



Tax on Inbound Investment

in 33 jurisdictions worldwide

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The acquisition (from the buyer's perspective)

- 1 What are the differences in tax treatment between an acquisition of stock in a company and the acquisition of business assets and liabilities?

There are a number of significant differences.

By way of an overview, the US tax system has a concept of symmetry. If the seller recognises gain on the transfer of stock or assets, the buyer will normally obtain a purchase price cost basis. On the other hand, if no gain is recognised by the seller, the buyer will generally take a carry-over basis in the stock or assets acquired. Please note that, unless specifically stated otherwise, all responses herein relate to US federal income tax treatment. While generally the same, state and local tax treatment can vary.

There are four principal methods used to acquire the stock or assets of a 'target' company:

- taxable purchase of stock of a target;
- taxable purchase of assets of a target;
- acquisition of stock of a target in a tax-free exchange; and
- acquisition of assets of a target in a tax-free exchange.

Because, as discussed below, two levels of tax will be imposed on a taxable asset sale, the corporate level tax on the sale and a tax to the shareholders on receiving a distribution of the sales proceeds, it is normally difficult to efficiently structure a taxable asset purchase unless there is an opportunity to make a section 338(h)(10) election (which, as more fully discussed in question 2, treats a stock sale as a sale of the underlying assets for tax purposes, at the cost of but one level of tax).

In a taxable stock purchase, the shareholders of the target generally recognise the gain or loss (usually capital gain or loss) on the sale of their stock on the difference between the value of the consideration received and the shareholders' tax cost or basis in their stock, which includes expenses of carrying out the acquisition (such as legal fees). The tax attributes of the target are generally not affected by the acquisition. However, the target's ability thereafter to use its net operating loss (NOL), capital loss and tax credit carry-forwards may be limited by certain Internal Revenue Code (IRC) sections such as section 382 (see question 7).

In a taxable asset purchase, the buyer takes a basis in the assets of the target equal to the purchase price paid, plus any liabilities transferred to the purchaser and plus any acquisition expenses incurred by the purchaser. The basis of target's assets including goodwill (except basis allocable to land) normally generates deductions (such as depreciation, amortisation and cost of goods sold). The target recognises full gain or loss on the sale of its assets. The tax attributes of the target are not acquired by the purchaser. The target's NOLs and other tax attribute carry-overs are generally usable by the target to offset gain on the sale.

In a taxable asset sale, if the target liquidates, its shareholders recognise gain or loss (usually capital) on the receipt of consideration in exchange for their stock in the liquidation.

The gain on the disposal of business assets or stock can be deferred if the transaction is structured as a tax-free reorganisation, which may be accomplished by various methods. The most common are:

- a merger of the target directly with an acquirer with either corporation surviving;
- an acquisition of the stock of the target in exchange for the voting stock of the acquirer;
- the acquisition of substantially all the assets of the local company for voting stock of the acquirer or a corporation in control of the acquirer; or
- a merger of the target into a direct subsidiary of the acquirer with the local company surviving (reverse triangular merger) or with the subsidiary surviving (forward triangular merger).

Each of these different forms of reorganisation have requirements for qualification that relate to the type and extent of non-qualifying consideration that may be used, eg:

- voting or non-voting stock;
- the amount of cash or other property;
- the amount of liabilities, if any, that may be assumed;
- the amount of the assets of the local company that must be acquired for qualifying consideration, eg, substantially all the assets; or
- stock constituting control of the acquired corporation (defined as at least 80 per cent of the voting power of all classes of stock entitled to vote and at least 80 per cent of all non-voting classes of stock).

Where non-qualifying consideration ('boot') is received in a transaction qualifying for tax-free reorganisation treatment, tax is generally imposed on the lesser of the gain realised by the seller in the transaction or the amount of boot.

