

# Technology and Telecommunications

By *Richard E. Andersen*

## Consolidation in the Global Positioning and Navigation Industry Illustrates Tax Issues and Opportunities in Cross-Border Acquisitions



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### Introduction

It never fails: what was once a small corner of a much larger and maturing industry sees a sudden burst of growth, and shortly thereafter the level of merger and acquisition activity experiences a similar boom as the players seek economies of scale, market penetration and (increasingly) access to competing technologies. Such is the history to date of the satellite positioning and navigation space, for years limited to vertical applications (maritime, aviation, *etc.*), but more recently riding a wave of rising consumer interest as both the software and hardware inputs have become cheaper and more end-user-friendly. Add the fact that the major industry players are geographically diverse, and you have a Petri dish for international tax techniques and traps in cross-border M&A transactions. This column uses the ongoing consolidation in this market as a template to conduct a high-level, transactionally organized review of the current state of play in the U.S. taxation of transnational acquisitions.

### Current and Recent Activity

As of this writing, a number of industry-consolidating transactions have been rumored, announced or completed in recent months. In the summer of 2007, Garmin Ltd. (a Cayman Islands company) acquired its exclusive German distributor of Garmin's consumer products, GPS Gesellschaft für Professionelle Satellitennavigation mbH (renamed Garmin Deutschland



**Richard E. Andersen** is a Partner in the New York office of Arnold & Porter LLP, where he heads the tax practice.

GmbH). Scandinavian powerhouse Nokia made an \$8 billion bid to acquire U.S. digital mapping provider Navteq in a cash merger, while two Dutch companies (TomTom BV and Tele Atlas BV) are involved in a recommended cash tender offer. Finally, rumors are heard throughout the market from time to time that Microsoft is interested in acquiring Garmin, or that (alternatively or incrementally) Microsoft could be interested in making a bid for the combined TomTom/Tele Atlas entity (similar speculation has arisen that Google would be interested in such a bid for itself).<sup>1</sup>

Clearly, there is a significant level of consolidating activity underway in this sector, and the various transactions can take different forms depending on the locations of the parties, the characteristics of their respective shareholder constituencies and their financial positions. The balance of this column summarizes the major U.S. tax considerations relating to the acquisition structuring options available to transaction participants in the mapping and navigation space.

In a “pure” transaction, in which no boot is offered, both the shareholders and the constituent corporations routinely achieve nonrecognition tax treatment for the exchanges and distributions inherent in the transaction.

## Available Forms of Acquisition and Their Consequences

### Taxable Transactions

**Cash Tender Offer.** In many ways, the simplest transactional template is the acquirer’s purchase of the target shareholders’ stock for cash. Where the target is a domestic corporation, the selling shareholders are virtually assured of capital treatment for the gain or loss realized on account of the sale, and in the absence of a Code Sec. 338(g) election, the appreciation or depreciation in the value of the target’s assets remains unrecognized (and their basis unchanged).<sup>2</sup> Subject to specific Code provisions stating otherwise,<sup>3</sup> the target’s other tax attributes are also unaffected. Whereas a domestic acquirer could consolidate the target into a U.S. group for tax purposes, this opportunity is denied to a foreign acquirer,<sup>4</sup> which must also be mindful of the U.S. withholding tax con-

sequences of receiving dividends from its new U.S. subsidiary.<sup>5</sup>

If the target is a foreign corporation, the foregoing analysis must be preceded by a determination of whether it is a controlled foreign corporation (CFC) or a passive foreign investment company (PFIC) in the hands of its U.S. shareholders. If 10-percent-or-greater U.S. shareholders of the target (measured by voting power) together are deemed to own (or to have owned) more than 50 percent (by vote or value) of the target in the year of sale or during the preceding five years, Code Sec. 1248 will recharacterize any gain recognized by those shareholders as dividend income to the extent of

their *pro rata* shares of the target’s earnings and profits. Unless the target is also a PFIC, the other U.S. shareholders will have the consequences described in the preceding paragraph.

