ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for M&A

December 27, 2017

On December 22, 2017, the President signed into law the 2017 U.S. tax reform bill formerly known as the Tax Cuts & Jobs Act (the "TCJA"). Most of the TCJA's provisions take effect January 1, 2018.

The TCJA introduces significant changes to the U.S. tax system. This memorandum sets forth a few key observations about the TCJA that may be relevant to M&A transactions.

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1. **Significant Reduction in Headline Tax Rates**.

— For corporations:

- The TCJA lowers the U.S. corporate tax rate to 21%, with corresponding changes to the deduction for dividends received from U.S. corporations. The rate reduction is effective starting in 2018.
- The corporate alternative minimum tax is repealed.

— For businesses conducted in flow-through forms (including through partnerships and S corporations), the TCJA provides for a deduction for purposes of income tax equal to 20% of qualified business income that is earned by a non-corporate taxpayer through the flow-through entity, resulting in a federal tax rate of 29.6% for a top bracket individual. Unlike the change in corporate tax rate, the deduction is not permanent and expires after 2025.

— The deduction is capped however at the greater of (a) 50% of the W-2 compensation treated as paid by the taxpayer or (b) the taxpayer's allocable share of 25% of such W-2 compensation plus 2.5% of the unadjusted acquisition cost of the pass-through entity's tangible assets.

— The deduction is not available for investment businesses, asset management businesses and many professional services businesses.

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— However:

- There are significant limitations on interest deductions (discussed immediately below).
- Many other tax preferences are eliminated.
- The reduction in tax rates will mechanically reduce the value of any tax assets owned by portfolio companies (e.g., value of TRAs in Up-Cs and DTAs for transaction expenses or NOLs).

— Partnership vs. Corporate Form: These changes in tax rates may affect the use of corporations and partnerships. Business income earned by individuals in the top brackets through a partnership is still subject to a lower effective federal income tax rate (29.6%) than income earned through a corporation (36.8%) *but* (i) the difference between the two rates is significantly smaller than under current law (39.6% for flow-through income vs. 52% for income earned through a corporation), and (ii) the corporate tax form allows for deferral (*i.e.*, taxation of earnings at 21% until dividends are paid or anti-abuse rules apply).

2. **Limit on Net Interest Expense Deductions May Affect LBOs and Acquisition Structures**. The TCJA limits the deduction for net business interest expense.

— The rule applies to any debt outstanding on Jan. 1, 2018 (*i.e.*, both new acquisition debt and debt that a target has incurred prior to the acquisition). There is no grandfathering.

— This rule, combined with the lower corporate tax rate, will significantly affect existing companies acquired using acquisition debt as well as the planning and structuring for LBOs. It will diminish the incentive to allocate the maximum amount of debt to the U.S. in a cross-border acquisition. The rule may increase the after-tax cost of financings for LBOs, and may make preferred equity financings, leasing or other interest equivalents more attractive than debt financings in some cases.

— The rule limits the deduction for net business interest expense to 30% of adjusted taxable income. "Adjusted taxable income" is similar to EBITDA for taxable years 2018 through 2021, and EBIT for 2022 and later years. Disallowed interest expense can be carried forward indefinitely.

- This limitation may raise the cost of financings for a company that incurs debt to make an acquisition.
- It is consistent with similar changes in law that have been enacted recently by some of our trading partners (e.g., Germany, UK) as a result of the OECD Base Erosion and Profit Shifting (BEPS) project.
- Particularly in 2022 and later years, for companies with significant expenditures eligible for expensing, there may be little or no capacity for interest deductions, due to the change from EBITDA to EBIT. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect, and therefore U.S. borrowers should take into account the switch to EBIT in considering their current debt profile.
  - Additionally, this change may encourage acquisitions of tangible assets eligible for 100% expensing (described below) in taxable years before 2022, to accelerate depreciation deductions into earlier years and increase capacity for interest expense deductions in 2022 and later years.
- The rule is expected to apply on a U.S. consolidated group-wide basis for domestic corporations. Partnerships are evaluated on a separate entity basis, with rules to avoid double counting and to allow "excess" adjusted taxable income to tier up. The location of debt financing among partnerships or non-consolidated companies may affect deductibility.

