The new tax legislation: Impact on M&A

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On December 22, 2017, President Trump signed into law H.R. 1 (the Act), previously known as the Tax Cuts and Jobs Act. The Act marks the most significant change to the U.S. federal income tax system since the Tax Reform Act of 1986.

In just the last few months, the Act has had a significant effect on the amount, type, structure, and modeling of M&A transactions. Mergers and acquisitions announced in the first two months of 2018 are at the highest dollar volume since the first two months of 2000, according to the Wall Street Journal.[1] CEOs have voiced their opinions that tax reform is creating a better deal environment. In an interview, Johnson & Johnson CEO Dominic Caruso said that the new tax law provides "more flexibility and ease of analysis in terms of getting a transaction done."[2]

This article highlights certain provisions of the Act and their impact on M&A transactions.

Is selling assets becoming less costly? Sell vs. spin

The structure of the divestiture of a line of business can be influenced by tax consequences.

Prior to the Act, the tax cost for a corporation to sell a business or business assets was 35 percent of the gain recognized (plus any state and local taxes). Therefore, many corporations preferred tax-free transactions, such as spin-offs, to achieve their goal of separating business lines. The Act reduced the corporate tax rate to 21 percent, which may encourage businesses to sell unwanted businesses and raise cash, rather than spin off an unwanted line of business. In addition, the ability to expense currently, rather than capitalize, certain capital expenditures can enable a business to sell assets and potentially offset the gain with current deductions. For example, assume that Corporation X has a subsidiary, Company Y, that it wants to sell. X has a tax basis in Y of $10, and Y is worth $100. Before the Act, X would have recognized a gain on the sale of $90, and paid tax of $31.50 (ignoring state and local taxes), leaving net proceeds of $68.50 to reinvest in the remaining business or distribute to shareholders. After the Act, X would still have a gain of $90 on the sale, but the tax bill would only be $18.90 (ignoring state and local taxes), leaving $81.10 to reinvest or distribute. Expensing of capital expenditures, as discussed below, creates an additional opportunity. If the proceeds of the sale ($100) are reinvested in tangible personal property with a depreciable life of less than 20 years, the entire $100 will be currently deductible. This will result in a current tax benefit of $21. Assuming that X otherwise has positive taxable income, the sale of Y will result in a net tax savings of $2.10 (i.e., $21 tax benefit less $18.90 tax cost).

[1] "Tax Cuts Fuel Biggest Merger Spree Since 2000," The Wall Street Journal, March 6, 2018.
[2] "Big Pharma CEOs Speak About Impact of Tax Reform on M&A," Zacks.com, January 11, 2018.

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Capex expensing – Accelerated tax deductions

As discussed in the previous example, the Act allows a corporation to currently deduct, rather than depreciate over time, the cost of tangible personal property that would otherwise have a depreciable life of less than 20 years, which generally includes most machines, automobiles, trucks, and airplanes.

This applies to assets purchased and placed in service from September 27, 2017, until December 31, 2022. After December 31, 2022, this acceleration of depreciation decreases annually by 20 percent until it is eliminated in 2027. The ability to expense applies to new assets and also to assets that were previously owned, if they are newly acquired by the taxpayer. This can significantly increase the tax benefit of purchasing certain equipment for use in a trade or business. For example, assume that in 2018 Corporation X wants to buy a business that is a subsidiary of Big Co, a corporate conglomerate. X agrees to purchase the assets of the business for $100. The business consists of $10 of working capital, $50 of machines, and $40 of goodwill.

Following the closing of the acquisition, X can take a current deduction of $50, reflecting the purchase price of the acquired machines. As a consequence of this ability to expense the acquisition of tangible assets, purchasers may seek to structure transactions as asset acquisitions (or deemed asset acquisitions, such as 338(h)(10) elections).

