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Impact of Recent Tax Legislation on M&A Transactions

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This post outlines at a high-level certain provisions under the recently enacted 2017 tax legislation (Pub. L. 115-97, the "Tax Act") that may affect M&A Transactions. Some of these rules are very complex, particularly in cross-border transactions, and this post describes them in general terms without all of their fine details. The discussion of foreign corporations below is in the context of foreign subsidiaries of U.S. groups.

Multiple Lower Effective Corporate Tax Rates

There are now multiple effective corporate tax rates and the much-despised corporate alternative minimum tax has been repealed. Because all of them are substantially below 35 percent, they may contribute to an increase in asset prices. In addition, tax benefits now may be less valuable to corporate purchasers than to non-corporate buyers.

Base Corporate Income Tax Rate—21 percent tax rate (effective for taxable years beginning after December 31, 2017). No sunset provision.

Certain Foreign Source Income Earned from the U.S ("FDII").—Intended to attract cross-border business back to the U.S., a tax rate lower than 21 percent is now imposed on certain excess returns earned by a U.S. corporation on the sale, license or lease of property or the provision of services to an unrelated foreign party for foreign use or consumption. (Additional rules apply when the transaction is with a related party.) In broad terms, the lower rate applies to the foreign source income from these transactions in excess of 10 percent of the corporation's allocable depreciable tangible property basis.

The effective tax rate on such income is 13.125 percent (through a 37.5 percent deduction) for taxable years beginning after December 31, 2017 and before January 1, 2026. The effective tax rate increases to 16.406 percent (through a reduction of the deduction to 21.875 percent) for taxable years beginning after December 31, 2025. No sunset provision.

Certain Foreign Source Income Earned by Controlled Foreign Corporations ("GILTI")—The Tax Act was heralded as incorporating "territoriality" into the U.S. tax system—that is, the income earned by foreign subsidiaries of U.S. corporations would not be subject to U.S. taxation, either when earned or distributed to its U.S. shareholder, similar to the practices followed by other developed countries. The reality is somewhat less—think of it as "partial territoriality". First, the "subpart F" deemed income inclusion rules (going back to 1962) are retained. Second, in broad terms, a foreign subsidiary's earnings (excluding its subpart F income and certain other income items) in excess of 10 percent of allocable depreciable tangible property basis (reduced by certain related interest expense) is included in income of its 10-percent U.S. shareholder on a current basis, whether or not corresponding cash distributions are made by the subsidiary. The actual distribution of such earnings is tax-free.

The effective tax rate on such income is 10.5 percent (through a 50 percent deduction, assuming no underlying foreign income taxes paid on such income) for taxable years beginning after December 31, 2017 and before January 1, 2026. Because of the interplay of revised foreign tax credit rules, the minimum foreign tax rate, at which no U.S. income tax would be due on such income, is 13.125 percent.[1] The effective tax rate increases to 13.125 percent (through a reduction of the deduction to 37.5 percent, assuming no underlying foreign income taxes paid on such income) for taxable years beginning after December 31, 2025. Similarly, because of the interplay of the revised foreign tax credit rules, the minimum foreign tax rate, at which no U.S. income tax would be due on such income, is 16.406 percent.[2] No sunset provision.

Observations

- Businesses with relatively little tangible depreciable property—such as businesses heavily dependent on intellectual property and service businesses—fare well under FDII and not as well under GILTI.
- The calculation of GILTI, including the component parts of GILTI (such as the calculation of the basis of depreciable tangible property), for any given U.S. taxpayer is generally aggregated over all controlled foreign corporations ("CFCs") for which the U.S. taxpayer is a 10-percent shareholder. This makes attempts by U.S. taxpayers to manipulate the GILTI rules more difficult.
- Although the GILTI rules apply to 10-percent shareholders of CFCs, the definition of CFC and the scope of 10-percent shareholders covered by the CFC rules have

unfortunately expanded. Accordingly, the new rules will apply to more situations than one might initially suspect.

- In the case of U.S. corporations with losses, the GILTI income inclusions may soak up those losses (without the benefit of the 50 percent GILTI deduction). Under prior law, U.S. corporations generally could avoid such reductions of its losses as long as they did not repatriate cash from their subsidiaries.

