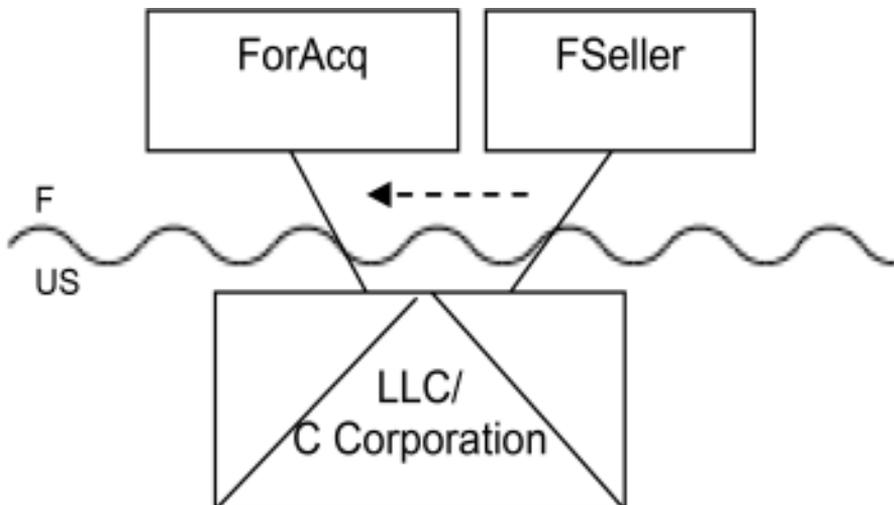
23 Rev Rul 91-32; 1991 CB 107. The recent Tax Court opinion in *Grecian Magnesite Mining v Commissioner*, 149 TC No 3 (2017) appears to overrule Rev Rul 91-32, by treating the sale of a partnership as a sale of personal property that would be foreign-source income, and not as US-source income from a sale of a business' assets. However, the IRS has not acquiesced and the case did not involve a single-member LLC that is disregarded for tax purposes. As a result, the issue is far from settled.

24 IRC ss 864(c) and 865.

Case Study 8: ForAcq and FSeller each own 50 per cent of LLC, a US limited liability company that is taxed as a partnership for US tax purposes. FSeller sells its 50 per cent interest in the LLC to ForAcq and will incur tax on any gain at marginal rates. More specifically, selling its partnership interest is taxed as if FSeller were selling half the business assets in the United States, which results in effectively connected income to a US trade or business.



Case Study 9: ForAcq and FSeller each own 50 per cent of the shares of an LLC that is taxed as a USC corporation pursuant to a check-the-box election. FSeller sells its shares to ForAcq at a gain. The gain from the sale of shares, which are personal property, is foreign-source income. The foreign-source income of a foreign corporation (here, FSeller) is not subject to US taxation.



Tax representations

Tax representations provide assurance that there will not be any surprises with respect to taxes. By forcing the seller to make a representation, the seller directly provides an answer that may not be obvious from any documents provided in the due diligence process. Moreover, representations lay the groundwork for termination or indemnity on their breach.

Concern over foreign tax credits is another sandwich structure issue arising from the foreign acquirer purchasing a US target with foreign subsidiaries. Representations are important regarding the proof of foreign income taxes paid or accrued to preserve foreign tax credits to reduce the effective rate of tax.²⁵

Taxpayers must maintain proof of foreign income taxes paid²⁶ to obtain the foreign tax credit.²⁷

The IRS will disallow any foreign tax credits a taxpayer cannot substantiate. Taxpayers claiming a foreign tax credit must substantiate the proof of the foreign income taxes paid with proper documentation that must be available for examination on request. Primary substantiation may be either the receipt of tax payment or the foreign tax return. If the IRS, in its unfettered discretion, is satisfied that it is impossible for the taxpayer to furnish primary substantiation, the taxpayer may furnish secondary substantiation.²⁸

Case Study 10: ForCo purchases USTarget, a C corporation, which has owned the shares of a foreign subsidiary ('ForSub') since 1987. ForSub has earnings and paid foreign income taxes since 1987, but those old records are patchy. ForCo's attorney should ensure that there is enough proof to claim foreign tax credits when the US target receives a dividend from ForSub.

To protect a foreign acquirer of a US-based multinational group,²⁹ the following representations should be made regarding the foreign tax credit as part of the taxes representation:

25 Non-creditable foreign levies may be deductible payments.

26 IRC s 905(b).

27 There are three types of foreign tax credits: direct foreign tax credits; deemed-paid foreign tax credits (for income taxes paid by a foreign subsidiary); and the foreign tax credit for withholding taxes. IRC ss 901 to 903.

