Impact of Tax Reform on Cross-Border M&A

2018 U.S. Cross-Border Tax Conference

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Notices

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
Agenda

01 General Overview of Tax Reform and the Impact on the M&A Market

02 Disposition of Controlled Foreign Corporation (CFC)

03 Acquisition of U.S. Target Corporation

04 Acquisition of Foreign Target Corporation

05 Spin-Offs
## Today’s presenters

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Tax reform – cornerstone provisions

Lower Corporate Rate – 21%

Global game-changing tax reforms

- Participation Exemption & Mandatory Repatriation Tax
- Immediate Expensing But Strengthened Interest Expense Limitation Rules
- Net Operating Loss Limitations and Enhancements
- Base Erosion Provisions

Tax on GILTI vs. FDII

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Overview of new international tax framework

**BEAT Section 59A**
- Imposes additional tax
- Based on limiting deductibility of deductible payments to related foreign persons

**163(j) Limit on interest deduction**
- Related and unrelated party debt
- 30% of EBITDA (EBIT in 2026)

**Branch Income – 21%**
- Current inclusion
- Separate basket
- 10 year carryforward
- Cannot get FDII

**Sub F – 21%**
- Foreign base company income and 956
- Current inclusion at 21%
- General and passive baskets
- 10 year FTC carryforward

**FDII – 13.125%**
- Income from sale, leases, licenses, and dispositions of property to foreign person for foreign use
- Income from services to person outside the US/LFDII section 250(b) @ 13.125%

**Distributions**
- PTI
- Participation Exemption (section 245A)
- Subject to tax if hybrids of inverted companies

**GILTI – 10.5% (13.125%)**
- CFC income that is not exempt or sub F
- Current inclusion with 50% deduction
- 80% FTC haircut
- Separate basket
- No FTC carryforward

**Exempt Income – 0%**
- FOGEI
- 10% QBAI
- High Tax sub F income (elective)

**Other Income – 21%**
- U.S. and Foreign source income that is not FDII or GILTI or eligible for DRDs

**U.S.**
Disposition of CFC
U.S. buyer of CFC

- FS, a CFC before the transaction, remains a CFC owned by U.S. Buyer. FS’s taxable year does not end as a result of the disposition.
- Because U.S. Seller does not own FS on the last day of the taxable year in which FS is a CFC, there should be no section GILTI inclusion by U.S. Seller under section 951A. See section 951A(e).
  - Under section 1248, gain recognized by U.S. Seller on the sale of FS would generally result in dividend income to the extent of non-PTI E&P attributable to U.S. Seller’s FS stock. For section 1248 purposes, E&P is attributed to the shares of FS owned by U.S. Seller based on the number of days in the taxable year that U.S. Seller owned the shares.
  - Under section 1248(j), any amount received by U.S. Seller that is a dividend under section 1248 is treated as a dividend for purposes of applying section 245A. Thus, U.S. Seller may claim a 100% dividends received deduction for any such dividend income.
  - U.S. Seller’s gain not attributable to earnings is fully taxed capital gain.
- U.S. Buyer should take into account any GILTI inclusion attributable to FS (under section 951(a)(2)(A)), which should be reduced by any amount treated as a section 1248 dividend with respect to U.S. Seller (under section 951(a)(2)(B)).
— In Alternative 1, FS ceases to be a CFC on the disposition by U.S. Seller. Consequently, U.S. Seller would own FS on the last day on which FS is a CFC, and U.S. Seller should be required to pick up any GILTI inclusion.

— In Alternative 2, even though FS is acquired by Foreign Buyer, it should remain a CFC because U.S. Sub should be treated as constructively owning 100% of the stock of FS (following the repeal of section 958(b)(4), downward attribution now permitted under section 318(a)(3)).

- Thus, the result to U.S. Seller should be the same as in the prior example involving U.S. Buyer.
- U.S. Sub should not have a GILTI inclusion with respect to FS because U.S. Sub does not have a direct or indirect ownership interest under section 958(a).
Out-from-under: Cross-chain sale by CFC

Step 1
— CFC1 sells CFC2 to FS for $200.

