ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for M&A

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On November 2, 2017, the much anticipated Tax Cuts & Jobs Act was introduced in the U.S. Congress. The bill has been amended twice, on November 3 and November 6.

This memorandum sets forth a few key observations about the proposed bill, as amended, that may be relevant to M&A transactions. It must be emphasized, however, that the bill is likely to go through many additional changes before it becomes law, if ever.

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

— For corporations, the bill would lower the U.S. corporate tax rate to 20% and the corporate alternative minimum tax would be eliminated.

— For partnerships, the tax rate applicable to individual investors generally would be reduced to 25%.

— 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**. The bill proposes two separate limits on net interest expense deductions. 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 more attractive than debt financings in some cases.

— First Rule. 30% EBITDA limit. The first rule limits the deduction for net business interest expense to 30% of adjusted taxable income (similar to EBITDA). Disallowed interest expense can be carried forward for 5 years.

- 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.

— 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. It operates by comparing U.S. vs global EBITDA. The net interest expense of U.S. borrowers would be capped at 110% of the U.S. share of the group’s overall EBITDA.

- This rule is a blunt instrument. It may deny U.S. interest expense deductions even if the US and global operations have similar leverage, because of differences in U.S. and non-U.S. interest rates. The rule also may deny 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 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.
- 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**. The bill would allow a taxpayer to immediately expense the entirety of the cost of “qualified property” in the year of purchase.

— The short life of the rule—it would apply to qualified property acquired after September 27, 2017, and would expire on January 1, 2023—would create an incentive to acquire assets eligible for immediate expensing within the next 5 years (including 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.

— Similarly, a seller of property may achieve a better sales price if it can sell assets eligible for immediate expensing within the next five years.

— 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.

— "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. 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 attributable to intangibles or other non-qualified property.

4. **Shift to a Territorial Tax System May Increase M&A Activities and May Impact the Structure of U.S. Groups**. The bill 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 (at a rate of 12% on liquid assets, and 5% on illiquid assets), effectively "unlocking" 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).

— 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).

- 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). In addition, gain from the sale of shares of foreign companies is not exempt from tax. There may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.
- 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. This rule is most likely 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.

5. **Limits on deductibility of net operating losses (NOLs)**. Limits would be put on the ability to deduct NOLs.

— Carrybacks of NOLs would be repealed (while carryforwards would become indefinite, with an inflation adjustment). The carryback and carryforward rules would only apply to NOLs that arise in taxable years beginning *after* December 31, 2017.

- 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 only be able to deduct NOLs to the extent of 90% of the company's taxable income under the proposal, consistent with the rules under the existing AMT. Since this rule applied 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. The 90% restriction would apply to taxable years beginning after December 31, 2017, *with no grandfathering for preexisting NOLs*.

6. **Excise Tax on Payments to Foreign Affiliates May Affect The Operational Structure of Multinational Groups**. The bill includes a new (and already very controversial) 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 a limited 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.

7. **Changes to the Deferred Compensation Rules Will Affect Performance-Based Compensation Structures**. The bill would significantly limit the flexibility of non-qualified deferred compensation (*e.g.*, such as equity options) as a tax-efficient form of compensation for management. This may significantly impact the incentive structure granted to management teams in connection with acquisitions.

— Performance vesting does not allow for deferral. Non-qualified deferred compensation would be included in income immediately upon vesting, with only service-based conditions (which would not include a non-compete) respected as vesting conditions that prevent immediate income inclusion. Performance-based conditions (*e.g.*, return thresholds or the occurrence of an IPO or qualifying exit) would not be treated as vesting conditions for this purpose.

— The rule would not apply to compensation in the form of property that is subject to section 83 (*e.g.*, restricted stock), but would otherwise cover deferred equity compensation (*e.g.*, options, SARs, RSUs or other deferred payments). The rule would not change the treatment of the grant of profits interests.

— The proposal would require all preexisting deferred compensation to be included in income by 2026 or the year it vests, whichever is later.

— The good news is that the bill would eliminate current law sections 409A and 457A, with related benefits of simplicity.

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