ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for M&A

January 25, 2018

On December 22, 2017, the President signed into law the 2017 U.S. tax reform bill formerly known as the Tax Cuts & Jobs Act (the "TCJA"). This event marks the culmination of an extremely rapid legislative process, beginning with the bill's introduction in the U.S. House of Representatives on November 2, 2017. Most of the TCJA's provisions took effect January 1, 2018.

The TCJA introduces significant changes to the U.S. tax system that are likely to have a profound impact both on the economy as well as on the structuring of M&A transactions. This memorandum sets forth a few key observations.

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Executive Summary

We believe there are 9 main takeaways, each of which is discussed in greater detail in this memorandum.

1. Significant reduction in headline tax rates for corporations and most business income earned by individuals through partnerships.
2. Acquisition structures in general, and LBOs in particular, may be affected by limitations on net interest expense deductions.
3. The value of NOLs may be significantly reduced as a result of new limitations on their use.
4. For the next 5-10 years, the accelerated expensing of asset acquisitions may encourage non-tech M&A.
5. The shift to a territorial tax system will free up offshore cash and may increase M&A activities. It may also impact the structure of U.S. groups.

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6. Both the operational structure of multinational groups (including intercompany cash flows) and the use of shareholder debt to finance acquisitions by non-U.S. buyers may be affected by new base erosion rules.
7. U.S. groups that derive high returns offshore, or that have operations that require few assets offshore (*e.g.*, services or sales businesses), may be subject to a higher effective tax rate.
8. Future inversions may have been stopped by the TCJA.
9. The number of entities that are subject to the CFC rules has been significantly expanded.

1. **Significant reduction in headline tax rates**.

— For corporations:

- The U.S. corporate tax rate is lowered to 21%, effective starting in 2018.
- The corporate alternative minimum tax is repealed.

— For individuals:

- The tax rate on business income earned by individuals through flow-through entities (including through partnerships, MLPs, S corporations and REITs) is lowered by a complicated mechanism that results in an effective top bracket rate of 29.6% (expiring after 2025).
- The rate reduction is accomplished by providing for a deduction equal to 20% of the qualified business income that is earned by a non-corporate taxpayer through the flow-through entity.
- This deduction is capped however at the greater of (a) 50% of the W-2 compensation treated as paid by the taxpayer and (b) the taxpayer's allocable share of 25% of such W-2 compensation plus 2.5% of the unadjusted acquisition cost of the pass-through entity's tangible assets. This cap does not apply for purposes of the deduction available to MLPs and REITs.
- This deduction is not available for investment businesses, asset management businesses and many professional services businesses. Industries that are likely to benefit are those with significant capital expenditures, such as oil and gas and real estate, or significant employee expenses.

— *Partnership vs. Corporate Form After the TCJA*: These changes in tax rates may affect the use of corporations and partnerships. Business income earned by individuals in the top bracket through a partnership is still subject to a lower effective federal income tax rate (29.6%) than income earned through a corporation by such individuals (36.8%) *but* (i) the effective tax rate for income earned through a corporation is significantly lower than under prior law (48%), (ii) the corporate tax form allows for deferral (*i.e.*, taxation of earnings at 21% until dividends are paid or anti-abuse rules apply), and (iii) corporations are able to obtain certain other tax preferences that individuals cannot (*e.g.*, a lower rate of tax on GILTI income, effective deemed paid foreign tax credits, dividends received deductions and participation exemption on certain foreign dividends, and deductions for state and local taxes).

— *Tax Attributes*: A byproduct of the reduction in tax rates is a mechanical reduction in the value of any tax assets owned by portfolio companies (*e.g.*, value of tax receivables agreements in Up-Cs and deferred tax assets for transaction expenses or NOLs).

2. **Acquisition structures in general, and LBOs in particular, may be affected by limitations on net interest expense deductions**. The TCJA introduces a new significant limitation on deductions for *net* business interest expense: net business interest expense cannot offset more than 30% of "adjusted taxable income."[1]

— The rule applies to any interest paid on or after January 1, 2018. There is no grandfathering for pre-existing debt, including debt that a target has incurred prior to the acquisition.

— This rule, combined with the lower corporate tax rate, will significantly affect both existing corporate groups that have utilized acquisition debt as well as the planning and structuring for future LBOs.

- It will diminish the existing incentive to allocate the maximum amount of debt to the U.S. in a cross-border acquisition.
- It 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.
- The rule also applies to businesses conducted through partnerships, which will also have an incentive to use alternative forms of financing.