U.S. Tax Considerations
— This sale is a transaction described in Section 304. As a result:
  - To the extent of the E&P of CFC2 (but not FS) the sales proceeds are treated as a dividend from CFC2 to CFC1. Section 301(c)(1); Section 304(b)(5).
    — Any deemed dividend from CFC2 to CFC1 may be tax-exempt. Section 954(c)(6).
    — Further, any deemed dividend is not expected to generate GILTI. Section 951A(c)(2)(A)(i)(IV).
    — See following slide for a discussion of planning relating to E&P generating transactions.
  - To the extent the sales proceeds exceed E&P, they are treated as a tax free return of CFC2’s tax basis. Section 301(c)(2).
  - To the extent the sale proceeds exceed CFC2’s tax basis and E&P, they are treated as capital gain (which may be subpart F income). Section 301(c)(3).
— U.S. Sub may be entitled to participation exemption on a future distribution of the sales proceeds. Section 245A.
Out-from-under: Cross-chain sale by CFC (cont’d)

Step 2
— Prior to the end of the taxable year in which Step 1 occurs, CFC2 engages in transactions that generate E&P.
— The amount of E&P that is generated should be such that the sales proceeds from Step 1 equals (i) CFC2 E&P, plus (ii) CFC1’s tax basis in CFC2.
  - Here, the sales proceeds are $200 and CFC2’s existing E&P is $50 and CFC1’s tax basis in CFC2 is $115; as a result, an additional $35 of E&P is needed.
— Examples of E&P generating transactions may include (i) transfers of appreciated assets by CFC2 to a subsidiary for common stock and non-qualified preferred stock in a partially taxable Section 351 transaction, or (ii) a Granite Trust transaction.

U.S. Tax Considerations
— Any E&P generated during the same tax year as Step 1 should be taken into account for purposes of determining the deemed dividend with respect to Step 1.
— It may be possible to undertake the E&P generating transactions either before or after the distribution assuming that CFC2 is a CFC through the time of the E&P generating transactions.
  - Under the revised attribution rules resulting from tax reform (including the repeal of Section 958(b)(4)), CFC2 shares should be attributed to U.S. Sub (causing it to be a CFC after the sale).
— The E&P generating transactions (regardless of when they occur during the year) should not result in GILTI income to any US corporation (since at the end of the year, no U.S. corporation (including U.S. Sub) will directly or indirectly own any CFC2 stock).
Out-from-under: Cross-chain sale by U.S. sub

Step 1
— U.S. Sub sells CFC1 to FS for $275.

U.S. Tax Considerations
— This sale is a transaction described in Section 304. As a result:
  - To the extent of the E&P of CFC1 (but not FS) the sales proceeds are treated as a dividend from CFC1 to U.S. Sub. Section 301(c)(1); Section 304(b)(5).
    — Any deemed dividend from CFC1 to U.S. Sub may qualify for participation exemption. Section 245A. However, need to consider potential application of Section 1059 (including Section 1059(e)).
    — Further, any deemed dividend is not expected to generate GILTI. Section 951A(c)(2)(A)(i)(IV).
    — See following slide for a discussion of planning relating to E&P generating transactions.
  - To the extent the sales proceeds exceed E&P, they are treated as a tax free return of CFC1’s tax basis. Section 301(c)(2).
  - To the extent the sale proceeds exceed CFC1’s tax basis and E&P, they are treated as capital gain (which may be subpart F income). Section 301(c)(3).
Out-from-under: Cross-chain sale by U.S. sub (cont’d)

Step 2
- Prior to the end of the taxable year in which Step 1 occurs, CFC1 engages in transactions that generate E&P.
- The amount of E&P that is generated should be such that the sales proceeds from Step 1 equals (i) CFC1 E&P, plus (ii) U.S. Sub’s tax basis in CFC2.
  - Here, the sales proceeds are $275 and CFC1’s existing E&P is $75 and U.S. Sub’s tax basis in CFC1 is $75; as a result, an additional $125 of E&P is needed.
- Examples of E&P generating transactions may include (i) transfers of appreciated assets by CFC1 to a subsidiary for common stock and non-qualified preferred stock in a partially taxable Section 351 transaction or (ii) Granite Trust transactions.

U.S. Tax Considerations
- Any E&P generated during the same tax year as Step 1 should be taken into account for purposes of determining the deemed dividend with respect to Step 1.
- It may be possible to undertake the E&P generating transactions either before or after the distribution assuming that CFC1 is a CFC through the time of the E&P generating transactions.
  - Under the revised attribution rules resulting from tax reform (including the repeal of Section 958(b)(4)), CFC1 shares should be attributed to U.S. Sub (causing CFC1 to be a CFC after the sale).
- The E&P generating transactions (regardless of when they occur during the year) should not result in GILTI income to any U.S. corporation (since at the end of the year, no U.S. corporation (including U.S. Sub) will directly or indirectly own any CFC1 stock).
Acquisition of U.S. target corporation
Stock vs. Asset acquisitions – U.S. target

