Impact of US Tax Reform on Mergers and Acquisitions: New Opportunities and Pitfalls

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On December 22, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act (TCJA), which includes numerous changes that will significantly impact mergers and acquisitions (M&A). Although the TCJA has rightly been described as the most far-reaching piece of tax legislation enacted since the Tax Reform Act of 1986, the new provisions generally serve as an overlay to existing tax law, rather than a complete rewrite of the prior Internal Revenue Code (Code).[1] Particularly as it relates to M&A, the old rules largely remain. That said, the TCJA's changes will have a significant impact on deal modeling, tax diligence and acquisition agreement negotiations. This memorandum discusses the changes to the Code most relevant to M&A and their potential impact. Overall, we expect that the reduction of the U.S. corporate tax rate to 21 percent will make the United States a more attractive jurisdiction for inbound M&A activity and also may increase the value of U.S. domiciled businesses. In addition, the changes to the international tax rules should allow many U.S. companies to access the cash of their foreign subsidiaries at a lower U.S. tax cost, which could provide them with liquidity to fund acquisitions.

Reorganizations and Other Corporate Transactions. The TCJA generally does not change the tax-free reorganization rules or the rules related to other types of corporate transactions, including spin-offs, corporate liquidations and incorporation transactions. For example, the same rules that previously determined whether a particular acquisition would qualify as a tax-free reorganization, such as the relative mix of stock and cash consideration, continue to apply following the enactment of the TCJA. Similarly, the requirements for a spin-off or split-off to qualify as tax-free to both the distributing corporation and its shareholders are unchanged.

While it is possible that the new corporate income tax rate of 21 percent will reduce the corporate-level benefit of structuring a transaction to be tax-free, it should be noted that the top capital gains and qualified dividend federal income tax rate for individuals was left unchanged at 23.8 percent (including the 3.8 percent Medicare tax on net investment income). Accordingly, in situations where tax-free treatment of shareholders is an important consideration, we would expect that the motivation to structure a transaction in a manner that is tax-free will largely remain unchanged.

Reduced Value of Net Operating Losses. The TCJA changed a U.S. corporation's ability to offset taxable income with net operating losses (NOLs) arising in tax years beginning after December 31, 2017, and to carry such NOLs both forward and back to different tax years. Under pre-TCJA law and setting aside the special rules applicable to NOLs under the corporate alternative minimum tax (AMT),[2] NOLs could offset 100 percent of taxable income, and unused NOLs could be carried back two years and forward 20 years. Under the TCJA, NOLs only can offset up to 80 percent of taxable income and cannot be carried back but can be carried forward indefinitely. Note, however, that NOLs arising in tax years that began on or before December 31, 2017, will remain subject to the two-year carryback and 20-year carryforward rule until their expiration and also will continue to be available to offset 100 percent of taxable income. As a result, corporations with pre-TCJA NOLs may be viewed as more valuable than corporations with newer NOLs.[3]

[1] All section references are to the Code.

[2] The corporate AMT was repealed under the TCJA effective for tax years beginning after December 31, 2017.

[3] It should be noted that Section 382, the complex provision that limits a loss corporation's ability following a greater than 50 percent ownership change to offset post-change income with pre-change losses, survived the TCJA unchanged.

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100 Percent 'Bonus' Depreciation. "Bonus" depreciation (an immediate write-off of an applicable percentage of the cost of newly acquired or constructed tangible property) is a concept that has been in the Code for many years. Congress has periodically changed the applicable percentage, but the basic rules (including the types of property that qualify) have largely remained the same. The rules in effect immediately prior to the amendments by the TCJA allowed a depreciation deduction of 50 percent of the cost of qualified property for the tax year in which the property was placed in service by the taxpayer. Under prior law, only the taxpayer that originally placed the property into service (generally, the first owner) would be eligible for the bonus depreciation (the "original use" requirement).

Under the TCJA, qualified property acquired after September 27, 2017, and placed into service on or before December 31, 2022, generally will be eligible for 100 percent bonus depreciation (*i.e.*, the purchase price for this property will be immediately deductible)[4] with no "original use" requirement.[5] The availability of 100 percent bonus depreciation to buyers, as well as the lower 21 percent tax rate now imposed on corporate sellers, may make asset sales or stock sales subject to a Section 338(h)(10) election more attractive.