— The rule limits the deduction for net business interest expense to 30% of adjusted taxable income. "Adjusted taxable income" is similar to EBITDA for taxable years 2018 through 2021, and EBIT for 2022 and later years. Disallowed interest expense can be carried forward indefinitely.

- Particularly in 2022 and later years, the change from EBITDA to EBIT may mean that businesses with significant expenditures eligible for expensing will have little or no capacity for interest deductions. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect; therefore the switch to EBIT should be taken into account in structuring acquisition debt beginning immediately.
    - For example, for a company with 100 of adjusted taxable income equal to EBITDA, and 40 of depreciation, the limit on interest expense deductions would be 30 through 2021. Starting in 2022, it would be 18. Companies therefore may want to take advantage of the immediate expensing permitted under the TCJA for certain types of tangible assets (described in paragraph 4 below) to accelerate such investments to pre-2022 years when depreciation is not taken into account in measuring adjusted taxable income for purposes of this interest expense limitation.

— 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.

— This rule 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.

[1] The separate limitation on interest expense deductions based on a worldwide leverage test, which was included in prior versions of the TCJA, was not adopted.

3. **The value of NOLs may be significantly reduced as a result of new limitations on their use.**

— Carrybacks of NOLs are no longer allowed. Carryforwards of NOLs become indefinite. These new carryback and carryforward rules apply only to NOLs that arise in taxable years *ending after* December 31, 2017 – *i.e.*, they capture some 2017 NOLs for non-calendar year taxpayers.

— For taxable years beginning after December 31, 2017, a company may use NOL carryforwards to offset only up to 80% of its taxable income (with unused NOLs carried forward into future years). This 80% cap applies to NOLs that arise in taxable years beginning after December 31, 2017.

— These changes will be relevant in modelling returns, such as the benefit of expensing, and should be taken into account in considering the impact of "transaction tax benefits" (*e.g.*, bonuses and refinancing costs) which a buyer is often asked to pay over to seller.

4. **The accelerated expensing of asset acquisitions may encourage non-tech M&A, particularly in the next 5 years**. The TCJA allows very beneficial accelerated expensing of the cost of certain "qualified property".

— Immediate expensing of the entire cost in the year of purchase is available for qualified property acquired after September 27, 2017 and placed in service before January 1, 2023.

- "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.
- Accelerated expensing is also allowed for property placed in service in 2023 and afterwards, with the percentage of cost that is immediately deductible stepping down annually until it reverts to the previously existing depreciation schedule 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 may create an incentive to acquire assets eligible for immediate expensing within the next 5 years (or accelerated expensing in years 6 to 10). As noted, because qualified property does not include intangible property, the deduction is likely to be less valuable to the tech industry or other businesses without significant tangible assets. In addition, because the deduction does not apply to goodwill, this provision may result in an increased focus on the value of tangible business assets as part of the purchase price allocation process.

— *Structuring Acquisitions*: Immediate (and accelerated) expensing will apply to purchases of used as well as new items, and thus may create incentives to structure acquisitions as asset purchases or deemed asset purchases (such as stock purchases with a section 338 or 336 election or conversion of a corporate target to an LLC prior to purchase), during the 5 to 10 year period. However, in determining the benefit of selling assets vs. selling stock, the relative value of immediate (or accelerated) expensing for the purchaser will still need to be balanced against potential additional tax on sellers.

— *Issues for Rollovers*: If the purchaser is "related" to the seller, accelerated expensing is not permitted; as a result in some circumstances the application of attribution rules will take on increased significance. For instance, depending on the specific facts, transactions that involve a partial rollover of the existing shareholders may result in the purchaser being "related" to the seller and thus a denial of this benefit.

5. **The shift to a territorial tax system will free up offshore cash and may increase M&A activities. It may also impact the structure of U.S. groups**. One of the most important changes introduced by the TCJA is a shift to a territorial system of international taxation, effective January 1, 2018.

— *Toll Charge*: A one-time transition tax is imposed on the undistributed earnings of foreign subsidiaries generally as of the end of 2017. The transition tax is payable by *any* 10% U.S. shareholder of a foreign corporation (determined on December 31, 2017), if the foreign corporation is either a controlled foreign corporation (CFC) or has at least one 10% U.S. shareholder that is a corporation. The one-time tax is imposed at rates of 8% and 15.5% for corporate shareholders (for earnings invested in tangible assets vs. cash), and 9.05% and 17.54% for investors taxed as individuals and subject to the highest marginal rate. *These rules will effectively "unlock" the trapped cash held offshore by U.S. multinationals*. Taxpayers can generally elect to pay the tax over 8 years, although there are triggers to accelerate the payment (*e.g.*, sale of all or substantially all of the assets of a taxpayer). There are rules permitting earnings deficits to offset undistributed earnings amounts.