Under IRC section 367, a transfer of the stock of a US corporation to a foreign acquiring corporation in a contemplated tax-free reorganisation will be taxed unless:

- US transferors receive no more than 50 per cent of the voting power and value of the stock of the foreign transferee corporation in the transfer;
- US officers, directors or 5 per cent or greater shareholders of the US target corporation do not own, in the aggregate, more than 50 per cent of the voting power and value of the foreign transferee;
- a US 5 per cent shareholder immediately after the transfer

enters into a five-year gain recognition agreement to the effect that the gain on the transfer will be taxed if the shareholder disposes of the consideration received, generally in a taxable transaction within five years; and

- the foreign acquiring corporation (including its 80 per cent or more subsidiaries) has been engaged in an active business for three years preceding the acquisition and at the time of the transfer that business is at least equal in value to that of the US company being acquired.

Generally, it is possible to structure a tax-free stock-for-stock reorganisation under section 367 using a foreign acquisition company where the target company is widely held, ie, has no 5 per cent shareholders and the acquiring company is the larger entity measured by value.

Where assets of the US company are acquired by a foreign corporation in a purported tax-free exchange, the gain will be recognised unless the assets consist of property to be used in the active conduct of a trade or business outside the US for at least 10 years immediately after the transaction. Even then, as a general rule, transfers of inventory and intangible property will be subject to tax. In the case of intangible property, the US transferor will be subject to tax on amounts deemed to be received based on an arm's length charge for the use of the intangible transferred.

- 2** In what circumstances does a purchaser get a step-up in basis in the business assets of the target company? Can goodwill and other intangibles be depreciated for tax purposes in the event of the purchase of those assets, and the purchase of stock in a company owning those assets?

Depending on the form of the acquisition, the purchaser (directly or through its ownership of the stock of the target) takes a carry-over basis or a cost basis in the assets of the target. The target's basis in its assets will carry-over if the transaction is structured either as (i) a tax-free organisation or reorganisation or (ii) a stock purchase with no election under IRC section 338(g) or 338(h)(10) to treat the stock purchase as an asset purchase.

The purchaser takes a stepped-up (or stepped-down) basis in the assets of the target if the purchaser (i) buys assets from the target in a taxable transaction or (ii) buys the stock of the target in a taxable transaction with an IRC section 338(g) or section 338(h)(10) election to treat the acquisition as an asset purchase. The stepped-up (or stepped-down) basis equals, in the aggregate, the sum of:

- the amount paid by the purchaser;
- any of the target liabilities transferred with the target stock or assets;
- in the case of a section 338(g) or 338(h)(10) election, any tax liability of the target generated by that election; and
- the purchaser's acquisition expenses.

In a stock purchase, the purchaser can generally make a section 338(g) election to treat the target as if it had sold and also purchased its own assets. This results in taxable gain (or loss) to the target.

A section 338(h)(10) election is available in certain limited circumstances, such as buying the stock of a subsidiary out of a consolidated group. Under the election, the consolidated group will be taxed on the deemed asset sale, but the sale of stock will be ignored, resulting in one level of tax to the seller but allowing the purchasers a step-up in the tax basis of the assets acquired. Where the seller's tax basis in its stock of the target and the basis in target's assets are comparable, the election can generally be

made without a tax detriment to the seller. Care should be taken, however, to review the state and local tax implications of the election to insure that no untoward tax consequences result.

The benefit to the purchaser of any step-up in basis will depend on the extent to which the step-up can be allocated to inventory and depreciable or amortisable assets (tangible or intangible, such as goodwill) rather than to property such as land. Under current tax law, the cost of purchased goodwill or going concern value is recovered on a straight line basis over a 15-year period.

If assets of a target are acquired that constitute a trade or business and the purchaser's basis in the assets is determined by reference to the consideration paid (eg, as in an asset purchase for cash), then both the purchaser and the target must allocate the purchase price in accordance with the 'residual method' as prescribed by regulations under the IRC. Under this method, the purchase price is generally allocated, to the extent of an asset's fair market value, in the following order of priority:

- (i) cash;
- (ii) actively traded personal property (eg, stock);
- (iii) certain marked-to-market assets;
- (iv) inventory;
- (v) all other assets (except assets in categories (i)-(iv) and (vi)-(vii));
- (vi) intangibles other than goodwill and going concern value; with
- (vii) any amount remaining allocated to goodwill and going concern value.