- Congress also has sought to increase the tax cost of doing business overseas through foreign subsidiaries by providing that foreign income taxes attributable to GILTI cannot be credited against U.S. income tax imposed on non-GILTI foreign source taxable income and, if they are not fully used in the year of the GILTI inclusion, they cannot be carried back or forward—“use them or lose them”.

- Sales of the stock of foreign subsidiaries with significant built-in gain in their underlying assets by U.S. corporations are likely to give rise to a renewed focus on the making of section 338 elections (deemed asset sales by foreign subsidiaries) by buyers because of the tax savings that may be available to sellers compared to a straight stock sale (although the tax considerations remain complicated).

- Generally, from the seller’s point of view, the SPA should require the buyer to make the election if requested by seller (and should not permit buyer to make the election without seller’s consent). If an election is made, the impact on the seller is that the deemed gain to the foreign subsidiary generally will give rise to a GILTI inclusion that will be taxed to the seller at the low effective U.S. income tax rate discussed above and thereby will have the effect of reducing the amount of stock gain taxed at 21 percent. Further stock gain (in excess of the GILTI inclusion), up to the amount of the untaxed, undistributed earnings and profits earned while the U.S. corporation owned the foreign subsidiary, should be exempt from U.S. income tax. (An exception to these results would be if the foreign subsidiary held “subpart F” assets, the deemed gain from these assets would be taxed to the seller at 21 percent.)

- A U.S. seller is likely to prefer that the foreign subsidiary not actually sell assets because of the commercial and other complexities (although this can, in appropriate circumstances, be managed by use of disregarded entities (“DREs”) under the foreign subsidiary) and because foreign income taxes may be incurred that cannot be fully credited against the U.S. income tax liability, adding to the actual tax cost of the transaction (which a DRE would not solve for).

- While a U.S. buyer will prefer an actual asset purchase, it may be willing to accept the section 338 election alternative because it will receive a stepped-up tax basis in the foreign subsidiary’s depreciable tangible property for its own GILTI purposes. These provisions may change the dynamic in the allocation of purchase price

among the assets of foreign subsidiaries.

- Foreign buyer is likely to push for actual asset sale.

While the cross-border focus of this post on foreign corporations has been on subsidiaries of U.S. corporations, it is worth noting that, because the GILTI rules apply to CFCs, U.S. individuals who are considered 10 percent shareholders of a CFC can have a GILTI inclusion. However, unlike U.S. corporate shareholders, the GILTI deduction will not be available to them and, therefore, they will be subject to regular federal income tax on their GILTI inclusion. And a U.S. individual who invests in a CFC through a U.S. partnership or S corporation can have a GILTI inclusion through the partnership or S corporation notwithstanding that the individual's indirect ownership of the CFC is less than 10 percent.

But Don't Lose the BEAT!

To manage the "erosion" of the U.S. tax base through payments by U.S. corporations to foreign affiliates giving rise to U.S. deductions, a base erosion anti-abuse minimum tax, commonly known as the "BEAT", has been added. The BEAT applies to "base erosion payments" made or accrued in taxable years beginning after December 31, 2017 by U.S. corporations with average annual gross receipts of at least $500 million over the prior three-year period (aggregating related U.S. corporations and certain foreign subsidiaries) and a "base erosion percentage" generally of three percent or more.

The BEAT is an add-on minimum tax and is due in any year in which it exceeds the U.S. corporation's regular tax liability. The BEAT base is equal to the sum of the corporation's regular tax base and in general payments by the corporation to foreign affiliates that give rise to U.S. tax deductions. The BEAT rate is five percent for a taxable year beginning in 2018, ten percent for taxable years beginning after December 31, 2018 and before January 1, 2026, and 12.5 percent for taxable years beginning after 2025.[3]

Observation

- The fact that the BEAT is payable in one year as a result of deductible payments to foreign affiliates that may create only temporary differences for GAAP may nevertheless create a permanent increase in the effective tax rate, because the reversing of the deductible payment back into income in the U.S. will notgive rise to a corresponding reduction in regular U.S. corporate tax liability in the future taxably year—this is mostly a financial statement issue.

