ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for M&A

November 14, 2017

On November 2, 2017, the much anticipated Tax Cuts & Jobs Act was introduced in the U.S. House of Representatives. The bill was amended several times before being approved by the House Ways & Means Committee on November 9.

On November 9, the U.S. Senate introduced its own version of the bill which, while having many similarities, is also significantly different (although the Senate's version is reflected only in a description, not legislative text).

This memorandum sets forth a few key observations about the proposed bills that may be relevant to M&A transactions. It must be emphasized, however, that the House and Senate bills are likely to go through many additional changes before a single agreed-upon bill becomes law, if ever.

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.

— 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 17.4% deduction against business income that is received through a partnership (with a cap equal to 50% of the W-2 compensation treated as paid by the taxpayer).

— However:

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- 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 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.
- 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) or the group's global leverage ratio (in the Senate bill).

- 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**. 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.

— 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 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**. 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 (in the House bill, at a rate of 14% on liquid assets, and 7% on illiquid assets; in the Senate bill at rates of 10% and 5%), 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 generally not exempt from tax (though the Senate bill would provide a potential exemption for a portion of such gains from the sale of a CFC. 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.

- 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 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. 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 without taking into account credits (including foreign tax credits) other than the research and development credit, and certain other adjustments).

- The rule would apply to corporations (including S corporations) and REITs 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 and foreign REITs would be subject to the rule if their ECI meets the gross receipts test.

- The Senate rule does not explicitly exclude payments of interest or other payments in connection with financial transactions. It 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).

— Under the Senate bill, subpart F income would include a new category of "global intangible low-taxed income" taxed at 62.5% of the usual rate (*i.e.*, a 12.5% rate).

— 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 (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) or 15.6% (under the Senate bill) in order to avoid triggering tax under this rule.

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.

— 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 Will Affect Performance-Based Compensation Structures (Senate bill only)**. The Senate bill (but not the House 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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