Section 338 contains consistency rules, which prevent the acquiring corporation from 'cherry-picking' certain assets from the acquired corporation, such as goodwill and going concern value, by purchase in order to receive a step-up in basis and then acquire the remainder of the corporation by stock purchase. The asset consistency rules generally provide that if an acquirer buys an asset from a target subsidiary, and the target's gain is reflected by an equivalent increase in its stock basis under the consolidated return rules, and if the acquirer then buys the target's stock (and does not make a section 338 election), the acquirer (or any of its affiliates that acquire the former target asset) is required to take a carry-over basis for the tainted asset. The stock consistency rules have been virtually eliminated, serving as a minor backstop for the asset consistency rules.

- 3** Is it preferable for an acquisition to be executed by an acquisition company established in or out of your jurisdiction?

As explained above, it is at times difficult to structure a tax-free reorganisation of a US target where the acquiring corporation is foreign, unless the target company is widely held, ie, has no 5 per cent shareholders and the acquiring corporation is the larger corporation, as measured by value. Therefore, a US acquisition company is often used where a tax-free reorganisation is contemplated.

In addition, there are benefits to acquiring a target company using an acquisition corporation established in the United States. For example, if the two corporations are domestic they are generally entitled to file a consolidated return entitling them to benefits (such as using the current losses of one corporation to offset the income of the other). Also, if the acquiring corporation has been established in the US, restructuring after the acquisition (or the actual acquisition itself) can be carried out using tax-free reorganisation techniques. Such tax-free reorganisations are often not

possible if the acquiring corporation is foreign.

In a taxable asset acquisition, the acquirer will have the facility to transfer assets outside the US, which can shield future appreciation and earnings from US taxation. This is useful where the purchase includes significant amounts of intellectual property.

4 Are company mergers or share exchanges common forms of acquisition?

Yes, but with limitations where one of the parties is a foreign corporation.

Under IRC section 367, with certain exceptions, if a US person (including a corporation) transfers property to a foreign corporation in connection with certain exchanges that would otherwise be tax-free, the foreign corporation is not treated as a corporation for purposes of determining the extent to which gain is recognised on the transfer. The purpose of this rule is to prevent taxpayers from avoiding US taxes by removing appreciated assets from the US taxing jurisdiction. As a result, transfers of property to a foreign corporation that would otherwise be tax-free are treated as taxable exchanges.

The rule requires the recognition of gain realised on specified transfers of property to foreign corporations. No loss may be recognised by reason of the rule's operation. Any losses realised but not recognised do not reduce the amount of gain recognised.

The rule does not apply to transfers of business assets to a foreign corporation in the following situations:

- with certain limitations, property that is to be used in the active conduct of a trade or business outside the US and continue to be used in the business by the foreign acquiring corporation for 10 years immediately after the acquisition; and
- stock or securities of a domestic corporation, where the transfer satisfies certain requirements (see question 1).

However, as a general rule, transferors of inventory and intangible property will be subject to tax even if the active conduct of a trade or business test is met. In the case of intangible property, the US transferor will be subject to tax on amounts deemed to be received based on an arm's length charge for the use of the intangible transferred.

5 Is there a tax benefit to the acquirer in issuing stock as consideration rather than cash?

No. The benefits of issuing stock as consideration accrue to the target corporation and its shareholders and not the acquiring corporation, because the use of stock may qualify the transaction as a tax-free reorganisation as described above.

6 Are documentary taxes payable on the acquisition of stock or business assets and, if so, what are the rates and who is accountable? Are any other transaction taxes payable?

