

Acquiring a Foreign Corporation – An Outline of Key Tax Considerations for U.S. C Corporations

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SOME BACKGROUND OF U.S. INTERNATIONAL TAX PRINCIPLES

In general, a U.S. parent corporation (Parent) will not include the income earned by a foreign subsidiary (Target) in the U.S. tax base until it is repatriated to the United States in the form of a dividend, unless one of the anti-deferral regimes applies. Deferral is denied, for example, if Target effectively allows its assets to be used by the Parent, which is deemed to happen if Target makes a loan to Parent, or if Target guarantees debt of Parent. Deferral is also denied if Target earns significant amounts of investment income, or if it earns income from certain related party sales or services outside of its country of incorporation.

When the income of Target is included in income of Parent, Parent is able to claim a credit against its U.S. federal income taxes for the foreign income taxes paid by Target. The foreign tax credit is, however, subject to significant limitations that frequently result in there being leakage – there is U.S. tax payable even if the effective tax rate of Target is higher than the U.S. tax rate.

President Obama's proposal for revising the international tax provisions would exacerbate the difficulties in achieving a rational effective tax rate. The proposals would, among other things, provide that expenses of Parent that are attributable to income of foreign subsidiaries that is deferred (not subject to current U.S. tax) would similarly be deferred. For example, if Parent has interest expense that is allocable to the investment in Target, that portion would not be deductible until the income of Target is included in the U.S. tax return of Parent.

Outlined below are some of the key income tax considerations for structuring the acquisition of Target.

FINANCING THE ACQUISITION

The general rule is that the financing for the acquisition should match the income that will be generated. If the borrowing occurs at the U.S. level, and is not pushed down to the Target, funds to service the debt may need to be dividended from Target to Parent. This gives rise to potential withholding tax in Target's jurisdiction. It also causes the dividend to be included in the U.S. tax base of Parent. Parent may be able to claim a credit for the underlying income taxes paid by Target, and for the withholding tax, but the U.S. rules for claiming the foreign tax credit often result in there being "leakage."

Parent could create a foreign acquisition company (ForAcqCo), and lend the proceeds of the borrowing to it in order to undertake the acquisition. This formalistically puts the interest deduction in the acquisition company. It raises a number of issues:

1. Many jurisdictions do not have consolidated tax returns, so the interest deduction is not beneficial to Target unless other planning occurs.
2. Interest would frequently be subject to a Target jurisdiction withholding tax, which may not occur in a third-party borrowing structure.
3. Related party interest is often subject to "thin capitalization rules," which limit the amount of deductible interest.

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4. In some jurisdictions intercompany loans are not permitted for purposes of acquisition or operating capital.

Alternatively, the borrowing could occur in the Target, or in the ForAcqCo with proper planning to have the benefit realized in Target. Sometimes this requires structuring the acquisition as a redemption of shares by Target, using the borrowed funds and equity that is infused by Parent. Alternatively, in some jurisdictions the two companies can merge after the acquisition.

1. The interest paid to the third party is often not subject to the thin capitalization rules that limit deductibility, but this is a country-by-country issue.
2. Confirmation is needed that the interest is not subject to a withholding tax if the lender is not in the same jurisdiction.
3. Guarantees of the debt by Parent raises issues of guarantee fees, and may implicate the deductibility of the interest under the thin capitalization rules.

If the debt is not put in place at the time of the acquisition, achieving a tax efficient “debt pushdown” after the fact can be quite challenging from a tax perspective. It frequently results in the amount of the pushdown being a dividend to Parent from a U.S. perspective, and may engender withholding taxes.

Having the debt at Target level is particularly important when Target is in a high tax jurisdiction, but the deductibility of the interest is key. Some jurisdictions have reduced the statutory rate of tax on corporations, but have at the same time limited the amount of deductible interest.

In some jurisdictions it may be possible to structure the debt to take the deduction for the interest expense in both Target’s jurisdiction and the U.S.. These opportunities are increasingly hard to find as the taxing authorities are closing them down, but should be considered.

USE OF A HOLDING COMPANY FOR THE ACQUISITION

Withholding tax. If Parent acquires the stock of Target directly, dividends from Target to Parent will be subject to any withholding tax of Target’s jurisdiction, offset only by the U.S. tax treaty with the jurisdiction, if one exists. It may be preferable to have a holding company inserted to permit for the elimination or reduction of the withholding tax. For example, within the EU dividends from one country to another are not subject to withholding taxes. If the holding company that receives the dividends is a resident of a country that permits dividends to be paid with-

out a withholding tax, a structure may be considered to marry the EU rules with the rules of that jurisdiction to eliminate the withholding tax.

Foreign tax credit aggregator. Parent may have sufficient foreign activities that it makes sense to use a holding company to group together investments with similar effective tax rates to manage the foreign tax credit planning. Note that the Obama tax proposals may undermine this planning.

Cash flow planning. If there are plans for financing the foreign activities among various countries it may make sense to use a non-U.S. holding company to facilitate cash movement outside of the U.S., without recognizing a dividend in the U.S..

Exit. Many jurisdictions impose a capital gains tax on the sale of Target. In some cases that tax is eliminated under a tax treaty between the jurisdictions of Target and its shareholder. For example, investing in India is often done through a Mauritius subsidiary for this reason. Alternatively, if there is no good treaty jurisdiction, the stock of the holding company itself may be sold. Note: some jurisdictions, notably India, are taking the position that the sale of the holding company itself may give rise to Indian tax.

ACQUISITION ELECTION – SECTION 338

In all acquisitions of foreign corporations, Parent should consider making an election under Section 338 of the Internal Revenue Code to treat the acquisition as if Target had sold its assets to a new corporation for the fair market value. This would result in Target having a completely clean U.S. tax balance sheet – no accumulated earnings and profits, no accumulated foreign tax credit history, etc. It would also reset the U.S. tax balance sheet to fair market value. All amortization and depreciation would be based on the purchase price. This would enable any goodwill to be marked to fair market value, and amortized. The result is that the earnings and profits, which are the base line for determining whether distributions from Target are “dividends” for U.S. tax purposes, are reduced. It may facilitate tax efficient distributions of earnings after the acquisition. If the sellers are not U.S. persons they should be indifferent to the making of the election.