CLEARY GOTTLIEB

ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for M&A

December 7, 2017

On December 2, 2017, the U.S. Senate passed the Tax Cuts & Jobs Act. Two weeks earlier, on November 16, the U.S. House of Representatives passed its version of the bill. The Senate and House bills, while broadly similar, also have many important differences.

The Senate and the House will need to agree on one consistent bill before it can become law. The Senate and the House will engage in significant negotiations over the coming days/weeks, which would require additional modifications to the bill before it is enacted. Recent press reports have suggested that the House may seek to adopt a revised bill substantially similar to the bill passed by the Senate, but the situation remains fluid and unpredictable, and additional changes are anticipated for the Senate bill as well.

This memorandum sets forth a few key observations about the proposed bills that may be relevant to M&A transactions.

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

— For corporations:

- The bills would lower the U.S. corporate tax rate to 20%, with corresponding changes to the deduction for dividends received from U.S. corporations. Under the House bill the rate reduction would be effective starting in 2018. The Senate bill would delay this for one year and have the rate reduction effective starting in 2019.
- The corporate alternative minimum tax would be eliminated in the House bill (but not in the Senate bill).

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- The retention of the corporate AMT in the Senate bill, at the current rate of 20%, can be expected to undermine many other provisions of the legislation that were favorable to corporations, as well as some existing benefits (like expensing for research and development, for example). This may have been an accident rather than a considered policy choice, and further modifications are expected to the Senate bill to address these issues.

— For partnerships, the House bill would generally reduce the tax rate applicable to individual investors to 25%, and the Senate bill would provide for a 23% deduction against business income that is earned by a non-corporate taxpayer through a partnership (with a cap equal to 50% of the W-2 compensation treated as paid by the taxpayer). The Senate's 23% deduction would expire after 2025.

— However:

- There are significant limitations on interest deductions (discussed immediately below).
- Many other tax preferences would be 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).

2. **Limits on Net Interest Expense Deductions May Affect LBOs and Acquisition Structures**. Both bills propose two separate limits on net interest expense deductions. In each bill, the "worst of" the two rules will apply.

— The proposals would apply 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.

— These rules, combined with the lower corporate tax rate, would significantly affect planning and structuring for LBOs. They would diminish the incentive to allocate the maximum amount of debt to the U.S. in a cross-border acquisition. The rules 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.

— *First Rule. 30% Earnings Limit.* The first rule limits the deduction for net business interest expense to 30% of adjusted taxable income (similar to EBITDA in the House bill and EBIT in the Senate bill). Disallowed interest expense can be carried forward, for 5 years in the House bill and indefinitely in the Senate bill.

- 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 under the Senate proposal, for companies with significant expenditures eligible for expensing, there may be little or no capacity for interest deductions.
- 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.

— *Second Rule. Limit Based on Groupwide Leverage*. The other new rule is intended to limit the net interest expense deductions of companies that are overleveraged in the United States compared to the company's global operations. The net interest expense of U.S. borrowers would be capped at 110% of the U.S. share of the group's overall EBITDA in the House bill. In the Senate bill, the cap would equal a percentage of the

group's global leverage ratio, initially 130% in 2018 but phased down to 110% for taxable years beginning in 2022 and afterwards.

- This rule is a blunt instrument. It may deny U.S. interest expense deductions if U.S. operations have higher leverage as a result of different capital needs for different types of business inside and outside the United States. The rule could also affect groups with low overall leverage, if that leverage is unevenly distributed between the group's U.S. and global operations – there is no de minimis exception. The House version of the provision may deny U.S. interest expense deductions even if the U.S. and global operations have similar leverage, because of differences in U.S. and non-U.S. interest rates.
- Structuring: This rule may limit the ability of U.S.-headed group to borrow at the parent company level to finance foreign acquisitions (unless the borrowing is then on-loaned to the foreign target).
- Domino Effect: Because this rule applies on a group-wide basis, an acquisition or disposition of a company or line of business may affect the overall ratios of the global group, with effects on unrelated existing debt of the parent or on existing debt of the target.

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

— In both bills, the immediate expensing would be available for qualified property acquired after September 27, 2017, and would expire on January 1, 2023. The Senate bill would also allow immediate expensing 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 would create an incentive to acquire assets eligible for immediate expensing within the next 5 to 9 years.