If more than 75 percent of the target’s income was passive income<sup>6</sup> in any year up to and including the year of the tender offer,

or if more than half its assets produced or were held to produce passive income, the target would be a PFIC and, with some exceptions, its U.S. shareholders who participate in the tender offer will recognize their gain at ordinary income rates and will suffer an interest charge tied to their respective holding periods.<sup>7</sup> (Cash is always a “bad” asset, so many technology companies that raise money to fund anticipated R&D or other preparatory activities can find themselves unexpectedly classified as PFICs.)

**Cash Merger.** An alternative to the classic cash stock purchase represented by the tender offer is the cash merger, in which the target’s shareholders are cashed out as in the tender offer but the mechanics of substituting the acquirer or its shareholders for the target’s shareholders are governed by a state merger statute.

The IRS has ruled that a “direct” cash merger (*i.e.*, one that does not involve an acquisition subsidiary, as described below) is treated as an asset sale by the target to the acquirer in exchange for the merger consideration, followed by a constructive liquidation of the target and a distribution of the merger consideration to the target’s historic shareholders.<sup>8</sup> As

a result, the cash merger often attracts two levels of tax to the sell side, making the structure unappealing in most cases.

**Triangular Acquisitions.** Changes in control of a target corporation often carry adverse nontax consequences, including the need to obtain third-party consents and the risk of invalidating licenses and other valuable intangible assets. Where the target needs to survive for such non-tax reasons, a “reverse subsidiary cash merger” is the technique most frequently employed: the acquirer forms a transitory subsidiary that is merged with and into the target, and the target’s historic shareholders surrender their shares for the cash merger consideration. This approach also avoids the double tax problem described above in the case of a direct cash merger, since the IRS has ruled that the reverse subsidiary cash merger is treated as a stock purchase for tax purposes.<sup>9</sup>

It is also possible to structure a taxable triangular acquisition so as to have the target disappear into the acquisition subsidiary. This “forward subsidiary cash merger” is treated as an asset sale for tax purposes,<sup>10</sup> reintroducing the inefficiency described above that makes a direct cash merger unattractive in the majority of cases.

## Tax-Free Transactions

The Code provides a number of methods for a strategic acquisition to be structured in a manner that avoids current tax consequences to either the constituent corporations or the participating target shareholders, so long as limited (in some cases) or no (in others) nonstock consideration (“boot”) is employed. The three principal forms of reorganization utilized in the acquisitive context are:

- a statutory merger or consolidation, either between the principal corporations themselves or between the target and a special purpose acquisition subsidiary<sup>11</sup>;
- an acquisition of the target’s stock solely for voting stock of the acquirer or its parent<sup>12</sup>; and
- an acquisition of the target’s assets for predominantly voting stock of the acquirer or its parent, followed by the target’s liquidation.<sup>13</sup>

Where boot is used as permissible consideration in a reorganization, tax-free treatment of the acquisition depends on the existence of continuity of shareholder interest, measured as a minimum equity component of between 40 percent and 50 percent of the total consideration paid to the target’s shareholders.<sup>14</sup> It is also necessary that the survivor continue at least one

substantial business of the target post-acquisition under the “continuity of business enterprise” requirement.<sup>15</sup>

**Asset Reorganizations.** In the purely domestic context, stock-for-stock mergers and their cousins, the assets-for-stock reorganization, are commonly employed to effect strategic combinations in a given industry. In a “pure” transaction, in which no boot is offered, both the shareholders and the constituent corporations routinely achieve nonrecognition tax treatment for the exchanges and distributions inherent in the transaction.