28 Treas Reg s 1.905 2(a)(2). In lieu of a receipt of payment, the taxpayer must provide a photocopy of the cheque, draft or other medium of payment showing the amount and date, with evidence establishing that the tax was paid for the taxpayer's account as its own tax on its own income. In lieu of a foreign return, the taxpayer must provide a certified statement of the accrued amount, with excerpts from books showing the computation of the accrued amount and, at the IRS's discretion, a bond.

29 Even if the foreign tax is not creditable, it may be deductible.

- (1) Taxes shall mean any payments or accruals (and includes any penalties or interest)³⁰ to any governmental body.
- (2) The US target and any affiliates have maintained proof of foreign taxes paid pursuant to Code section 905 and the regulations thereunder.
- (3) The US target has delivered or made available to the buyer complete and accurate copies of all tax returns (for income taxes and all other tax returns) for foreign affiliates for all taxable years since 31 December 1986 and complete and accurate copies of all examination reports and statements of deficiencies assessed against the US target since 31 December 20X1.

To avoid any surprises with the tax authorities, the foreign acquirer's attorney should scrutinise all income tax returns (especially for years not closed for assessment under the applicable statute of limitations), the accountant's work papers and the tax reserve. Moreover, the foreign acquirer should ask the seller to represent that:

- (1) The US target has timely filed all tax returns (for income taxes and all other material tax returns) required to be filed.
- (2) The US target is not currently under any extension of time within which to file any tax return, nor has any such extension been requested.
- (3) Tax returns are complete and accurate (in all material respects).
- (4) All taxes due and owing by the US target (whether or not shown on any tax returns) have been paid.
- (5) No liens for taxes exist on the assets of the US target.

The attorney should evaluate the issues that the IRS and the state taxing authorities have been investigating. The attorney should ask about the status of all current and prior audits. The attorney should compare past audit reports with their US target's established reserves to understand the aggressiveness of the US target.³¹

Representations regarding audits should include the following:

- (1) No deficiencies for taxes of the US target have been claimed, proposed or assessed by any taxing authority or other governmental body.
- (2) No pending or threatened audits, assessments or other actions for or relating to any liability with respect to taxes are under discussion with either a taxing authority or any other governmental bodies.
- (3) The US target has not waived any statute of limitations with respect to taxes or agreed to any extension of time with respect to a tax assessment or deficiency, nor has any request been made in writing for any such extension or waiver.

30 Penalties and interest are not creditable.

31 Although often overlooked, state and local taxes can present additional exposure.

- (4) No claim has ever been made by an authority in the jurisdiction where the US target does not file a tax return that it is or may be subject to taxation by that jurisdiction with respect to the taxes that would be the subject of such tax return.

The foreign acquirer's attorney should review the US target's tax returns, with a focus on aggressive tax positions and should evaluate the US target's position to withstand any challenge (common issues may include unreasonable compensation and transfer pricing). The foreign acquirer can reduce its exposure to the US target's pre-closing aggressive tax positions if adequate reserves exist.

The US target must file a Schedule UTP with respect to tax positions for which the taxpayer would either record a tax reserve on its financial statements or not record a tax reserve because the taxpayer expects to prevail on the position. The following representation should protect the foreign acquirer: 'There are not any positions for which the US target should have filed a Schedule UTP for any year for which the statute of limitations remain open.'

Information returns report the activities of foreign affiliates. If the US target has foreign subsidiaries, the foreign acquirer should ensure that the US target has been filing Forms 5471.³² If the foreign acquirer is purchasing the US target from a foreign seller, the foreign acquirer should ensure that the US target has been filing Forms 5472.³³

For each failure to file, penalties are at least \$10,000 and may include suspending the running of the statute of limitations *for all items on the return*.³⁴

To prevent problems with representations, the attorney should define tax returns to include information returns filed with any taxing authority or governmental body.

Withholding taxes often beg the issue of gross-ups. Many agreements expressly state that the foreign acquirer may deduct and withhold applicable taxes from the purchase price. The foreign acquirer should confirm there is not a gross-up of the purchase price. A proforeign acquirer representation would be as follows:

The foreign acquirer shall be entitled to deduct and withhold from the consideration otherwise payable such amounts as the foreign acquirer is required to deduct and withhold under the Internal Revenue Code, or any tax law, with respect to the making of such payment. To the extent that amounts are so withheld, such withheld amounts shall be treated as having been paid to the seller.