3. **Expensing Of Asset Acquisitions May Encourage non-Tech M&A in the Next 5 Years**. The TCJA allows a taxpayer to immediately expense the entirety of the cost of "qualified property" in the year of purchase.

— The immediate expensing is available for qualified property acquired after September 27, 2017, and placed in service before January 1, 2023.

- Immediate expensing is also allowed for property placed in service in 2023 and afterwards, with the percentage of cost that is immediately deductible stepping down annually until it is phased out completely for property placed in service after 2026 (or 2027, in the case of certain property with longer production periods).
- The short life of the rule may create an incentive to acquire assets eligible for immediate expensing within the next 5 to 9 years.

— Immediate expensing will apply to purchases of used as well as new items, and thus may create incentives to structure stock purchases with a section 338 or 336 election, or to structure transactions as asset sales or deemed assets sale, during the 5 to 9 year period. However, in determining the benefit of selling assets vs. selling stock, the relative value of immediate expensing for the purchaser will still need to be balanced against additional corporate-level gains for sellers.

— Property acquired from a "related" person is not eligible for immediate expensing; as a result in some circumstances the application of attribution rules will take on increased significance and, depending on the specific facts, transactions that involve a partial rollover of the existing shareholders may not allow taxpayers to avail themselves of this benefit.

— "Qualified property" is, generally, depreciable tangible property (including used property), and does not include shares in corporations, real estate, or intangibles such as goodwill and intellectual property. It also does not apply to property that is leased rather than purchased.

4. **Limits on Deductibility of Net Operating Losses (NOLs) May Significantly Reduce the Value of NOLs**.

— Under the TCJA, carrybacks of NOLs are no longer allowed, while carryforwards become indefinite. The carryback and carryforward rules apply only to NOLs that arise in taxable years *ending after* December 31, 2017 – *i.e.*, they capture some 2017 NOLs for non-calendar year taxpayers.

- This will be relevant in modelling returns, and should be taken into account in considering the impact of "transaction tax benefits" (*e.g.*, bonuses and refinancing costs).

— A company may use NOLs to offset a maximum of 80% of the company's taxable income for taxable years beginning after December 31, 2017 (with unused NOLs carried forward into future years).

- To the extent you have existing NOLs, this rule – together with the reduced 21% corporate tax rate – could significantly reduce the benefit of those NOLs, and therefore reduce the value of your deferred tax assets.

5. **Shift to a Territorial Tax System May Increase M&A Activities and May Impact the Structure of U.S. Groups**. The TCJA adopts a territorial system of international taxation, effective January 1, 2018. It will likely result in the repatriation of significant amounts of offshore cash to U.S. corporates.

— A one-time transition tax will be imposed on the earnings of foreign subsidiaries. The earnings will be taxed at rates of 8% and 15.5% for corporate shareholders (for earnings invested in tangible assets vs. cash), and 9.05% and 17.54% for investors taxed as individuals and subject to the highest marginal rate. *These rules will*

effectively "unlock" the trapped cash held offshore by U.S. multinationals. Taxpayers can generally elect to pay the tax over 8 years, although there are triggers to accelerate the payment (*e.g.*, sale of all or substantially all of the assets of a taxpayer). There are rules permitting earnings deficits to offset undistributed earnings amounts.

— Under the new system, going forward, the dividends received by a U.S. corporation from its 10%-or-greater-owned foreign subsidiaries (by vote or value) are generally exempt from tax if attributable to non-U.S. source earnings of the subsidiaries.

- Dividends exempted from tax reduce the U.S. corporation's basis in the foreign subsidiary, reducing the U.S. corporation's ability to claim losses on a sale of the subsidiary.
- The participation exemption does not apply to foreign corporations that are passive foreign investment companies.
- The exemption also does not apply to so-called "hybrid dividends" (dividends that are deductible by the foreign subsidiary).
- The exemption is available only to U.S. corporate shareholders who have held foreign subsidiary stock for at least 1 year (subject to potential tolling rules).