Generally, taxes such as stamp taxes, taxes on the bulk sale of assets and other taxes apart from income taxes are not imposed under US federal tax law but may be imposed under state or local law. The imposition and nature of these taxes varies from jurisdiction to jurisdiction. A common form of state and local tax is a tax on the transfer of real property. Such tax may be imposed not only on the direct transfer of real property but also on the transfer of interests in entities holding real property. The only jurisdiction in the US that imposes any form of value added tax is the state of Michigan (ie, Michigan's single business tax,

which, in 1975, replaced a number of business taxes, including the corporate income tax).

7 Do net operating losses survive a change in control of the target? If not, are there techniques for preserving them?

Net operating losses (NOLs) are generally subject to limitation on their use to the extent that there has been a more than 50 per cent increase in ownership by one or more 5 per cent shareholders at any time during a rolling three-year testing period, ie, an 'ownership change'. The definition of these terms and the application of the NOL rules are highly technical and complex. Where an ownership change occurs, use of the company's NOLs is generally limited to an amount equal to the equity value of the company on the date of the ownership change multiplied by a long-term tax exempt rate published by the Internal Revenue Service (IRS).

The loss corporation may also use its NOLs against built-in gains (that exist on the change date) that it recognises during the five years starting on the date of the ownership change, provided that the loss corporation had a specified threshold amount of unrealised built-in gains on the date of ownership change.

Section 382 operates to limit the use of, not disallow, NOLs. Therefore, if the acquisition price is substantial in relation to the amount of NOLs, and if there are significant built-in gains, the target company may be able to use all or substantially all of its NOLs to offset taxable income within the framework of the section 382 rules.

The most straightforward technique to avoid the imposition of a limitation to the use of NOLs is to stagger the acquisition so that an ownership change does not occur during any three-year testing period. The acquirer, however, may not be granted an option or similar understanding or agreement entitling it to complete the acquisition. If such an option or understanding exists, an ownership change will be considered to have occurred.

There are more aggressive strategies using partnership and joint venture arrangements that are entered into between the target company and the acquirer, which could be challenged by the IRS. Therefore, in general, the limitations imposed by section 382 are difficult to avoid in most change of control circumstances.

8 Does an acquisition company get interest relief for borrowings to acquire the target? Are there restrictions on deductibility where the lender is foreign, a related party, or both? Can withholding taxes on interest payments be easily avoided? Is debt pushdown easily achieved?

Debt instruments will often be issued by a purchaser as consideration for its acquisition of a target's stock or assets or to raise financing for such acquisition.

Unrelated party debt

As a general rule, interest paid on debt to an unrelated party is deductible by the payer. There are exceptions, however, under the IRC. A provision that was enacted to curb the growth of conglomerates during the 1960s disallows deductions for interest on certain subordinated debt in excess of US\$5 million per year incurred to acquire stock or two-thirds of the non-cash operating assets of another corporation. The kind of debt that previously came under this provision is now rarely used by acquiring corporations.

A corporation may be limited in its ability to deduct the interest on applicable high-yield discount obligations (AHYDO). The AHYDO provision generally applies where debt bears a

yield greater than the applicable federal rate (AFR) plus five percentage points and contains significant original issue discount or payment-in-kind features. If the AHYDO provision applies, deductibility of certain interest is deferred until actually paid in cash and, to the extent the debt's yield exceeds the AFR plus six percentage points, an incremental portion of such interest is permanently disallowed.

No deduction is allowed for interest (including original issue discount) on a 'disqualified debt instrument', which is an instrument issued by a corporation that is payable in equity of the issuer or a related party.

Certain provisions under the IRC generally limit the ability of a corporation to carry-back net operating losses that are created by interest deductions allocable to particular debt financed stock acquisitions or distributions to its shareholders. This is because the interest expenses associated with those transactions do not have a sufficient relationship to the operations of earlier periods to justify a carry-back attributable to those interest expenses.

Related party debt

Additional provisions deny interest deductions for interest payments to related parties. Under the 'earnings stripping' rules, no deduction is allowed for interest on obligations held by related persons, at least in part, if the corporation's debt-to-equity ratio exceeds 1.5:1, its interest expense exceeds 50 per cent of a modified taxable income amount, and the related recipients of the interest pay no US tax on the interest. The provision also applies to interest on indebtedness to unrelated persons if the indebtedness is guaranteed by a related person that is either tax-exempt or a foreign person.