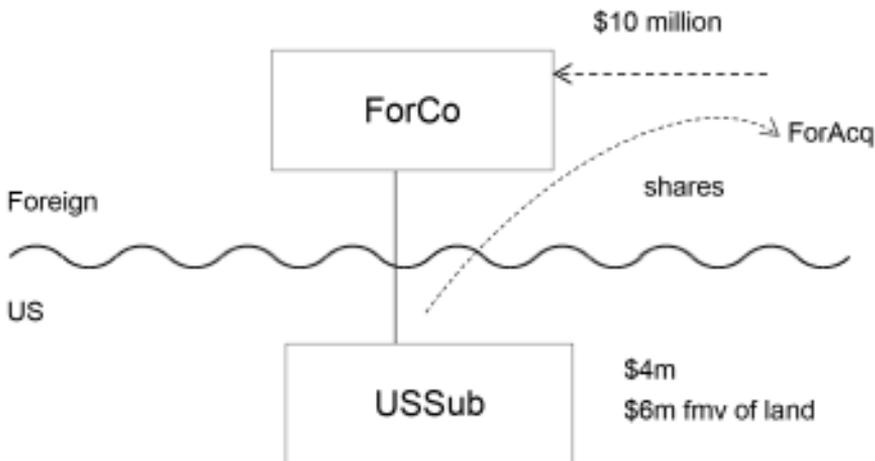
32 IRC ss 6038 and 6046.

33 IRC s 6038A.

34 IRC s 6501(c)(8).

Purchasing shares of a US real property holding corporation (more than 50 per cent of the net fair market value of the US target consists of US real estate) from a foreign seller may cause withholding and, accordingly, gross-up issues.³⁵ The foreign acquirer should determine whether the shares of the US target constitute an interest in a US real property holding corporation, which would result in the foreign acquirer withholding 15 per cent of the purchase price under the foreign investment in real property tax (FIRPTA).

Case Study 11: ForCo owns a US corporation, USSub. USSub has cash of \$4m and US real estate with a net fair market value of \$6m. ForAcq purchases the shares of USSub for \$10m. Under FIRPTA, USSub is a US real property holding corporation because over 50 per cent of its net fair market value constitutes US real estate (\$6m divided by \$10m equals 60 per cent). As a result, the United States imposes the FIRPTA tax on ForCo's gain on the sale of shares of USSub in the same manner as if ForCo merely sold the US real estate.



However, suppose that the US real estate has a mortgage of \$5m. Because the net fair market value of US real estate is less than 50 per cent (\$1m is the net fair market value of the property and \$1m divided by the \$5m value of ForCo equals only 20 per cent), the United States would not impose FIRPTA on the sale of the shares of USSub.

When determining the net fair market value of the US real estate, the attorney should conduct the painstaking process of determining which debt the US real estate secures. If FIRPTA concerns still exist, the foreign acquirer can ask the foreign seller to provide certification that the US target's shares

35 IRC s 897.

are not shares of a US real property holding corporation.³⁶ In addition to the certification, a representation protecting the foreign acquirer is as follows: ‘the US target is not a US real property holding corporation as defined in Code section 884 and the regulations thereunder and has not been for the last five years.’³⁷

Tax indemnity

The indemnification of taxes usually occurs on a dollar-per-dollar basis. Although floors, baskets and caps listed in previous portions of the share purchase agreement may apply, these are a matter for negotiation. Assuming that the opportunity to collect on an indemnity already exists, a sample tax indemnity provision would be as follows:

Seller agrees to indemnify and hold foreign acquirer harmless from and against all taxes that the US target will have to pay as a result of the subsequent tax audit for taxes for periods before or on the effective date, if and to the extent that:

- (a) payment of such taxes is due after the effective date;
- (b) payment of taxes are not the result of changes in the accounting or taxation principles introduced by the foreign acquirer after the closing date unless required by law;
- (c) there are no tax savings or refunds corresponding with the payment of additional taxes, including reciprocal effects such as the lengthening of depreciation periods or the transfer of taxes from one to another tax assessment period; or
- (d) the payment of taxes is not the result of a change in law after the effective date.

Moreover, the foreign acquirer may want indemnification for tax attributes, under the theory that the foreign acquirer is paying for them so they better exist. Tax attributes would include, for example, net operating losses and the proof of foreign income taxes previously discussed.