Complications can arise in the cross-border context, principally through the application of Code Sec. 367. Acquisitions in which a foreign target is acquired by a U.S. corporation are rarely within the ambit of Code Sec. 367(b), since that provision (as is made clear by the underlying regulations) applies only where the status of a CFC or one of its 10-percent U.S. shareholders is affected by the transaction. (Such transactions, however, can implicate loss importation and built-in loss issues of the target, and post-acquisition transactions, discussed below, can be subject to Code Sec. 367(b)’s provisions.) By contrast, Code Sec. 367(a) routinely applies to deny tax-free treatment to “outbound” A and C reorganizations (*i.e.*, those in which a U.S. target is acquired by a foreign corporation).<sup>16</sup>

**Stock Reorganizations.** Where the acquirer is prepared, at least as an initial matter, to keep the target as a separate unit of the acquirer’s group, a tax-free deal is often structured as a solely-for-voting-stock B reorganization in which control of the target is acquired from the target’s historic shareholders. Transfers of foreign target shares are generally granted tax-free treatment under Code Sec. 367(a) and 367(b). Although Code Sec. 367(a) appears to prohibit outbound B reorganizations of U.S. target corporations, the regulations contain a complicated supplemental nonrecognition provision that permits such transactions (subject to Code Sec. 367(a)(5)) where (1) target “insiders” (officers, directors and five-percent shareholders) do not control the survivor, (2) any five-percent shareholders sign a “gain recognition agreement,”<sup>17</sup> (3) the target or a qualified affiliate has been engaged in an active business outside the United States for at least 36 months preceding the acquisition, and (4) the acquirer is no less valuable than the target immediately before the transaction.<sup>18</sup>

**Indirect Acquisitions.** The regulations bring many types of three-party reorganizations within the ambit of Code Sec. 367(a) even where the target or its assets

are being transferred to a U.S. acquirer.<sup>19</sup> These forms of transaction (which include otherwise tax-free triangular subsidiary acquisitions) share the characteristic that the consideration for the domestic acquirer's acquisition of the target or its assets consists at least in part of stock or securities of the acquirer's foreign parent corporation.

**Inversions.** Cross-border acquisition transactions were significantly complicated by the enactment of Code Sec. 7874 in 2004. If substantially all the assets of a domestic corporation are acquired by a foreign corporation and the domestic corporation's former shareholders hold at least 60 percent of the acquirer's stock (by vote or value) immediately after the transaction, the acquirer will be taxable on gain from the sale of stock or assets, and on income from a license, earned during the succeeding 10 years.<sup>20</sup> If the target's former shareholders hold 80 percent or more of the foreign acquirer immediately after the transaction, the acquirer is treated as a domestic corporation for all purposes of the Code.<sup>21</sup> Numerous exceptions and special rules apply (including some introduced by the regulations).<sup>22</sup>

## Financing the Acquisition

In taxable acquisitions, the acquirer will frequently resort to third-party debt financing to secure the required cash consideration, and in many cases (including virtually all private equity transactions) the financing will be structured so as to put the burden of debt service (and the resulting interest expense deduction) on the target. Where the target is a domestic corporation, numerous limitations and special rules must be carefully considered, including:

- debt-equity considerations (the body of common law that determines whether an instrument purporting to be debt should in fact be treated as equity, either because of its terms or because the amount of nominal equity is deemed insufficient to support the level of nominal debt);
- the withholding tax consequences of interest payments (neither traditional bank debt nor financing secured directly from its new parent would generate interest eligible for the U.S. withholding tax exemption on "portfolio interest" under Code Sec. 881(c)<sup>23</sup>);
- the limitation on deductibility of certain subordinated "corporate acquisition indebtedness" if specified conditions are satisfied<sup>24</sup>;
- the "earnings-stripping" rules, which defer otherwise allowable interest expense paid to, or

guaranteed by, a foreign person to the extent the interest expense exceeds a specified multiple of the U.S. debtor's adjusted taxable income<sup>25</sup>; and

- the original issue discount (OID) rules, including especially the deferral or denial of deductions for interest and OID on "applicable high-yield debt obligations."<sup>26</sup>

Conversely, where a U.S. acquirer purchases a foreign target, the U.S. tax impact of interest expense incurred by the target is generally driven by (1) the rules for allocating and apportioning interest expense on a worldwide basis,<sup>27</sup> and (2) in the case of a hybrid target (*i.e.*, one that defaults to, or elects, noncorporate status for U.S. tax purposes under the "check-the-box" regulations<sup>28</sup>) computing any "overall foreign loss" under Code Sec. 904(f).<sup>29</sup> Both these provisions are principally relevant for purposes of determining the U.S. acquirer's foreign tax credit position.