Bonus depreciation is unavailable for goodwill and other intangible property, which remains amortizable under the straight-line method (*i.e.*, pro rata) over 15 years.[6] Accordingly, buyers generally will have an incentive to allocate as much purchase price as possible to tangible, depreciable property eligible for 100 percent bonus depreciation,[7] whereas sellers will continue to have an incentive to allocate purchase price to whichever assets have the highest tax basis and therefore produce the lowest taxable gain.[8] Given the potentially significant time value benefits of 100 percent bonus depreciation, it is likely that increased attention will be paid to establish a particular purchase price allocation (or at least guidelines for allocation) in asset purchase agreements in order to avoid purchase price allocation disputes after closing.

[4] The bonus depreciation will be phased out 20 percentage points a year over five years beginning in 2023.

[5] To be eligible for 100 percent bonus depreciation, the property generally must be acquired from an unrelated party by purchase.

[6] As under prior law, qualified property continues to include: (i) tangible property that has a recovery period of 20 years or less, (ii) certain computer software and (iii) water utility property. Under the TCJA, qualified property now also includes certain qualified film, television and live theatrical productions.

[7] There may be circumstances where 100 percent bonus depreciation would not be advantageous for a buyer. For example, if the immediate purchase price deduction put the buyer into a significant NOL position, the use of that NOL in future years would be subject to the 80 percent limitation previously described.

[8] Non-corporate taxpayers and taxpayers with expiring capital losses should consider the consequences of depreciation recapture, which would treat gain as ordinary income to the extent of prior depreciation deductions.

Limits on Interest Deductibility. In a sweeping change to prior law, the TCJA sharply limits the ability of businesses to deduct interest payments when calculating their taxable income, which could force a fundamental re-evaluation of the capital structure of every business that is subject to U.S. tax.

Under the new limitation, a taxpayer's allowable deduction for business interest expense in a particular tax year is limited to the sum of: (i) business interest income plus (ii) 30 percent of adjusted taxable income (which generally corresponds to earnings before interest, taxes, depreciation and amortization (EBITDA) for tax years beginning before January 1, 2022, and earnings before interest and taxes (EBIT) thereafter). Any disallowed business interest expense is carried forward indefinitely (by being treated as business interest paid or accrued in each succeeding tax year) and 100 percent of the carryforward is available in any tax year. However, such carryforwards are potentially subject to limitation under Section 382 if the corporation with such carryforwards experiences an ownership change.

We expect that the new interest deduction limitation could provide incentives for many businesses to raise capital through means other than debt, *e.g.*, through leases, derivatives or equity issuances. It also could impact leveraged buyouts, both future deals and deals that already have closed. There is no rule that "grandfathers" existing debt incurred to fund consummated transactions or debt for pending acquisitions, even in situations where there is a binding acquisition agreement and lender commitment letter.

The New International Tax System

Dividend Exemption System. The TCJA introduced a dividend exemption system that, subject to a one-time transition tax described below and certain other limited exceptions, exempts from U.S. federal income tax dividends paid by foreign subsidiaries to their U.S. corporate parents. Under the new system, U.S. corporate shareholders that own 10 percent or more of a foreign corporation are entitled to a 100 percent dividends-received deduction for the foreign source portion of the dividends received from the foreign corporation, provided that a one-year holding period is met. Prior to the TCJA, the active business earnings of a foreign subsidiary generally were not subject to U.S. federal income tax until repatriated in the form of a dividend, at which point they would be subject to tax at the 35 percent corporate rate with a credit for any foreign taxes paid by the subsidiary on the income. The new dividend exemption system will allow U.S. corporations to access the cash on the balance sheets of their foreign subsidiaries at a significantly lower U.S. tax cost than under the previous worldwide tax

system, which could provide fuel for additional acquisitions by U.S. corporations. As a practical matter, however, many U.S. corporations may find that very little of their foreign subsidiaries' income will be eligible for the 100 percent exemption due to the application of the "GILTI" tax, discussed below.

The dividend exemption system generally does not apply to sales of stock of foreign corporations, except to the extent the gain on such sales is treated as a dividend under Section 1248. Accordingly, U.S. tax advisers will still be required to provide input on how to structure efficiently sales of foreign subsidiary corporations.