Note that, although 'portfolio interest' is not subject to a 30 per cent withholding tax that applies to other US source interest income received by non-resident aliens, portfolio interest does not include interest if the interest is received by 10 per cent shareholders or if the interest is contingent interest. Portfolio interest is interest (including original issue discount) that is paid on certain unregistered and certain registered debt obligations.

Under a matching principle, amounts payable to a related foreign person, such as interest on indebtedness, may be deducted only upon actual payment, even if the taxpayer's general method of accounting is the accrual method. Current legislative activity includes proposals which would tighten the rules on deductibility of related party debt. It is unclear whether any of the proposed changes will be enacted into law.

Income tax treaties

The general mechanism for reducing or eliminating the withholding taxes on the payment of interest to a foreign person is application of certain US income tax treaties. As discussed in question 13, in general, absent an income tax treaty there is a 30 per cent withholding tax on US source interest income received by foreign persons.

Debt pushdown

Debt pushdown is generally easily achieved in the US taxing jurisdiction. For example, if the acquiring corporation establishes a US subsidiary that borrows funds for an acquisition, which is guaranteed by the parent, and then the subsidiary merges into the acquired corporation, which distributes the cash to the acquired corporation's shareholders, the debt has been effectively pushed down from the parent to the acquired corporation. Similarly, the parent of a consolidated group can push down debt to its subsidiary by having the subsidiary assume the debt of the parent.

In that case, the parent's basis in its subsidiary's stock would be correspondingly reduced. If the parent's basis in the subsidiary's stock is not sufficient to absorb all of the reduction, an 'excess loss account' is established which represents a potential income item in the hands of the parent, recognition of which will occur on the occurrence of certain triggering events, such as the disposition of the subsidiary's stock by the parent. If the parent and subsidiary are not part of a consolidated group, such a pushdown would be considered a distribution to the parent which would be a dividend to the extent of the subsidiary's earnings and profits. The parent may qualify for a dividends received deduction on receipt of the dividend.

9 What forms of protection are generally sought for stock and business asset acquisitions? How are they documented?

Most protections with respect to taxes are found in the applicable asset or stock purchase agreement. These provisions tend to be highly negotiated. The basic contractual provisions in the acquisition document that the parties must focus on for tax purposes include: (i) tax representations and warranties; (ii) pre- and post-closing covenants relating to taxes; and (iii) indemnification provisions. In addition, purchase price determinations and readjustments, dispute resolution clauses, and other provisions in the acquisition agreement (including, for example, the definitions sections) may have a significant impact on the manner in which a specific tax provision operates. The content of these provisions will depend on whether the acquisition is structured as a stock or asset deal.

In the case of a stock acquisition, the primary purpose of the tax provisions in the acquisition agreement is to identify the potential tax liabilities of the target company and allocate these liabilities between the seller and the purchaser. In contrast, in the case of an asset acquisition, where the seller generally retains the liabilities of the target company (unless the purchaser expressly assumes such liabilities) the primary function of the tax provisions, at least from the purchaser's perspective, is to ensure that the purchaser obtains the seller's assets free and clear of any tax liens. In the case of the acquisition of a member of a consolidated return group, the purchaser and seller must consider several additional issues, generally related to the extent of the target company's liability for pre-closing taxes of other members in the seller's consolidated group (and the target company's ability, if any, to participate in dealings with tax authorities with respect to these liabilities) and carry-backs and carry-forwards of losses or credits between pre-closing and post-closing periods.

Representations and warranties

From the purchaser's perspective, the principal purpose of representations and warranties relating to taxes is to identify, and to the extent possible eliminate, potential tax problems which otherwise will be inherited by the purchaser in the transaction.