— The Senate bill would retain the current law requirement that the original use of qualified property must commence with the taxpayer. Under the House bill, however, immediate expensing would 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 that 5 year period. Property acquired from a "related" person would not be eligible for immediate expensing under the House bill; as a result in some circumstances the application of attribution rules would take on increased significance.

— "Qualified property" is, generally, depreciable tangible property (including, in the House bill but not the Senate bill, 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. The House bill also excludes any property used in a real property trade or business.

— In determining the benefit of selling assets vs. selling stock, the relative value of immediate expensing for the purchaser may need to be balanced against additional corporate-level gains.

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

— A one-time transition tax would be imposed on the earnings of foreign subsidiaries. The House bill provides for these earnings to be taxed at rates of 7% and 14% (for earnings invested in tangible assets vs. cash). The Senate bill operates by providing deductions of 78.6% and 58.6% against the taxpayer's deemed repatriation income for assets in those categories, which correspond to effective tax rates of 7.5% and 14.5% for corporate investors, and 8.5% and 16.4% for individual investors taxed at the highest marginal rate. These rules would effectively "unlock" the trapped cash held offshore by U.S. multinationals. Taxpayers can generally elect to pay the tax over 8 years.

— Under the new system, the dividends received by a U.S. corporation from its 10%-or-greater-owned foreign subsidiaries would generally be exempt from tax (if attributable to foreign source income).

- Dividends exempted from tax would 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 bill would repeal current law section 956 with respect to U.S. corporate shareholders (*i.e.*, the rule which requires a U.S. shareholder of a controlled foreign corporation (CFC) to currently include in income the earnings of the CFC reinvested in United States property).

- Loans from CFCs to U.S. corporate shareholders, and pledges of CFC stock to support borrowings of U.S. corporate shareholders, therefore would no longer give rise to deemed dividend inclusions.
- This would greatly simplify the acquisition of multinational groups and their financing. It is possible that even prior to the bill becoming law, credit agreement negotiations may start to take into account potential changes of law (*e.g.*, springing credit support).

— There are a few notes of caution however:

- 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 voting power 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 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.

5. **Limits on Deductibility of Net Operating Losses (NOLs) May Significantly Reduce the Value of NOLs**. Limits would be placed on the ability to deduct NOLs.

— Carrybacks of NOLs would be repealed, while carryforwards would become indefinite (with an inflation adjustment, in the House bill). The carryback and carryforward rules would apply only to NOLs that arise in taxable years beginning *after* December 31, 2017 in the House proposal. In the Senate bill, the carryback and carryforward rules would apply to NOLs arising in taxable years *ending after* December 31, 2017 – *i.e.*, they would capture some existing NOLs.

- This may 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 would be able to deduct NOLs only to the extent of 90% of the company's taxable income under the House proposal. Under the Senate proposal, the deduction for NOLs would be capped at 90% of taxable income for taxable years 2018 through 2022, and at 80% of income for 2023 and later years. Since a 90% cap applies in the AMT context under current law this means that, in many cases, the effective tax rate for the use of NOL carryovers is not changing materially under the House proposal or the first few years of the Senate

proposal. The 90%/80% restriction would apply to taxable years beginning after December 31, 2017. Under the House bill (but not the Senate bill), the 90% restriction would *not grandfather preexisting NOLs*.

6. **Base Erosion Rules for Payments to Foreign Affiliates May Affect The Operational Structure of Multinational Groups**. Both the House and Senate bills impose tax on outbound payments to foreign affiliates.

— The House bill includes a 20% excise tax on outbound payments from domestic corporations (and branches) to foreign affiliates (excluding certain securities, commodities and service transactions, as well as interest and certain other payments). The tax would apply starting in 2019. Taxpayers can elect to avoid the excise tax by instead treating these outbound payments as "effectively connected income" to the foreign recipient, which would be currently taxable in the United States with an 80% foreign tax credit offset allowed. The excise tax seems designed as a club to force taxpayers to make the effectively connected income election.