## Collateral Transactions

In both the taxable and tax-free contexts, acquirers often engage in additional transactions in parallel with, or after, the main acquisition in order to reorganize the target's assets or capital structure or to rationalize the group's post-acquisition organization chart. In some cases, those collateral transactions and their tax characteristics have no impact on, and are not affected by, the tax profile of the principal transaction, whereas in others the combination of transactions may lead to different, and perhaps unintended, results.

**"Back-End" Merger.** If a tender offer results in the acquisition of most, but not all of the target's shares, the acquirer will often avail itself of a state law merger statute to mandatorily "squeeze out" non-tendering shareholders. If done for the acquirer's shares (or for shares of its parent), the merger will generally qualify for nonrecognition treatment; but if a cash squeeze-out is contemplated, the tax consequences would be those of a taxable direct merger. Consideration should be given to the use of a transitory acquisition subsidiary to benefit from the more advantageous treatment of reverse subsidiary cash mergers.

**Acquisition of Target's Outstanding Debt.** In connection with the acquisition of a target's equity, the acquirer will often want to improve the target's balance sheet going forward and eliminate a potentially disruptive constituency in the form of holders of the target's debt. This can be done by either (1) restructuring the target's debt (*i.e.*, replacing the

existing indebtedness with new obligations having terms more favorable to the target), or (2) redeeming the existing indebtedness for cash (perhaps at a discount to its face value and/or accrued interest balance). Where the target's debt is being restructured, consideration must be given to whether the new debt is sufficiently different from the old debt to be treated as a taxable sale or exchange of the former by the holders under the *Cottage Savings* regulations.<sup>30</sup> On the other hand, a redemption of the old debt for cash by the target (or a related person<sup>31</sup>) for less than face value may generate phantom income to the target unless it is insolvent or under the protection of a U.S. bankruptcy court.<sup>32</sup>

**Acquisition Followed by Intra-Group Transfer.** In order to rationalize its corporate structure post-acquisition, an acquirer may wish to move the assets or stock acquired in the main transaction to another location on the corporate organization chart. These transactions often involve some combination of (1) tax-free reorganizations, (2)

incorporations of new subsidiaries (presumptively tax-free under Code Sec. 351), and (3) subsidiary liquidations (often tax-free under Code Secs. 332 and 337). In addition to meeting the respective technical requirements for tax-free treatment of the collateral transactions themselves, consideration must be given to both (1) the impact of Code Secs. 367 and 7874 on those transactions, and (2) whether the collateral transactions affect the desired tax treatment of the principal acquisition transaction.<sup>33</sup>

## Conclusion

Industry consolidations in sectors with several participants in different countries generate tax consequences to the companies involved and their shareholders that are both similar to and broader than those faced by purely domestic players. The variations in detail border on the infinite, but the majority of them fall into the categories outlined in this article, which may serve as a template to begin the tax analysis of a given acquisition.

## ENDNOTES

<sup>1</sup> See [www8.garmin.com/uk/media/press\\_release/030707/GarminGermanDistributor.pdf](http://www8.garmin.com/uk/media/press_release/030707/GarminGermanDistributor.pdf); <http://lbs.gpsworld.com/gpslbs/article/articleDetail.jsp?id=461533>; [www.engadget.com/2007/11/18/tomtom-to-make-4-2-billion-bid-for-tele-atlas/](http://www.engadget.com/2007/11/18/tomtom-to-make-4-2-billion-bid-for-tele-atlas/); <http://findermentalism.com/2007/10/09/microsoft-set-to-buy-garmin/>; [www.techconfidential.com/money-out/blog/money-out/deals-ahoy-in-navigation-marke.php](http://www.techconfidential.com/money-out/blog/money-out/deals-ahoy-in-navigation-marke.php).