Tax covenants

Covenants are promises to act or to refrain from acting. Tax covenants allocate the responsibility for tax compliance, tax payment and cooperation.

³⁶ Treas Reg s 1.1445-5(b)(4)(iii).

³⁷ A five-year look-back rule prevents a foreign seller from stuffing cash in what would otherwise be a US real property holding corporation. IRC s 897(c)(1)(i)(II).

The allocation of tax compliance responsibility between the parties typically considers taxes due post-closing for pre-closing periods and taxes due post-closing for straddle periods. Accordingly, tax covenants often focus on both review rights and preparation that is consistent with previous returns. For post-closing returns filed, a sample covenant may say:

The foreign acquirer shall prepare or cause to be prepared and file or cause to be filed all income tax returns for the US target that are due to be filed after the closing date. The foreign acquirer shall permit the seller to review and comment on each such income tax returns described in the preceding sentence prior to filing and shall make such revisions to such income tax returns as are reasonably requested by the seller.

However, the foreign acquirer should be concerned with any tax filings between the execution date of the share purchase agreement and the close. These changes may have an impact on the future tax aspects of the US target and are typically reserved by either the US target or the seller. Accordingly, the foreign acquirer should reserve the right to review and comment on any filings during this pre-close period.

Tax compliance does not necessarily mean tax payment. The attorney must consider all periods, but the straddle period covenant is the most important period. A sample covenant may say:

The portion of any tax that is allocable to the taxable period that is deemed to end on the closing date will be (i) in the case of real property, personal property, and similar ad valorem taxes, deemed to be the amount of such taxes for the entire straddle period multiplied by a fraction, the numerator of which is the number of calendar days of such straddle period in the pre-closing tax period and the denominator of which is the number of calendar days in the entire straddle period, and (ii) in the case of all other taxes, determined as though the taxable year of the US target terminated at the close of business on the closing date.

All parties providing the necessary information is the focus of the cooperation covenant:

The foreign acquirer, US target and seller shall cooperate fully, as and to the extent reasonably requested by the other party, in connection with the filing of tax returns and any audit, litigation or other proceeding with respect to taxes. Such cooperation shall include the US target and seller retaining and providing records and information that are relevant to any such audit, litigation or other proceeding and making employees available to provide additional information and explanation of any material provided hereunder.

Conclusions

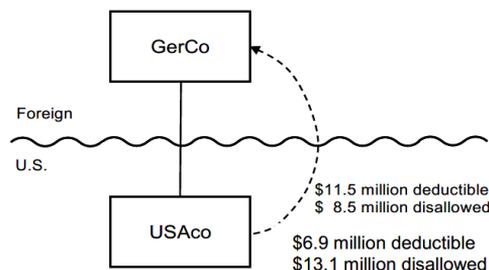
A shares purchase of a US target is fraught with uncertainty with respect to US tax issues. Through proper planning, due diligence, structuring and drafting, a foreign acquirer can reduce the risk that uncertainty brings. Moreover, a foreign acquirer may actually enjoy some tax savings, which will ultimately increase value.

Addendum for Thin Capitalisation Revision in The 2017 Tax Cut and Jobs Act

Any debt financing of a foreign-owned US company must consider the new rule limiting interest deductions in the United States. The old limit on interest deductions contained a complex five-part test. The new limit simply does not permit deducting any net business interest expense that exceeds 30% of EBITDA. Code section 163(j).

Case Study 3: GerCo, a German company, acquires all the shares of USAco, a US company that derives all of its income from US business operations. In a recapitalization, GerCo recharacterizes equity in USAco as debt such that USAco pays annual business interest of \$20million under the GermanUS Tax Treaty. The results from USAco's first year of operations are as follows:

Gross profit.....	\$60million
Other operating expenses.....	<\$37million>
EBITDA.....	\$23million
Net Business Interest expense	<\$20million>



Thirty percent of EBITDA is \$6.9 million. As a result, \$13.1 million of interest (the amount of the \$20 million of net business interest that exceeds \$6.9 million) is not deductible.

Moreover, if a foreign acquirer tries to aggressively use rents, royalties, and interest to strip income out of the United States, the US company may be subject to a Base Erosion Anti-Abuse Tax ("BEAT"). BEAT is an alternative minimum tax for US companies with gross receipts in excess of \$500 million. Code sec. 14221.