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Impact of New Tax Provisions on M&A Deals

Tax Reform Update

On December 22, 2017 President Trump signed into law H.R. 1 — a sweeping tax reform law that changes the tax landscape for many M&A deals. Congress initially labeled the bill as the "Tax Cuts and Jobs Act" but later removed that name in order to comply with Senate rules regarding the budget reconciliation process. Because no description of tax is ever free from acronyms that make us tax geeks geekish, we call this new law the *TCJA* and are offering a prize to anyone who can pronounce that name.

The TCJA brings tax simplicity for many lower-income Americans but adds plenty of complexity — and opportunity — for businesses. This paper summarizes the most significant tax changes that will affect the M&A practice.

But first, here are the major ways this new law has changed the business landscape:

1. Corporate tax rate dropped from a high of 35 percent to a high of 21 percent. In addition, accelerated cost recovery now makes investment in new plant and equipment cheaper than ever on a net present value basis. Limitations on interest deductions could prove a challenge for some corporate taxpayers, especially in the MBO and LBO context.

2. Individual rates changed, mostly downward, though changes to deductions means that some individuals will see an increase in federal income taxes.

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3. A special deduction in new IRC Section 199A is provided for sole proprietors (those independent contractors), owners of S corporations, partnerships and business trusts. Given the economic significance of this provision, we prepared a separate outline on this topic.

4. International taxation changed from a worldwide system to a territorial system and taxes a deemed repatriation of prior earnings held offshore. Depending on whom you believe, that will either create jobs in the U.S. or encourage more businesses to move jobs offshore.

Notable Impacts on M&A

Asset Deals Now Materially More Attractive Due to Ability to Immediately Expense Acquisition of Tangible Property

Taxpayers can immediately expense 100 percent of the cost of certain property acquired and placed in service through 2022. Unlike prior law bonus depreciation, taxpayers can now deduct the cost of used property, not just new property.[1]

Accelerated cost recovery makes an asset sale structure more tax appealing to buyers (compared with a stock deal). How much more attractive depends on the extent to which the target has depreciable tangible property. Remember, asset deals include stock purchases treated as asset deals pursuant to elections under IRC 336 or 338.

Self-Developed Intangibles Generate Ordinary Income

Prior to enactment of the TCJA, property held by a taxpayer (whether connected or not with the taxpayer's trade or business) generally was considered a capital asset under IRC 1221(a). However, certain assets were specifically excluded from the definition of a capital asset, including inventory property, certain depreciable property and certain self-created intangibles (e.g., copyrights, musical compositions).

Under the TCJA, effective for dispositions after December 31, 2017, the definition of capital asset no longer includes patents, inventions, models or designs (whether or not patented), and secret formulas or processes, which are held either by the taxpayer who created the property or by a taxpayer with a substituted or transferred basis from the taxpayer who

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created the property (or for whom the property was created). Unless such assets can be re-characterized as capital assets under IRC 1231, expect sellers to push down the valuation or such assets by “sliding” the value over to goodwill or going concern. Also, anticipate debating such valuations with the IRS.

Limitations on Use of Net Operating Losses

Net operating losses (NOLs), already subject to material limitations following a change of ownership, are now less valuable in most situations. New NOLs — i.e., those arising in tax years beginning after December 31, 2017 — can only offset a maximum of 80 percent of taxable income in any future year.[2]

Under prior law, NOLs could be carried back two years and carried forward 20 years. Now NOLs can be carried forward indefinitely but can no longer be carried back to prior tax years.

New Limitations on Business Interest Expense Deductions

Under prior law, business interest generally was deductible when computing taxable income (subject to a number of limitations). Under the TCJA, for tax years beginning after December 31, 2017 the deduction for net interest expense is limited to 30 percent of the business's *adjusted* taxable income (subject to certain exceptions not applicable here). From 2018 to 2021, *adjusted* taxable income is computed without regard to deductions allowable for depreciation and amortization. For these purposes, *adjusted* taxable income should be roughly equivalent to EBITDA.

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Disallowed business interest may be carried forward indefinitely.

This change will obviously influence a business’s leverage and could reduce the benefits of debt financing *vis a vis* non-participating preferred stock.

Beware of Deferred Taxes Payable on Deemed Income Inclusions From Foreign Subs

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TCJA imposes a one-time mandatory deemed repatriation tax on certain deferred foreign income held by certain foreign corporations with one or more "United States shareholders" (*i.e.*, U.S. persons that own a 10 percent or greater voting interest in the foreign corporation). As a practical matter, this rule may result in a tax liability for a U.S. company that is the target of an M&A transaction and owns foreign subsidiaries or other interests in foreign corporations. This transition tax is computed on the United States shareholder's share of the greater of aggregate post-1986 accumulated foreign earnings and profits of the foreign corporation as of November 2, 2017 or December 31, 2017 — generally without reduction by any distributions made during the tax year ending with or including the measurement date. Most taxpayers will elect to pay the transition tax in installments over eight tax years; as a result, a target company liable for the transition tax may have ongoing payment obligations that would extend beyond the closing date of an M&A transaction.

New Withholding Tax on Sales of Partnerships Engaged in U.S. Trades or Businesses

For decades, the IRS has argued that the sale of a partnership interest should be treated as effectively connected with a U.S. trade or business to the extent that the seller of the interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of sale.[3] For just as long, our team and other tax lawyers have advised clients that the IRS had no authority for such position. Recently a court considered and rejected the IRS's position, so they went to Congress to change the law.

The TCJA provides that, with respect to sales of partnership interests on or after November 27, 2017 gain or loss from the sale of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the seller of the interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of sale.

The TCJA further imposes a new withholding requirement, under which the buyer of a partnership interest must withhold a 10 percent tax on the "amount realized" by the seller on the sale of a partnership interest occurring after December 31, 2017, if any portion of the seller's gain on the sale of the interest would be effectively connected income as described

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above and the seller does not provide a certification of non-foreign status. Buyers of partnership interests (including in connection with M&A transactions) now need to withhold or secure the appropriate certifications and other contractual protections. Similarly, foreign sellers need to ensure that they comply with any applicable reporting and tax payment obligations with respect to sales of partnership interests. Going forward, foreign buyers of U.S. partnership interests with effectively connected assets may avoid future withholding by acquiring the partnership interest using a U.S. blocker corporation.

New Limits on Deductibility of Executive Compensation by Public Companies

Previously, IRC 162(m) limited deductions by public companies for their executive compensation to $1 million per executive, but a host of exceptions allowed just about every public company to avoid this limit.

The TCJA substantially expands the application of the deduction disallowance rules applicable to top executives' compensation exceeding $1 million per year, not only by eliminating the pre-2018 exemption or "performance-based compensation," but also by eliminating the prior law exemptions for compensation deductible in years in or after an executive has terminated service.

Further, the types of companies subject to Section 162(m) have also been expanded to include foreign companies that are publicly traded through American depository receipts and to companies that have publicly traded debt, even if they have no publicly traded stock.

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If you have any questions regarding the new tax law, please don't hesitate to contact a member of our Tax Team.

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[1] The 100 percent write-off starts to evaporate by 20 percent per year beginning in 2023 but that's a long way off.

[2] Consequently, companies with even large NOLs will now pay a 4.2 percent minimum tax rate (21 percent*80 percent) on profit. But

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remember that under prior law when we had a corporate alternative minimum tax, NOL absorption was often limited to 90 percent anyway, so the 80 percent limit may be less material than advertised.

[3] The IRS articulated this position in Rev. Rul. 91-32.

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