Lowering the Effective Cost of Asset Deals by Expensing Purchased Depreciable Tangible Property

A purchaser of depreciable tangible property (with a "recovery period" of 20 years or less) generally can deduct 100 percent of the cost of new property and used property that is purchased from an unrelated seller and was not previously used by the purchaser, as long as such property is purchased and placed in service between September 27, 2017 and December 31, 2022. After 2022, the percentage of the cost that can be deducted in the year of purchase steps down over time, except that property with a recovery period of 10-20 years, aircraft and other transportation property benefit from a one-year extension in each case.[4]

The cost of purchased computer software that is not acquired in connection with the acquisition of a trade or business is treated similarly.

Observations

- While special depreciation regimes have been provided in the past to incentivize the investment of capital into new equipment, this is the first time in memory that these depreciation incentives have been made available to used property on the same basis. It is hard to come up with a policy justification in support of the expensing of the cost of used property.
- In the case of purchased buildings, it appears that, through component depreciation in accordance with a cost segregation study, the purchaser may be able to allocate a portion of the purchase price to depreciable tangible property with a recovery period of 20 years or less.
- In the case of an asset deal (or deemed asset deal—think 338) in which the allocable cost that can be expensed is significant, agreement between the seller and the purchaser on the allocation of the purchase price becomes more significant than under prior law. Depending upon the amount of depreciation recapture (taxable at ordinary income tax rates), non-corporate sellers may resist the allocation to property that can be expensed.

Financing Limitations

30 percent interest cap—The deduction of a taxpayer's business interest expense (net of business interest income) is generally limited to 30 percent of approximately EBITDA for taxable years beginning after December 31, 2017 and before January 1, 2022, and 30 percent of approximately EBIT for taxable years beginning on or after January 1, 2022. Excluded interest deductions can be carried forward indefinitely and deducted in a subsequent taxable year, subject to the applicable 30 percent cap. No sunset provision.

For a partnership, the limitation applies at the partnership level and, based on the legislative history, for a group of affiliated corporations filing a consolidated tax return, the limitation should apply to the consolidated group as a whole. The partner-level limitation rules are complex, but are generally intended to ensure that excess interest expense carried forward from one partnership investment can only offset income allocated by that partnership in the future.

The limitation will not apply to taxpayers with gross receipts of $25 million or less (typically, determined by averaging receipts over the three prior taxable years, and combining the receipts of certain affiliated entities), or to certain regulated public utilities. In addition, businesses engaged in real property development, construction or rental property management, or similar companies may elect out of this limitation. However, the trade-offs of this election are that the business would be required to use a somewhat slower depreciation method for its real property and certain improvements thereon, and any portion of such property that otherwise would be eligible for immediate expensing would no longer qualify for this tax benefit.

Observations

- No "grandfathering" of pre-existing debt. Accordingly, the limitation applies to existing capital structures.
- Sale-leasebacks that are not re-characterized as loans under general tax principles may become more attractive in connection with the funding of an acquisition because the rental deductions should not be subject to this limitation. The ability of the purchaser to expense the cost of certain purchased depreciable tangible property (discussed above) may lower the cost of such sale-leasebacks to sellers.
- In the case of a stock purchase, any excess interest expense of the target company will carry over as an available tax attribute in future years. Unlike NOL carry forwards (discussed below), the deduction of the interest expense carry over against taxable income is not subject to a percentage limitation of taxable income,

but is subject to the interest cap and the application of section 382.

- Whether a real estate related business should elect out of these rules generally will require "running" the numbers.

Section 956 remains with us—Often a tough issue in the past has been the guarantees and other credit enhancements requested by lenders from foreign subsidiaries of U.S. borrowers. The concern by the U.S. shareholder is not to trigger the untaxed earnings of its foreign subsidiaries. With the shift to a system that now permits the repatriation of cash without U.S. taxation, it would be natural to conclude that section 956 would no longer provide a "policing function" and, therefore, should have been repealed by the Tax Act. While the Senate bill would have repealed this section as to U.S. shareholders that were C corporations, it survived at Conference and continues to be law. Income inclusions by virtue of section 956 will be taxed at the 21 percent base rate ("carrying" underlying foreign tax credits) with no GILTI tax benefit.