Stock Acquisition

- Parent recognizes gain in U.S. Target stock at 21% tax rate.
  - Parent has cost basis in U.S. Target stock, but no basis step up for assets.
  - U.S. Target retains its historic tax attributes (NOLs, E&P, etc.), subject to limitations.
  - Acquire all assets and liabilities of U.S. Target.
  - Lower transaction costs; less complicated

Asset Acquisition

- Tax paid by U.S. Target on built-in gain in assets at 21% rate.
  - Results in basis step up for U.S. Target’s assets held by U.S. Acquirer.
  - U.S. Target attributes may offset gain, but other historic tax attributes are eliminated.
  - If section 338(h)(10) is available, can elect to treat stock acquisition as a deemed disposition of assets.
    - Achieves step-up in asset basis though deemed purchase by “New U.S. Target.”
    - Consequences of deemed sale included in U.S. Target’s former consolidated group.

Stock vs. Asset acquisitions – U.S. target

- Parent recognizes gain in U.S. Target stock at 21% tax rate.
  - Parent has cost basis in U.S. Target stock, but no basis step up for assets.
  - U.S. Target retains its historic tax attributes (NOLs, E&P, etc.), subject to limitations.
  - Acquire all assets and liabilities of U.S. Target.
  - Lower transaction costs; less complicated

Asset Acquisition

- Tax paid by U.S. Target on built-in gain in assets at 21% rate.
  - Results in basis step up for U.S. Target’s assets held by U.S. Acquirer.
  - U.S. Target attributes may offset gain, but other historic tax attributes are eliminated.
  - If section 338(h)(10) is available, can elect to treat stock acquisition as a deemed disposition of assets.
    - Achieves step-up in asset basis though deemed purchase by “New U.S. Target.”
    - Consequences of deemed sale included in U.S. Target’s former consolidated group.

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Stock vs. Asset acquisitions – considerations after tax reform

**Lower Corporate Tax Rate**
- Reduces amount of tax on gain in asset and stock sale scenarios.
- Reduces value of tax attributes going forward.

**Amended Section 168(k)**
- Allows immediate 100% deduction for the cost of qualified property (i.e., tangible depreciable property with a class life of 20 years or less) acquired and placed in service after September 27, 2017, and before January 1, 2023.
  - Increased deduction phases down in 20% increments from 2023 to 2026.
  - Immediate expensing applies not only to “original use property,” but also to used property if it is the taxpayer’s first use.
  - Excludes acquisitions from related parties.
  - Unavailable for (i) goodwill and other intangible property, which remains amortizable under the straight-line method (i.e., pro rata) over 15 years, and (ii) non-U.S. taxpayers.

**NOL Deduction Limitations**
- New rules under section 172 reduce value of NOLs.
- NOLs arising after 2017 can only offset 80% of taxable income.
- Indefinite carryforward, but cannot be carried back.
Stock vs. Asset acquisitions – considerations after tax reform

— Immediate expensing could cause buyers to want to structure taxable acquisitions as asset deals (or deemed asset deals under section 338(h)(10)) rather than stock deals where target has a substantial amount of tangible property.
  - Basis step-up allows for increased depreciation deductions under section 168(k).
  - Additional upfront expensing may create NOLs, which are subject to 80% taxable income limitation, although indefinite carryforward means such NOLs should remain available for use.
  - Consider whether to elect out of full expensing if it would result in creation of an NOL that would only be usable to the extent of 80% of taxable income.
  - Election to forego full expensing may be made on a class-by-class basis.
— Exclusion of amortizable acquired goodwill from immediate expensing impacts tax implications of purchase price allocations.
  - Buyers will want to maximize allocation of purchase price to assets eligible for bonus depreciation.
— May consider partial asset dispositions, subject to section 338 consistency rules.
— In the case of a stock sale, inheritance of historic target attributes must be considered under new rules.
  - Reduced value of inherited NOLs due to lower 21% corporate tax rate.
  - Pre-2018 NOL carryovers have increased value because not subject to 80% limitation.
Notice 2018-30 – section 168(k) and section 382

— Notice 2018-30, released on May 8, 2018, addresses certain consequences related to the interaction of section 168(k) and section 382. The notice is effective for ownership changes that occur after that date.

— As background, Notice 2003-65 provides two alternative approaches to the determination of recognized built-in gain (RBIG) and recognized built-in loss (RBIL) under section 382(h): (i) the “338 approach,” and (ii) the “1374 approach.”

- The 338 approach identifies RBIG and RBIL by comparing the loss corporation’s actual items of income, gain, deduction, and loss with those that would have resulted if a section 338 election had been made with respect to a hypothetical purchase of all of the outstanding stock of the loss corporation on the change date. The 338 approach treats as RBIG or RBIL the difference between the loss corporation’s actual allowable cost recovery deduction with respect to an asset and the hypothetical cost recovery deduction that would have been allowable with respect to the asset had a section 338 election been made for a purchase of the loss corporation’s stock.