<sup>2</sup> Where it is available, the Code Sec. 338(g) election will grant a step-up in the target's basis, but usually at the cost of recognizing any unrealized appreciation in those assets on the buy side. Absent a net operating loss or other special circumstance, the trade-off is rarely worth it, so the election is seen only infrequently unless the target is part of the seller's consolidated return.

<sup>3</sup> For instance, Code Sec. 382 (limiting post-acquisition net operating losses).

<sup>4</sup> Code Sec. 1504(b)(3).

<sup>5</sup> Code Sec. 1442. The 30-percent gross withholding tax (collection of which is the responsibility of the U.S. subsidiary) imposed by that provision can be mitigated by an income tax treaty between the United States and the foreign acquirer's home country; such treaties generally reduce the withholding tax rate on such dividends to 10 percent, five percent or, increasingly, zero.

<sup>6</sup> As defined by reference to Code Sec. 954(c).

<sup>7</sup> Code Sec. 1291. The principal exception is the "qualified electing fund" (QEF) election, which substitutes pass-through treatment of the PFIC's income for the interest charge regime described in the text; in the context of the companies that are the focus of this article, shareholders are unlikely to know or suspect that the companies are PFICs, so as a practical matter QEF elections will not serve to shield those shareholders from the interest charge regime.

<sup>8</sup> Rev. Rul. 69-6, 1969-1 CB 104.

<sup>9</sup> See Rev. Rul. 73-427, 1973-2 CB 301; Rev. Rul. 79-273, 1979-2 CB 125; Rev. Rul. 90-95, 1990-2 CB 67.

<sup>10</sup> Rev. Rul. 69-6, *supra*.

<sup>11</sup> Code Sec. 368(a)(1)(A), (a)(2)(D), (a)(2)(E).

<sup>12</sup> Code Sec. 368(a)(1)(B).

<sup>13</sup> Code Sec. 368(a)(1)(C).

<sup>14</sup> Reg. §1.368-1(e).

<sup>15</sup> Reg. §1.368-1(d).

<sup>16</sup> Code Sec. 367(a)(5) effectively denies nonrecognition to outbound asset reorganizations unless the foreign survivor is controlled by five or fewer domestic corporations.

<sup>17</sup> Reg. §1.367(a)-8T sets out the requirements of such a gain recognition agreement, under which the five-percent shareholder agrees to recognize the deferred gain and pay interest on the resulting tax if the shares of the target or substantially all of its assets are disposed of within five years of the acquisition.

<sup>18</sup> Reg. §1.367(a)-3(c).

<sup>19</sup> Reg. §1.367(a)-3(d).

<sup>20</sup> Code Sec. 7874(a), (d).

<sup>21</sup> Code Sec. 7874(b).

<sup>22</sup> See, e.g., Reg. §§1.7874-1T, -2T.

<sup>23</sup> Code Sec. 881(c)(2)(3).

<sup>24</sup> Code Sec. 279.

<sup>25</sup> Code Sec. 163(j).

<sup>26</sup> Code Sec. 163(e)(5), (i).

<sup>27</sup> Reg. §§1.861-8–1.861-13T.

<sup>28</sup> See Reg. §§301.7701-1, -2, -3.

<sup>29</sup> For purposes of calculating the Code Sec. 904 foreign tax credit limitation of the U.S. acquirer, all or a portion of its (desirable) foreign-source income for a given year will be reclassified as domestic-source income to the extent of the balance in its "overall foreign loss account," a running total of the positive variance between (1) the deductions properly allocated or apportioned to foreign-source gross income, and (2) the amount of that gross income.

<sup>30</sup> Reg. §1.1001-3. A secondary point to consider arises from the fact that, in connection with a debt restructuring, holders are often asked to consent to changes in the terms of their existing debt and are paid a

“consent solicitation fee” for their trouble; the proper tax treatment of such fees is subject to some uncertainty, and may depend on whether the consenting holders are also tendering all or a portion of their existing debt.

<sup>31</sup> Code Sec. 108(e)(4).

<sup>32</sup> See Code Sec. 108(a).

<sup>33</sup> As to the last point, see, e.g., Code Sec. 368(a)(2)(C).



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