Observations

- Lenders may push for foreign credit support in light of the amount of the "previously taxed income" shield of foreign subsidiaries arising from the income inclusion by the U.S shareholder of the foreign subsidiaries' earnings under GILTI and the Repatriation Tax (discussed below) as well as the lower corporate tax rate.
- Borrowers will likely still resist, on the grounds that section 956 still could generate negative tax consequences under certain circumstances.
- In fact, because section 956 allows for the "carrying up" of foreign tax credits (which tax-exempt distributions from foreign subsidiaries no longer do), the continued existence of section 956 could create tax planning opportunities for some multinational groups.

20 Percent Pass-Through Deduction for Non-Corporate Taxpayers

Non-corporate taxpayers are now generally subject to a maximum federal income tax rate of 37 percent. To maintain rough parity between the taxation of businesses operated by partnerships and S corporations on the one hand and C corporations on the other hand (taking into account the second level of tax on distributions by C corporations), non-corporate taxpayers generally may deduct 20 percent of a pass-through entity's business income, resulting in an effective federal income tax rate of 29.6 percent on that income. This deduction is available in taxable years beginning after December 31, 2017 and ceases to be available in taxable years beginning after December 31, 2025.[5]

However, there are a number of limitations to the deduction's full usage and, therefore, like GILTI, it may offer less than what has been promised:

First, the deduction may not exceed 20 percent of the taxpayer's overall taxable income (excluding any net capital gain).

Second, the deduction is not available in connection with the operation of many service businesses—knocking out in particular businesses involving the performance of services in the fields of health, law, engineering, architecture, accounting, actual science, performing arts, consulting, athletics, financial services, or brokerage services or any trade or business where the principal asset of such business is the reputation or skill of one or more of its employees or owners, or the performance of services consisting of investing, investment management, trading, or dealing in securities, partnership interests, or commodities.

Third, it appears that deductions with respect to the earnings of qualified businesses will be reduced or eliminated by losses with respect to qualified businesses. And if qualified businesses have a net loss, that loss carries over and can reduce the deduction in subsequent taxable years.

Fourth, a deduction with respect to a profitable qualified business cannot exceed the greater of the taxpayer's share of 50 percent of the business' employee wages or the taxpayer's share of the sum of 25 percent of such employee wages and 2.5 percent of the depreciable tangible property used in the business.[6]

Fifth, a deduction is generally only available with respect to foreign-source income to the extent that the income would be considered "effectively connected" with the conduct of a U.S. trade or business had the pass-through entity been a foreign corporation.

This deduction has no effect on the 3.8 percent tax on net investment income paid by many investors on their partnership income.

Observations

- Businesses with high profit margins compared to the level of employee costs and/or the amount of depreciable tangible property may find the deduction limited.
- For non-corporate taxpayers, the substantial reduction in corporate income tax rates may make a C corporation attractive as the acquisition vehicle. The savings in federal income taxes can be used to pay down debt or finance expansion and,

therefore, may reduce borrowing or additional capital needs. On exit, the value of the tax savings from the sale of assets to a strategic corporate buyer will not be as significant as under the prior higher corporate tax rate. On the other hand, the plan to make distributions in the not-too-distant future will militate against the use of a C corporation.

One-Time Repatriation Tax and Future Tax-Free Distributions of Overseas Earnings—or "Knockout the Lockout"[7]

Prior to the Tax Act, the U.S. shareholder faced a 35 percent U.S. income tax (less applicable foreign tax credits) on the distribution by its foreign subsidiaries of their previously untaxed earnings. As a result, U.S. shareholders generally preferred to retain these earnings offshore—this practice was commonly referred to as the "lock-out effect".

The U.S. shareholder now must include the post-1986 untaxed earnings of its foreign subsidiaries, measured as of November 2, 2017 or December 31, 2017—whichever date yields a greater amount, in its income in its taxable year that ends with or within the last taxable year of the foreign subsidiaries beginning before January 1, 2018. The U.S. shareholder's income inclusion is subject to U.S. income tax at the rate of 15.5 percent for cash and cash equivalents and 8 percent for non-cash assets.[8]

However, in what only can be characterized as the spirit of generosity of the holiday season, Congress granted the benefit to U.S. shareholders of allowing them to make an affirmative election to pay the associated tax liability in eight "back-loaded" annual installments (with the majority of the payments made in the final three years) and without any interest charge. The first installment will be due when the tax liability would have been due had the election not been made.[9] Even if this option is chosen, the upfront distribution of these earnings will be tax-free to the U.S. shareholder and will not accelerate the tax liability.