- The 1374 approach identifies built-in items by incorporating the rules of section 1374, which generally relate to the imposition of entity-level tax on net realized built-in gains of S corporations.

— Notice 2018-30 provides that section 168(k) has unintended collateral consequences with the 338 approach (e.g., the additional first year depreciation would increase recognized built-in gain and reduce recognized built-in loss in the first year of the recognition period), and that the hypothetical cost recovery deduction using section 168(k) does not provide a reasonable estimate of the income or expense produced by a built-in gain or loss asset during the recognition period. The notice expresses similar concerns with the 1374 approach.

— Notice 2018-30 therefore modifies the 338 approach and the 1374 approach by providing that:

- The hypothetical cost recovery deductions used in the 338 approach to identify RBIG or RBIL are determined without regard to section 168(k); and

- In computing the amount of cost recovery deductions that are not attributable to an asset’s built-in loss on the change date under the 1374 approach, the hypothetical deductions that would have been allowable had the loss corporation purchased the asset for its fair market value on the change date are determined without regard to section 168(k).
Other considerations – section 163(j)

interest limitations

- Revised section 163(j) provides new rules limiting the deduction of business interest expense for taxable years beginning in 2018.
  - Generally limits deduction of net business interest to 30% of adjusted taxable income.
  - Any business interest not allowed as a deduction due to the limitation is carried forward and treated as business interest paid or accrued in the next taxable year. Such carryover is treated as an attribute in section 381(a) transactions.
  - There is no carryforward of any excess limitation.
- Impacts ability to utilize debt in structuring acquisitions and use/location of debt within affiliated groups.
- Notice 2018-28 indicates that forthcoming regulations will clarify that:
  - All interest paid or accrued by a C corporation on indebtedness of such corporation will be business interest, and all interest on indebtedness held by the corporation that is includible in its gross income will be business interest income.
  - The limitation on the amount allowed as a deduction for business interest applies at the consolidated group level. Thus, the limitation is applied based on consolidated taxable income and intercompany obligations are disregarded.
  - Disallowance and carryforward of a deduction for a C corporation’s business interest expense will not affect whether or when such business interest expense reduces E&P of the corporation.
Acquisition of foreign target corporation
Stock vs. Asset acquisitions – foreign target

Purchase of Foreign Target Stock with no Section 338(g) Election
— U.S. Acquirer has cost basis in Foreign Target stock, but no basis step-up for assets.
  - Foreign Target retains its historic tax attributes (NOLs, E&P, etc.), subject to limitations.
  - Acquire all assets and liabilities of Foreign Target.
Stock vs. Asset acquisitions – foreign target

Purchase of Foreign Target Stock with Section 338(g) Election

— U.S. Acquirer makes unilateral section 338(g) election to treat stock acquisition as an asset sale.
— Treats the transaction as a purchase of Foreign Target’s assets for U.S. tax purposes. As a result of the election:
  — In deemed transaction, “New Foreign Target” takes a fair market value tax basis in the assets (including the stock of Target subsidiaries);
  — Foreign Target’s historic tax attributes, including E&P, are eliminated; and
  — Additional section 338(g) elections may be made with respect to lower-tier 80%-owned subsidiaries.
— In acquisition of Foreign Target with no U.S. shareholder, a section 338(g) election is not expected to result in any additional U.S. tax cost.
- Results would differ if Foreign Target were owned by a U.S. corporation (e.g., potential GILTI or subpart F pickup).
Foreign target acquisitions – effects of section 338(g) election

— Traditionally, the benefits of a section 338(g) election (asset basis step-up, clearing out E&P) were clear, making it advantageous to make the election for a foreign target corporation in most cases.

— After tax reform, need to consider whether the election will actually result in a benefit.
  - The examples that follow demonstrate that, in certain cases, a step-up in asset basis may not provide a tax benefit while sacrificing any step-up in the U.S. acquirer’s stock basis in the foreign target corporation.
  - In more complicated cases, extensive modeling would be needed to assess the tax benefits and costs of a section 338(g) election.
  - Practical difficulties associated with the acquisition of a foreign corporation in which a section 338(g) is not made may still outweigh the additional tax cost (e.g., determining historic U.S. tax basis and E&P for the foreign target).
Stock vs. Asset acquisitions – foreign target