U.S. corporate borrowers also should be aware that the TCJA did not include, as was widely anticipated, a repeal of Section 956 for U.S. corporations, which provides that a U.S. shareholder of a controlled foreign corporation (CFC) is treated as receiving a deemed dividend from the CFC if it provides a guarantee or pledge of the U.S. shareholder's debt, or if the U.S. shareholder pledges more than 66 2/3 percent of the stock of a first-tier CFC and provides certain negative covenants. As a result of retaining Section 956, such a "deemed" dividend from a CFC to a U.S. corporate shareholder may be subject to U.S. tax at the full 21 percent corporate rate, reduced by any available foreign tax credits, even in situations where an actual cash dividend of the same amount from the CFC would have been exempt under the dividend exemption system. Credit agreements entered into by U.S. borrowers thus will continue to need carve-outs for credit support arrangements from CFCs.

One-Time Transition Tax. Upon moving to the new dividend exemption system, the TCJA imposes a one-time mandatory transition tax on the previously untaxed deferred foreign earnings of certain foreign subsidiaries accrued since 1986 at a rate of 15.5 percent for cash and cash-equivalent profits and 8 percent on other reinvested foreign earnings.[9] The tax is not imposed on the foreign subsidiary but is imposed instead on U.S. shareholders that own 10 percent or more of the foreign subsidiary on the last day of the foreign subsidiary's last tax year that began before January 1, 2018.[10] The foreign subsidiaries of U.S.-parented multinationals often have a tax year that ends on November 30 or December 31 (though it is possible to have another fiscal year). U.S. shareholders that owned 10 percent or more of the stock of a foreign subsidiary with a December 31 tax year incurred the transition tax liability on December 31, 2017. With respect to a foreign corporation with a November 30 tax year, the 10 percent U.S. shareholders of that corporation will incur the transition tax liability on November 30, 2018. It is critical to note that the 10 percent U.S. shareholders on the last day of the foreign corporation's relevant tax year generally are responsible for their pro rata share, based on their percentage ownership on that date, of the transition tax liability, even if they recently purchased their shares and the deferred earnings of the foreign corporation accrued prior to their acquiring their shares.[11]

Taxpayers may elect to pay the transition tax over eight annual installments (without interest). Going forward, it is crucial that acquirers of both U.S. and foreign companies analyze and quantify the potential transition tax exposure as part of their standard list of tax structuring and diligence. Anyone acquiring U.S. corporations with foreign subsidiaries should be mindful of the target's potentially significant deferred U.S. tax liability, which may be accelerated in connection with post-acquisition integration transactions.

Acquisitions of foreign corporations by U.S. acquirers will require particularly careful attention for the remainder of 2018. If the foreign target has a November 30 tax year or if a U.S. target has significant foreign subsidiaries with a November 30 tax year, then, as previously discussed, the U.S. owner of the foreign corporation's shares on November 30, 2018, will be responsible for 100 percent of the transition tax, regardless of how recently it acquired the shares. U.S. acquirers that enter into acquisition agreements in 2018 should take into account the possibility of this tax exposure in the event their acquisition closes on or before November 30, 2018, because they would own the foreign target on the date the transition tax is incurred. This could be addressed in a few ways, including through an up-front purchase price reduction or a tax indemnity that allocates the economic responsibility for the transition tax to the target's shareholder(s).

In the case of an S corporation with foreign corporate subsidiaries, each of the S corporation's shareholders may elect to defer payment indefinitely until the occurrence of certain triggering events, at which point the S corporation's shareholders generally can elect to pay the tax over eight annual installments (without interest). Triggering events include the termination of S corporation status, the liquidation or sale of substantially all of the assets

[9] For U.S. C corporations, the transition tax also can be reduced by the full amount of any pre-existing foreign tax credit carryforwards from prior tax years and by 80 percent of the foreign tax credits made available by the transition tax income inclusion.

[10] S corporations, U.S. partners in U.S. partnerships and U.S. individuals who own 10 percent or more of a foreign corporation also are subject to the transition tax if the foreign corporation is a CFC or there is at least one U.S. C corporation that also is a 10 percent shareholder of the foreign corporation.