Covenants

Covenants may relate to pre-closing or post-closing periods. Typical covenants in a stock purchase agreement include:

- preparation and filing of tax returns and payment of taxes;
- notification of tax proceedings;
- tax elections, waivers and settlements;
- termination of existing tax-sharing agreements; and
- a covenant that the transferor is a non-foreign person.

Indemnification

The indemnity provisions provide for payment of damages in the event that one of the parties to the agreement breaches its representations, warranties or covenants to the other party. The principal concerns in structuring the indemnity provisions include:

- how long the representations and warranties should survive the closing;
- to whom the purchaser can look for indemnity;
- to what extent the purchaser is entitled to a hold-back or escrow (and for what time period);
- which party should have the authority to contest any tax items which may give rise to an indemnity obligation under the acquisition agreement; and
- what, if any, minimum ‘baskets’ or maximum ‘caps’ should be placed on the amount that one party can recover from the other.

Post-acquisition planning

10 What post-acquisition restructuring is typically done and why?

In an acquisition of a US target company with foreign subsidiaries by a foreign acquiring corporation, post-acquisition restructuring should be considered in order to minimise layers of income and withholding tax upon repatriation of earnings to the foreign acquiring corporation from foreign target subsidiaries owned by the US target.

The principal objective of a restructuring is to minimize or eliminate US income tax and US withholding tax on foreign earnings. The objective may be accomplished by ‘removing’ income from the acquired US group or its directly-owned foreign subsidiaries and having such income earned instead by the new foreign parent (or having foreign affiliates owned directly by the new foreign parent).

First, the group net asset value and income can be reduced either by (i) removing gross asset value from the US group or (ii) creating indebtedness owing from the US group to the new foreign parent. Gross assets can be removed from the US group by (i) distributing existing gross assets of the US group to the foreign parent or (ii) having the foreign parent make future investments that otherwise might be made by the US group. To the extent that the foreign corporation acquired the US group in a taxable acquisition for cash, various techniques can be used to cause the US target to incur acquisition indebtedness, with the result that the net asset value of the US group would be reduced.

Second, freeing net asset value and US earnings can be accomplished through a number of techniques, including:

- a ‘preferred stock freeze’ (in which the US target recapitalises all or substantially all of its common stock of its foreign subsidiaries into preferred stock of equal value and the foreign acquiring corporation acquires all of the common stock of the foreign subsidiaries);
- the sale of foreign subsidiary stock; or
- a stock-for-stock exchange or asset merger in which the US group receives preferred stock in a foreign affiliate of the foreign acquiring corporation.

Third, the US group’s income can be shifted to the foreign parent or its directly owned foreign affiliates in low-tax jurisdictions by having the foreign parent or affiliate become the principal entrepreneur in the development, manufacture and sale of products.

11 Can tax-neutral spin-offs of businesses be executed and, if so, can the net operating losses of the spun-off business be preserved?

Generally yes, but it is difficult to accomplish a tax-free spin-off after a taxable (and in some instances after tax-free) acquisition of the stock or assets of a target company.

In general, a spin-off allows the tax-free split of two or more active businesses or divisions of a single business.

If the statutory requirements are met, the spin-off will generally not subject the distributing corporation to a corporate level income tax on the gain inherent in the shares of the spun-off or ‘controlled corporation’ and will not subject distributing shareholders to tax on the value of the controlled shares they receive or the gain inherent in the exchange of distributing shares for controlled shares in a split-off.

The statutory requirements are that:

- the distributing corporation must own a sufficient interest in the controlled corporation or have ‘control’ immediately before the spin-off (for this purpose, control means that the distributing corporation owns at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other outstanding classes of stock of the controlled corporation);
- generally all of the distributing corporation’s stock in the controlled corporation must be distributed;
- both the distributing and the controlled corporation must be engaged in an active trade or business (that was not acquired in a taxable acquisition) for at least five years before the spin-off;
- there must be a sufficient corporate, not shareholder, business purpose for the spin-off, eg, there may be so-called ‘fit and focus’ business problems associated with trying to manage or operate two different businesses within a single group;
- the spin-off is not a device principally to distribute earnings and profits tax-free; and
- there is continuity of ownership by the existing shareholders of the distributing and controlled corporation after the spin-off.