— *Territorial Tax System*: Under the new system, going forward, the dividends received by a U.S. corporation from its 10%-or-greater-owned foreign subsidiaries (by vote or value) are generally exempt from tax if attributable to non-U.S. source earnings of the subsidiaries.

- The exemption is available only to U.S. corporate shareholders who have held the foreign subsidiary stock for at least 1 year (subject to potential tolling rules).
- The exemption is not available if the foreign corporation is passive foreign investment company (a "PFIC").
- The exemption also does not apply to so-called "hybrid dividends" (dividends that are deductible by the foreign subsidiary).
- Dividends exempted from tax 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.

— *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 equity (by vote or by value) will be fully taxable (with potential for foreign tax credit relief).
- The exemption does not apply to gains from the sale of shares (although it does apply to any gains recharacterized as dividends under section 1248). There may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.

— *Limitations on Credit Support from CFCs Remain in Place*. Despite the exemption for actual dividends from foreign subsidiaries, the TCJA retains the existing rule (section 956) that requires a U.S. shareholder of a CFC to currently include in income the earnings of the CFC reinvested in United States property. Loans from CFCs to U.S. corporate shareholders, pledges of CFC stock to support borrowings of U.S. corporate shareholders, and other investments by CFCs in U.S. property (including owning stock of U.S. affiliates and other U.S. tangible and intangible property) will continue to give rise to deemed dividend inclusions that are fully taxable, and therefore section 956 will continue to constrain the structuring of debt incurred by U.S. entities with significant foreign assets.

— Absent additional provisions, the new territorial tax system would create a strong incentive to move operations offshore. In order to mitigate this, the TCJA broadens the scope of the CFC rules and introduces a series of new taxes and rules that affect the deductibility of payments to foreign affiliates. We discuss these and their potential impact for M&A transactions in paragraphs 6-9, below.

6. **Both the operational structure of multinational groups and the use of shareholder debt to finance acquisitions of U.S. businesses by non-U.S. buyers may be affected by new base erosion rules.**

— The TCJA targets earnings stripping or base erosion by imposing a new minimum tax (called the "BEAT") on the taxable income of a corporate taxpayer, modified so as to deny deductions for "base erosion payments."

— "Base erosion payments" are deductible payments from domestic corporations and branches to foreign affiliates, excluding mainly (i) cost of goods sold (except for corporations that expatriate from the United States after November 9, 2017), (ii) certain payments for services representing cost reimbursement with no mark-up, (iii) certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers) and (iv) payments that are subject to U.S. withholding tax.

- There are no exclusions for interest (*e.g.*, interest on shareholder debt) or other payments in connection with financial transactions other than derivatives. Moreover, there is an unfavorable rule that treats any interest expense that is non-deductible under the limit described in paragraph 2 above as paid to unrelated parties for purposes of the BEAT, which maximizes the deductible interest that is treated as paid to related parties and therefore subject to the BEAT.
- "Affiliate" is construed broadly for this purpose, and includes not only entities that are "controlled" by, or "control," the U.S. taxpayer but also entities that own as little as 25% of the taxpayer (by vote or value) or are controlled by, or control, such owners.

— The tax due equals the excess of (a) the minimum tax rate applied to the corporation's taxable income after adding back base erosion payments over (b) the corporation's tax liability at the regular corporate rate.

- *Rates*:
  - The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years.
  - Increased rates apply to U.S. affiliated groups that include a bank or registered securities dealer: 6% in 2018, 11% in 2019 through 2025 and 13.5% in 2026 and later years. However, as noted above, the base erosion tax does not apply to most payments in connection with derivatives which are marked to market.
- *Tax Credits*: In calculating a corporation's tax liability at the regular corporate rate for purposes of the BEAT, tax credits are generally taken into account, thereby increasing the BEAT liability. However, in 2018 through 2025, research tax credits and 80% of low-income housing and energy credits are excluded from the calculation, with the effect that these credits can mitigate BEAT liability.

— The BEAT applies to corporations with at least $500 million in annual gross receipts and for which base erosion payments represent at least 3% of total deductions (2% for a U.S. affiliated group that includes a bank or securities dealer). Aggregation rules apply to test related entities on a group-wide basis. Foreign corporations are subject to the rule if their income that is effectively connected to a U.S. trade or business meets the gross receipts and 3% tests.