- The election would allow the foreign recipient to be taxed at a rate of 20% of the net profits (based on the profitability for the group of the specific product line) and, potentially, a branch profits tax of 30% (as reduced by applicable tax treaties).
- The rule only applies to groups with aggregate outbound payments subject to the rule exceeding $100 million.
- This controversial proposal, which is intended to address transfer pricing concerns, would subject to U.S. taxation income that is generally viewed as attributable – economically and under international tax principles – to foreign tax jurisdictions. The rule was somewhat of a surprise (although it is in some way a variation on the "Border Adjustment Tax" that was included in the Republicans' 2016 blueprint for tax reform).
- This excise tax could dramatically affect the taxes imposed on a multinational group, and would need to be taken into account in evaluating integration plans and tax synergies.

— The Senate bill provides for a minimum tax of 10% on the amount by which deductible payments to foreign affiliates exceed taxable income (determined taking into account research and development credits but no other credits) in 2018 through 2025. In 2026 and later years, the rate increases to 12.5% and taxable income is determined taking into account all credits.

- The rule would apply to corporations with at least $500 million in annual gross receipts and for which deductible payments to foreign affiliates represent at least 4% of total deductions. Foreign corporations would be subject to the rule if their ECI meets the gross receipts test.
- Increased rates would apply to U.S. banks and registered securities dealers: 11% through 2025 and 13.5% in 2026 and later years. However, the base erosion tax would not apply to most payments in connection with derivatives which are marked to market.
- The Senate rule does not exclude payments of interest or other payments in connection with financial transactions other than derivatives. Instead, the Senate bill includes an unfavorable rule that treats any interest expense that is non-deductible under the limits described above as paid to unrelated parties for purposes of this base erosion tax, which maximizes the deductible interest that is treated as paid to related parties and therefore subject to the base erosion tax.
- The Senate Finance Committee has indicated that the Senate bill would, however, exclude cost of goods sold from the scope of deductible payments subject to the rule.

— The Senate bill would also disallow deductions for interest and royalty payments to foreign affiliates that are hybrid payments or made to hybrid entities.

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

— Under the House bill, U.S. shareholders of CFCs would be subject to tax on a current basis on 50% of a CFC's returns in excess of a certain threshold which is keyed off the CFC's depreciable assets (resulting in a 10% rate for corporate shareholders).

— Under the Senate bill, a U.S. shareholder's income would include 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% rate) through 2025, and at 62.5% of the usual rate (*i.e.*, a 12.5% rate) in 2026 and later years.

— These rules most likely are intended to capture CFCs that earn high returns on assets consisting of intangibles or that have assets that are not depreciable or that have already been significantly depreciated.

— Under each rule, an 80% foreign tax credit would be available to corporate shareholders (subject to some limitations). As a result, a CFC would need to pay tax at an effective rate of 12.5% (under the House bill and under the Senate bill through 2025) or 15.6% (under the Senate bill in 2026 and later years) in order to avoid triggering tax under this rule.

— The Senate bill also includes a special 12.5% tax rate (increased to 15.625% 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." The bill also includes a special rule under which a distribution in taxable years before 2021 of intangible assets from a CFC to a U.S. shareholder would be included in the shareholder's income only to the extent of the asset's adjusted basis (effectively allowing low-cost repatriation of intangible assets). These rules, when taken together, may encourage bringing some offshore intangible assets back to the United States.

8. **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.

— Both bills would expand 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 Joint Committee on Taxation of a prior version of the Senate bill indicated that the new downward attribution rule was 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 bill passed by the Senate has not been modified to reflect that intent.

— The Senate bill 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).

9. **Changes to the Deferred Compensation Rules May Affect Performance-Based Compensation Structures**. Both bills would generally leave intact the current regime for deferred compensation (though previous drafts of the bills have included very significant changes). However:

— Both bills include a new deferral provision for certain types of broad-based employee equity, which may apply to certain private companies.

— Both bills expand 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 Senate bill would grandfather compensation vested prior to 2017 under existing contracts.

10. **Dividends from Expatriated Entities to U.S. Shareholders (Senate bill only)**. Under the Senate bill, dividends from any non-U.S. companies that has completed an inversion transaction would no longer be eligible for the preferential U.S. tax rate applicable to qualified dividends from non-U.S. corporations

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