Purchase of Foreign Target Stock with no Section 338(g) Election

- U.S. Acquirer purchases the stock of Foreign Target for $100. Foreign Target has a $0 basis in its assets.
- In Year 1, Foreign Target generates $20 of GILTI.
  - Foreign Target pays $5 of foreign tax, which generates a $4 FTC (applying 80% limitation).
  - U.S. Acquirer pays zero U.S. tax ($2.63 U.S. tax on GILTI and section 78 gross-up, offset by $4 FTC).
  - GILTI FTC is segregated into own FTC basket with no carryover permitted for excess credits.
- Under section 961(a) (by way of section 951A(f)), U.S. Acquirer’s stock basis in Foreign Target should be increased by $20, the amount of its GILTI inclusion.
Stock vs. Asset acquisitions – foreign target

Purchase of Foreign Target Stock with Section 338(g) Election

— U.S. Acquirer purchases the stock of Foreign Target for $100 and makes a section 338(g) election, increasing the basis in Foreign Target’s assets to $100.

— In Year 1, Foreign Target has $20 of Tested Income, which is offset by $20 of depreciation deductions claimed with respect to Foreign Target’s assets.
  - U.S. Acquirer has a GILTI inclusion of zero.

— No adjustment is made to U.S. Acquirer’s stock basis in Foreign Target under section 961(a).

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<td>Foreign Target</td>
<td>Asset Basis</td>
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Spin-offs
Effect of tax reform on spin-offs

— Reduced corporate tax rate of 21% makes recognition of gain on distributions of stock potentially less onerous.
  - Despite burden of qualification under section 355 and related restrictions, would still expect that the benefit of avoiding gain recognition would prevail in most cases.

— In foreign context, changes to the U.S. international tax system mean that rules under section 367 affecting section 355 distributions may be less important.
  - Under old law, taxpayers sought to allocate E&P in a spin-off to minimize the likelihood of a deemed dividend under section 367(b).
  - Now, because of section 245A, a deemed dividend under section 367(b) may be tax exempt.

— Spin-offs often involve adding leverage to Controlled, which now must consider the impact of section 163(j).
Use of debt in spin-offs – debt assumption

— In a section 368(a)(1)(D)/355 reorganization, Distributing may shift debt to Controlled as part of the transaction.

— Controlled’s assumption of Distributing debt should not result in the recognition of gain, provided:
  - The amount of the liabilities assumed does not exceed the basis of the assets contributed to Controlled; and
  - The liabilities assumed were incurred in the ordinary course of business and are associated with the assets transferred (i.e., section 357(b) does not apply).
Use of debt in spin-offs – controlled borrowing

- Distributing can extract cash from Controlled if such cash is paid out to its shareholders or creditors.
  - If Distributing receives cash from Controlled, it may distribute the cash to its shareholders and/or creditors as part of the transaction without incurring tax. Section 361(b)(1)(A).
  - However, if the cash is transferred to Distributing’s creditors, nonrecognition is only available up to the amount of the adjusted basis of the assets transferred to Controlled. Section 361(b)(3).
  - Distributing can also transfer Controlled stock to its creditors without gain recognition. Section 361(c)(3).
Use of debt in spin-offs – debt swap

Distributing may use Controlled securities to repay its creditors or to swap its debt for such securities.

- Distributing is permitted to transfer Controlled securities to its creditors without gain recognition, which is not limited by the amount of the adjusted basis of the assets transferred to Controlled. Section 361(c)(3).

Issues could arise if Distributing debt is considered issued in anticipation of the distribution.

- Former IRS no-rule area (removed in 2017).
- Forthcoming guidance expected to address Distributing’s use of Controlled’s stock, securities, or other obligations to retire putative debt of Distributing.
Leveraged spin-offs and tax reform

— The ability to add leverage to Controlled must take into account the basis limitation rule and the practical issues and costs associated with a debt exchange.

— Adding leverage to Controlled must now also consider the new interest deduction limitation in section 163(j).
  - Controlled’s capacity to take on debt may be reduced if its ability to deduct interest is subject to the limitation in section 163(j).
  - From Distributing’s perspective, the departure of Controlled could also impact how it is affected by the section 163(j) limitation (due to any resulting decrease in adjusted taxable income).
  - Although disallowed interest deduction carryforwards are a section 381 attribute, section 381 is inapplicable in a divisive D reorganization. If Controlled is a preexisting corporation and part of Distributing’s consolidated group, any carryforwards attributable to Controlled should be allocated to Controlled on its departure from the group.

— Consider alternative means of moving leverage onto Controlled.
  - For example, Distributing could retain and sell tangible assets to Controlled, which could obtain benefit of 100% depreciation deduction on such assets.
Thank you
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