— This is not a full participation exemption. Dividends received by non-corporate taxpayers as well as dividends from subsidiaries in which the U.S. taxpayer does not own 10% of the equity (by vote or by value) will be fully taxable (with potential for foreign tax credit relief). The exemption does not apply to gains from the sale of shares (although gains recharacterized as dividends under section 1248 would be exempt). There may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.

— A domestic S corporation which owns 10% or more of the stock of the foreign corporation appears to be eligible for the participation exemption, in which case large individual shareholders (or groups of individual shareholders) may benefit from transferring the stock in a foreign corporation they own into an S corporation. There are additional consequences to owning an interest in an S corporation that individual shareholders should consider before undertaking such a transfer.

— Despite the exemption for actual dividends from foreign subsidiaries, the TCJA retains the existing rule (section 956) that requires a U.S. shareholder of a CFC to currently include in income the earnings of the CFC reinvested in United States property. Loans from CFCs to U.S. corporate shareholders, pledges of CFC stock to support borrowings of U.S. corporate shareholders, and other investments by CFCs in U.S. property (including owning stock of U.S. affiliates and other U.S. tangible and intangible property) will continue to give rise to deemed dividend inclusions that are fully taxable and to place significant limitations on the structuring of debt incurred by U.S. entities with significant foreign assets.

— The new system creates a strong incentive to move operations offshore—in order to mitigate this, the TCJA tightens the CFC rules and introduces a series of new taxes or rules that affect the deductibility of payments to foreign affiliates. We discuss these and their potential impact for M&A transactions in paragraphs 6-9, below.

6. **The End of Inversions?** The changes to the taxation of non-U.S. earnings will significantly limit the benefit of "inverting" U.S. corporations into foreign corporations. In addition, the TCJA introduces a series of adverse tax rules for corporations that invert after the TCJA is enacted (*e.g.*, the reduced qualified dividend rate is no longer available for dividends from foreign companies that undertake a 60% inversion after the

enactment of the TCJA and there is an increase in the one-time transition tax for any U.S. corporation that inverts within 10 years of the enactment of the law).

7. **Base Erosion Rules for Payments to Foreign Affiliates May Affect Both The Operational Structure of Multinational Groups and The Use of Shareholder Debt to Finance U.S. Acquisitions by Non-U.S. Entities**.

— The TCJA imposes a minimum tax (called the "BEAT") on a U.S. corporation's taxable income after adding back certain "base erosion payments."

— Base erosion payments are deductible payments from domestic corporations and branches to foreign affiliates, excluding cost of goods sold (except for corporations that expatriate from the U.S. after November 9, 2017), certain payments for services, and certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers). Deductible payments are also excluded to the extent they are subject to U.S. withholding tax.

- There are no exclusions for interest (*e.g.*, shareholder debt) or other payments in connection with financial transactions other than derivatives. Moreover, there is an unfavorable rule that treats any interest expense that is non-deductible under the limit described in "Limits on Net Interest Expense Deductions" above as paid to unrelated parties for purposes of the minimum tax, which maximizes the deductible interest that is treated as paid to related parties and therefore subject to the minimum tax.

— The tax due equals the excess of (a) the minimum tax rate applied to the corporation's taxable income after adding back base erosion payments over (b) the corporation's tax liability at the regular corporate rate.

- The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years.
- Increased rates apply to U.S. banks and registered securities dealers: 6% in 2018, 11% in 2019 through 2025 and 13.5% in 2026 and later years. However, the base erosion tax does not apply to most payments in connection with derivatives which are marked to market.
- In calculating tax liability at the regular corporate rate, certain credits are not taken into account, with the effect that the credits can mitigate the amount of minimum tax paid. In 2018 through 2025, 80% of low-income housing and energy credits are excluded, and in 2026 and later years, all credits are excluded.