— There is significant uncertainty about how the BEAT will be applied in practice. Guidance from the Treasury Department and the Internal Revenue Service is needed to clarify many aspects of the BEAT.

— *"Hybrid" transactions and entities.* The TCJA also disallows deductions for interest and royalty payments to foreign affiliates where the foreign recipient is not subject to tax on the payments due to a different characterization of the payment or the recipient (as to its regarded or transparent tax status) by the foreign jurisdiction.

7. **U.S. groups that derive high returns offshore, or that have operations that require few assets offshore (*e.g.*, services or sales operations), may be subject to a higher effective tax rate.**

— The TCJA targets the incentive to move operations offshore by expanding U.S. taxpayers' taxable income to include a new category of income: the "global intangible low-taxed income" or "GILTI" derived by the CFCs of which such taxpayers are 10% shareholders.

- GILTI is taxed to individual shareholders at 100% of the applicable rate; and taxed to corporate shareholders at 50% of the usual rate (*i.e.*, a 10.5% rate) through 2025, and at 62.5% of the usual rate (*i.e.*, a 13.125% rate) in 2026 and later years.

— *Not Just Intangibles*. Despite its name, GILTI does not focus on intangibles. It is computed as the excess of the CFC's net income for the year (with certain exceptions) over a benchmark rate of return that is keyed off the CFC's basis in its depreciable assets.

- As a result, GILTI will potentially subject to current U.S. taxes a significant portion of the income of CFCs that (i) earn high returns on assets (*e.g.*, intangibles), (ii) have assets that are not depreciable or have already been significantly depreciated, or (iii) have a business (*e.g.* sales or services) that does not require tangible assets.

— *Not Necessarily Low Taxed.*

- 80% of foreign taxes attributable to the GILTI are creditable by corporate shareholders (subject to some limitations, including most notably no carryforwards or carrybacks of excess credits). As a result, a CFC would need to pay tax at an effective rate of 13.125% (through 2025) or 16.41% (in 2026 and later years) in order to avoid triggering tax for its corporate U.S. shareholders under this rule.
- Individuals do not however get the benefit of these credits. In other words, individual U.S. shareholders of a CFC may be subject to tax at 100% of the applicable rate (see above) on their share of a CFC's GILTI, no matter how much tax the CFC has paid on that income.

— *Incentives for U.S. Production.* The TCJA also includes a special 13.125% tax rate (increased to 16.41% 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 GILTI. This rule may encourage bringing some offshore intangible assets back to the United States.

8. **The end of inversions?**

— The switch to a semi-territorial tax system (discussed in paragraph 5 above) will significantly reduce the U.S. tax benefits of "inverting" U.S. corporations into foreign corporations.

— In addition, the TCJA introduces a series of adverse tax rules for corporations that invert after the TCJA is enacted (*e.g.*, the pre-existing reduced rate for qualified dividends received by non-corporate shareholders is no longer available for dividends from foreign companies that undertake a 60% inversion after the enactment of the TCJA; cost of goods sold will be treated as base erosion payments subject to the BEAT for companies

that invert after November 9, 2017; and there is an increase in the one-time toll charge on unrepatriated earnings for any U.S. corporation that inverts within 10 years of the enactment of the law).

9. **The number of entities that are subject to the CFC rules is significantly expanded**.

— In general, a CFC is defined as 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 for this purpose. However, under prior law, "downwards attribution" from foreign persons to U.S. persons did not apply.

— The TCJA expands the attribution rules applicable for CFC purposes, allowing downwards attribution from foreign persons to U.S. persons. This could cause a foreign corporation to be treated as a CFC in a situation where significantly less than 50% of the foreign corporation's equity is directly or indirectly owned by U.S. shareholders, in particular 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 was not previously treated as a CFC could become liable for tax on subpart F income and subject to the GILTI rules described in paragraph 7 above.

- This change is effective beginning with the last tax year of a CFC that begins *before* January 1, 2018 (in other words, it will apply to the 2017 tax year for a CFC that is on a non-calendar tax year).
- An explanation by the House-Senate Conference Committee indicates that the new downward attribution rule is not intended to result in 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 TCJA does not include language to reflect that intent.

— The TCJA also expands the definition of a 10% U.S. shareholder to any U.S. person that owns 10% by value (or 10% of voting power, as was the case under previous law).

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