In addition, the spin-off will be taxable at the corporate level, but not to the shareholders, if (i) after the spin-off, any person holds a 50 per cent or greater interest in either the distributing or controlled corporation that is considered to have been acquired by purchase within the five-year period preceding the transaction, or (ii) pursuant to a plan during a two-year period before and after the spin-off, 50 per cent or more of either the distributing or controlled corporation is acquired. Regulations under the IRC afford for several ‘safe harbours’ that provide circumstances in which a post-spin-off transaction will not be considered to be part of the requisite plan, thus somewhat mitigating the result of this rule.

Where the stock or assets of an acquired company (either distributing or controlled) is acquired in a taxable transaction within five years of a spin-off, generally, (i) the active conduct of a trade or business requirement, which would make the spin-off taxable at both the corporate and shareholder levels, and (ii) the provision imposing tax only at the corporate level where 50 per cent or more of either distributing or controlled are acquired by purchase, may not be met.

NOLs will not be limited unless an ownership change in either the distributing or controlled corporation occurs. See question 7 for a discussion of these limitations.

- 12** Is it possible to migrate the residence of the acquisition company or target company from your jurisdiction without tax consequences?

In the US, taxation depends on the place of incorporation and the source of income, not residence. A change of residence within the intent of this question occurs where the acquisition or target company by merger or liquidation changes its place of incorporation to a location outside the US (which is treated as an asset transfer).

The liquidation of the US target or the US acquiring corporation into a foreign parent company will be subject to US corporate income tax, with limited exceptions described below. The rationale for the exception is that, in the circumstances in which they apply, the United States retains taxing jurisdiction over the gain inherent in the distributed assets.

One exception, provided that certain procedural requirements relating to furnishing notice to the IRS are met, applies in the case where the distributed trade or business assets are used in the conduct of a US trade or business and continue to be used in the business by the foreign distributee corporation for 10 years immediately after the distribution. This exception, however, will not shield the value of most intangible assets from tax.

A second exception applies to the extent that the assets of the liquidated US corporation are US real property interests (which includes stock in US corporations, where more than 50 per cent of the corporation's assets consist of US real property interests, a 'United States real property holding corporation').

Subject to anti-abuse rules, the third exception applies where the assets distributed by the US liquidating corporation consist of shares of a US corporation in which the liquidating corporation owns at least 80 per cent of its stock by both voting power and value. Where the liquidating corporation, however, is a United States real property holding corporation, this exception will not apply unless the subsidiary being distributed is also a United States real property holding corporation.

- 13** Are interest and dividend payments made out of your jurisdiction subject to withholding taxes and, if so, at what rates? Are there domestic exemptions from these withholdings or are they treaty-dependent?

Generally, yes. The US imposes a flat 30 per cent tax and withholding obligation on the payer with respect to interest and dividend payments attributable to US source income from a US payer to foreign persons.

There is a domestic exemption from the tax for payments of interest on portfolio debt obligations where the appropriate documentation from the foreign payee is obtained. Generally, portfolio interest, however, does not include interest on debt obligations held by a 10 per cent shareholder (certain ownership attribution rules apply in making this determination) or with respect to payments of certain contingent interest, eg, interest determined by reference to the income from sales of the debtor.

Reductions or elimination of the 30 per cent tax and withholding rate may be available on interest and dividends paid to residents of a country with which the US has entered into an income tax treaty. The treaty tax rates may be less than those otherwise applicable under the treaty with respect to interest and dividends paid by a subsidiary to a foreign parent corporation.

- 14** What other tax-efficient means are adopted for extracting profits from your jurisdiction?

In addition to interest and dividends that may be eligible for reduced rates of taxation pursuant to an applicable income tax

Update and trends

There has been an interesting pooling of capital through joint ventures between strategic buyers and private equity investors. There has also been an expansion of the use of limited liability companies (LLCs) (a tax transparent vehicle) to make investments into the US.