— The minimum tax applies to corporations with at least $500 million in annual gross receipts and for which base erosion payments represent at least 3% of total deductions (2% for U.S. banks and securities dealers). Foreign corporations are subject to the rule if their ECI meets the gross receipts and 3%/2% tests.

— In addition, the TCJA also disallows deductions for interest and royalty payments to foreign affiliates that are hybrid payments or made to hybrid entities.

8. **Base Erosion Rules for Low-taxed Intangibles Income May Affect Groups Holding Intangible Assets Offshore**.

— Under the TCJA, a U.S. shareholder's income includes a new category of "global intangible low-taxed income" taxed to individual shareholders at 100% of the applicable rate; and taxed to corporate shareholders at 50% of the usual rate (*i.e.*, a 10.5% rate) through 2025, and at 62.5% of the usual rate (*i.e.*, a 13.125% rate) in 2026 and later years.

— This rule most likely will capture CFCs that (i) earn high returns on assets consisting of intangibles, (ii) have assets that are not depreciable or have already been significantly depreciated, or (iii) have a business (*e.g.* sales or services) that does not require tangible assets.

— *Foreign Tax Credits*. 80% of foreign taxes attributable to this low-taxed intangibles income is creditable by corporate shareholders (subject to some limitations), but not by individuals. As a result, a CFC would need to pay tax at an effective rate of 13.125% (through 2025) or 16.41% (in 2026 and later years) in order to avoid triggering tax for its corporate U.S. shareholders under this rule.

— *Incentives for U.S. Production*. The TCJA also includes a special 13.125% tax rate (increased to 16.41% in 2026 and later years) for a domestic corporation's "foreign-derived intangible income," which is income related to services provided and goods sold by the domestic corporation for a foreign use, and is calculated in a similar manner as "global intangible low-taxed income." This rule may encourage bringing some offshore intangible assets back to the United States.

9. **Changes to the CFC Attribution Rules Would Significantly Expand CFC Taxation**.

— Under current law, a CFC is a foreign corporation that is directly or indirectly controlled by 10% U.S. shareholders who collectively own more than 50% of the foreign corporation's equity. Attribution rules apply in determining who is a 10% shareholder for purposes of determining whether a foreign corporation is a CFC. However, "downwards attribution" from foreign persons to U.S. persons does not apply.

— The TCJA expands the attribution rules applicable for CFC purposes, allowing downwards attribution from foreign persons to U.S. persons. This could cause foreign corporations to be treated as CFCs in situations where significantly less than 50% of the foreign corporation's equity is directly or indirectly owned by U.S. shareholders, particularly where such foreign corporation is affiliated with (but not a subsidiary of) another U.S. corporation. As a result, U.S. shareholders that directly or indirectly own or invest in at least 10% of the equity of a foreign corporation that is not treated as a CFC under current law could become liable for tax on subpart F income and subject to the rules for low-taxed foreign intangibles income described above.

- An explanation by the House-Senate Conference Committee indicates that the new downward attribution rule is not intended to result in new income allocations to 10% U.S. shareholders who are not otherwise related (at a 50% level) with U.S. entities that are attributed ownership of the foreign corporation. However, the text of the TCJA does not include language to reflect that intent.

— The TCJA also expands the definition of a 10% U.S. shareholder to any U.S. person that owns 10% by value (as well as the current rule which looks to 10% of voting power).

10. **Changes to the Deferred Compensation Rules May Affect Performance-Based Compensation Structures**. The TCJA generally leaves intact the current regime for deferred compensation (though previous drafts of the TCJA included very significant changes). However:

— The TCJA includes a new deferral provision for certain types of broad-based employee equity, which may apply to certain private companies.

— The TCJA expands the group of covered employees that are subject to the $1 million cap on deductible compensation to include the CFO as well as the CEO, and repeal the exception from this rule for performance-based compensation. The TCJA grandfathers compensation vested prior to 2017 under existing contracts.

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