This installment tax liability will be accelerated and the remaining payments will become due in the following circumstances: the U.S. shareholder's failure to pay an installment tax payment; a liquidation or sale of substantially all of the assets of the U.S. shareholder, a cessation of business by the U.S. shareholder or any similar circumstance. The acceleration of the tax liability in the case of the sale of all or substantially all of the assets can be avoided if the buyer enters into an agreement with the IRS under which the buyer is liable for the remaining installments due as if the buyer were the U.S. shareholder.

In general, the distribution by a foreign subsidiary of its earnings to its U.S. shareholder should not give rise to U.S. income tax (whether that distribution is made out of previously taxed income as under prior law or out of untaxed earnings).

Observations

- A source of acquisition funding can be the repatriation of earnings from foreign subsidiaries of the U.S. shareholder.
- This low-taxed income will soak up the U.S. shareholder's NOLs, if any, unless an election is made not to apply the NOLs against this income. Foreign tax credits (in modified form) may be available to offset the U.S. income taxes on this income.
- It appears that a foreign subsidiary's pre-1987 untaxed earnings, if any, can be distributed tax-free to its U.S. shareholder and the Repatriation Tax will not apply to these earnings.
- Depending upon the size of the foreign subsidiaries, extensive due diligence may be necessary for the buyer, confirming:
  - If deferral of the payment of the tax liability was chosen, that the election was properly made;
  - That the amount of post-1986 earnings subject to the Repatriation Tax was properly computed; and
  - That the allocation between cash/cash equivalent assets and non-cash assets was proper.
- Tax indemnity issues pose a challenge for the buyer where the installment payment election has been made because substantial tax liability may arise many years down the road based on incorrect positions taken when the election was made. A key question—Who assumes that risk?

Reduction in the "Loss Shield"

Changes to NOL rules—For NOLs arising in taxable years beginning after Dec. 31, 2017, such NOLs can be carried over to subsequent taxable years, but will be usable only up to the lesser of the available NOL carryover and 80 percent of the taxpayer's taxable income in such subsequent taxable year (without regard to any NOL deductions). In addition, for NOLs arising in taxable years ending after December 31, 2017, such NOLs cannot be carried back and now can be carried forward indefinitely. Under the law in effect prior to the Tax Act, NOLs could be carried back two years and could be carried forward 20 years. (Special rules apply to losses attributable to farming businesses, and to insurance companies.)

Observations

- Old rules continue to apply to NOLs arising in taxable years that are not covered by the effective date provisions.
- Many private companies incur net operating losses in the short period prior to closing (by virtue of option exercises, option cancellation payments, other compensatory payments and other deal related expenses) and have carried these losses back to obtain tax refunds in the past. This monetization of tax benefits will no longer be available (except for estimated tax payments made for the short period) and should have the effect of intensifying the negotiation between sellers and purchasers over the compensation to sellers for the purchasers' future use of these tax benefits.

Limitation on "Excess Business Loss" Deductions by Non-Corporate Taxpayers—Taxpayers other than C corporations cannot deduct their excess business losses against other income in taxable years beginning after December 31, 2017 and before January 1, 2026. These losses will be treated as NOLs that may be carried forward to subsequent years to offset excess business income. An "excess business loss" is the excess of a taxpayer's aggregate deductions attributable to the taxpayer's businesses over the sum of the taxpayer's aggregate gross income attributable to the taxpayer's business plus $250,000 for single filers and $500,000 for joint filers (indexed for inflation). In the case of a partnership or S corporation, the limitation is applied at the partner or shareholder level.

Observation

- With the adoption of the "passive loss" rules in 1986, it is unclear whether this new limitation will have any material impact on M&A transactions.

Cut-Back of Tax-Free "Like Kind" Exchanges—The utilization of tax-free like kind exchanges is restricted to real property that is not held primarily for sale generally for exchanges completed after December 31, 2017.

Observation

- In the past, like kind exchanges had been used in sports industry and media deals. This option will no longer be available.

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