In addition, Congress has refocused its attention on interest stripping.

treaty (see question 13), US income tax treaties also generally provide for reduced rates of tax and withholding on payments of industrial or copyright royalties.

The payment of interest or royalties is generally deductible by the payer corporation in arriving at its taxable income. Dividend payments are not deductible. It is therefore more tax-efficient to distribute economic profits by means of interest or royalty payments than by dividends.

The IRS may scrutinise royalty arrangements to ensure that the US taxpayer is not overpaying for the intellectual or other property that the foreign parent is licensing to it. The transfer pricing rules generally seek to establish the arm's length price by reference to the royalty that would be paid between unrelated parties for the same licence.

In the case of interest paid to a foreign parent, where the 30 per cent withholding tax is eliminated or reduced under an income tax treaty, the IRC will disallow a portion of the interest deduction to the extent that the US taxpayer has a debt-to-equity ratio in excess of 1.5:1 and has excess interest expense, defined as the amount of its net interest expense that exceeds 50 per cent of its taxable income (computed without regard to net interest expense and certain enumerated items and increased by any unused limitation for prior years). Any interest amount not deductible may be carried forward to the next taxable year and tested for deductibility under these rules for that succeeding year except that the debt to equity ratio requirement does not apply.

Disposals (from the seller's perspective)

- 15** How are disposals most commonly carried out – a disposal of the business assets, the stock in the local company or stock in the foreign holding company?

The seller of a business conducted in corporate form generally prefers to sell the stock of the corporation rather than the corporate business assets to avoid the corporate level tax imposed on the gain realised on an asset sale.

On the other hand, the purchaser generally prefers to acquire assets not stock, to avoid inheriting any latent corporate liabilities of the seller and because the direct purchase of assets allows the purchaser to obtain a fresh cost basis in the acquired assets, including goodwill and growing concern value, which may be depreciated or amortised for tax purposes (goodwill and growing concern value may generally be amortised on a straight-line basis over 15 years).

Where the seller is a member of a US-affiliated group of corporations, filing a consolidated return, and the target corporation is a subsidiary, there is generally an opportunity to make a section 338 tax election to structure the transaction as a stock sale for corporate law purposes, but an asset sale for tax purposes. See the response to question 2 for a discussion of the election.

In general, the disposal of the business will take the form of either a sale of the assets of the local company or its stock. An acquirer will generally not wish to acquire stock of the foreign holding company. One circumstance in which the seller may insist on selling the foreign holding company rather than the local company is where the local company owns real estate interests and the foreign seller would therefore be subject to US taxation on the sale of the local corporation's stock, but would not be subject to US taxation if it sells the shares of the foreign holding company.

- 16** Where the disposal is of stock in the local company by a non-resident company, will gains on disposal be exempt from tax? Are there special rules dealing with the disposal of stock in real property, energy and natural resource companies?

Generally, no. Sales of the stock in the local company by the non-resident company will be subject to US taxation only where the local company is a United States real property holding corporation, generally a corporation where more than 50 per cent by value of its assets are US real estate interests (but excluding

a publicly traded corporation in which the shareholder did not hold more than 5 per cent of the corporation's stock), or in the rare circumstance in which the foreign owner is engaged in a trade or business in the US and the stock in the local company is directly needed in the conduct of that trade or business.

- 17** If a gain is taxable on the disposal either of the shares in the local company or of the business assets by the local company, are there any methods for deferring or avoiding the tax?

The gain on the disposal of business assets or stock can be deferred if the transaction is structured as a tax-free reorganisation. Tax-free reorganisations may be accomplished by various methods. For a discussion of these methods, see question 1.

Where more than 50 per cent of the value of the assets of the local company consist of the US real estate interests, the tax-free reorganisation outlined above will not result in non-recognition of gain to foreign sellers unless the interest the foreign sellers receives in the exchange also constitutes a United States real property interest.

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