[11] The earnings of the foreign corporation that accrued during periods when the foreign corporation was not a CFC and did not have a 10 percent or greater U.S. corporation as a shareholder are not subject to the transition tax. As a practical matter, it may be very difficult to track the precise ownership of a foreign corporation since 1986. In addition, a U.S. shareholder's transition tax liability is reduced by dividends paid by the foreign subsidiary during the foreign subsidiary's relevant tax year to other shareholders not subject to the transition tax.

of the S corporation, the S corporation ceasing to exist or a transfer of any share of stock in the S corporation by the taxpayer (including upon death). Although the transition tax liability is imposed on the shareholders of the S corporation, the S corporation itself is jointly and severally liable for any transition tax liability for which a deferral election is made. Accordingly, an acquirer of such an S corporation could be forced to bear the selling shareholders' transition tax liability absent adequate contractual protection. In addition, the acceleration of the transition tax liability will create a disincentive for S corporation shareholders to sell unless they are compensated for the cost.

GILTI. The new "global intangible low-tax income" (GILTI) tax has been advertised as a global minimum tax on the income of CFCs derived from their use of intangibles, which, like the transition tax, is imposed on the 10 percent or greater U.S. shareholder(s) of the CFC and not the foreign corporation itself. In reality, the GILTI tax is significantly broader and is not limited to income derived from the use of intangible assets. Instead, a CFC's total net income, regardless of whether attributable to intangible or tangible property, over a 10 percent "routine" return on the CFCs' aggregate tax basis in its tangible, depreciable property, is subject to the GILTI tax. U.S. corporations are entitled to a deduction against their GILTI that is intended to result in their paying tax on this income at an effective rate of 10.5 percent for tax years prior to 2025 and 13.125 percent for tax years after 2025, and reduced by 80 percent of their foreign tax credits. Accordingly, any CFC with a low tax basis in its tangible, depreciable assets could attract a GILTI tax, regardless of whether the CFC's business utilizes intangible assets. In practice, this could mean that very little of the foreign earnings of many CFCs are eligible for the 100 percent dividend exemption because the earnings will instead be subject to the GILTI tax.[12] For these CFCs, the GILTI tax, in effect, will result in an end to the deferral of U.S. tax on much of their foreign business income. Because a CFC's tax basis in its tangible, depreciable assets provides a "cushion" against the GILTI tax, offshore acquisitions treated as asset acquistions for U.S. tax purposes may become increasingly attractive to U.S. parented groups relative to stock acquisitions. Prospective U.S. acquirers of foreign corporations holding meaningful tangible, depreciable property will want to consider structuring the acquisition as an asset purchase or stock purchase with a Section 338(g) election.

[12] Additionally, U.S. taxpayers are required to allocate their interest expense between their U.S. and foreign source income. Any interest expense allocated against GILTI could limit a U.S. corporation's ability to use foreign tax credits against this income.

'Inverter' Penalties. A recurring theme of the TCJA is that so-called "inversions" (*i.e.*, acquisitions by foreign corporations of U.S. corporations in which, following the acquisition, the former shareholders of the U.S. corporation own, or are treated as owning, at least 60 percent and less than 80 percent of the stock of the foreign acquiring corporation) are strongly discouraged, particularly for the next 10 years.

First, individual shareholders of foreign acquiring corporations that first complete an inversion after the enactment of the TCJA are permanently ineligible for the qualified dividend income rate of 23.8 percent (including the 3.8 percent Medicare tax on net investment income) on dividends received from such foreign corporation, which instead would be taxed at ordinary rates (currently, 40.8 percent taking into account the maximum 37 percent federal rate applicable through 2025, at which point it returns to 39.6 percent, and the 3.8 percent Medicare tax on net investment income).

Second, if the transition tax applies to a U.S. corporation that participates in an inversion within 10 years following the enactment of the TCJA, then the U.S. corporation's transition tax is recomputed at a 35 percent tax rate (the maximum marginal corporate income tax rate in effect prior to the enactment of the TCJA) and the U.S. corporation must pay as part of its income tax liability for the year it participates in the inversion transaction the difference between the recomputed transition tax at the 35 percent rate and the amount of transition tax it originally paid at the reduced 8 percent and 15.5 percent rates.

Finally, new rules apply under Subpart F that make it more difficult to engage in post-inversion tax planning (even with respect to U.S. corporations that inverted prior to the enactment of the TCJA), and certain disadvantageous rules apply to corporations that complete a tax inversion after November 9, 2017, under the new Base Erosion & Anti-Abuse Tax (BEAT), which is an alternative tax intended to mitigate erosion of the U.S. tax base by corporations that make deductible payments to related non-U.S. parties. The BEAT is the amount by which a U.S. corporation's income tax liability, computed without taking into account certain deductible "base eroding" payments and using a 10 percent rate, exceeds the U.S. corporation's regular income tax liability.

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