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Limitations on the deductibility of interest

The Act limits the ability of a borrower to deduct net interest expense in excess of 30 percent of "adjusted taxable income." Adjusted taxable income is generally defined, under the Act, as taxable income, with interest, depreciation, and amortization added back (i.e., similar to EBITDA). After 2021, only interest will be added back to the definition of adjusted taxable income (i.e., similar to EBIT). Adjusted taxable income is based on taxable income, not GAAP or book income, and therefore for this purpose EBITDA and EBIT are tax, not GAAP, numbers.

Disallowed interest expense is carried forward indefinitely and may be used in future years to the extent that net interest expense does not exceed 30 percent of adjusted taxable income. If a company undergoes a change of control while it has disallowed interest expense, the ability to use these amounts following the change of control will be limited in a manner similar to the way net operating loss deductions are currently limited following a change of control. The following example illustrates the potential impact of this provision of the Act:

> In the first year, Company A would have $50 of taxable income if its interest expense were fully deductible. It has $30 of net interest expense and $5 of depreciation and amortization, in each case for tax, not book, purposes. Adjusted taxable income is therefore $85, of which 30 percent is $25.50. Therefore, Company A can only deduct $25.50 of its net interest expense, and $4.50 is deferred. In the second-year, Company A would have $100 of taxable income if its second year interest expense were fully deductible, $30 of net interest expense, and $5 of depreciation and amortization for tax purposes. Adjusted taxable income is $135, of which 30 percent is $40.50. Therefore, all of Company A's current net interest expense and the prior year's deferred interest expense of $4.50 may be deducted in the second year.

Based on current interest rate levels and levels of leverage (say approximately 5x leverage with a blended debt cost of approximately 6 percent), this limitation may not affect certain companies or buyouts. The effect may be felt more at companies with higher leverage levels, or if interest rates rise. It may also lead corporations to shift debt to non-U.S. jurisdictions to maintain interest deductibility on a global basis.

Understanding the limitation on the deductibility of interest under the Act is an important part of modeling the cash flows of a target company. The deduction for interest (as well as depreciation for capital expenses) can be very different for GAAP and tax purposes under the Act, and should be modeled accordingly.

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Repatriation tax

The new international tax regime created by the Act taxes historical tax-deferred offshore earnings at reduced rates and allows future offshore earnings to be repatriated tax free. This should generally increase the amount of corporate cash available for M&A transactions.

The Act generally requires that 10-percent U.S. shareholders of a controlled foreign corporation (CFC) and of certain other foreign corporations include in income their pro rata portion of the foreign corporation's earnings and profits as of November 2, 2017, or December 31, 2017, whichever is greater. This income inclusion is required whether or not any dividends are actually distributed to the U.S. shareholder. A CFC is generally a foreign corporation that is more than 50 percent owned by 10-percent U.S. shareholders.

For corporations, the rate of tax is effectively 15.5 percent to the extent of liquid assets held overseas and 8 percent on the remainder. The taxpayer can generally elect to pay this tax over eight years. For example, assume Company X, a Delaware corporation that is a calendar year taxpayer, owns 80 percent of the stock of Company Y, a foreign corporation that also has a calendar taxable year. Company Y has been in operation for 20 years, and has $100 of earnings and profits (roughly retained earnings). As of the end of 2017, Company Y had $50 of cash reserves, and had spent $50 on capex that can be roughly traced to the $100 of earnings and profits. Assume also that Company Y's average cash position for its two prior taxable years was not greater than $50 (because the Act includes a lookback rule that can increase a foreign corporation's cash amount in certain cases). Company X will have to include in income $80 for 2017 (80 percent of $100), whether or not it receives a dividend from Company Y. Of this $80, half will be taxed at 15.5 percent, and $40 will be taxed at 8 percent (it is also possible that the tax liability may be reduced by credits for a portion of the foreign taxes paid by Company Y). Company X can elect to pay this tax over eight years.

For M&A purposes, an acquirer of Company X would first want to confirm that Company Y properly calculated its earnings and profits, and therefore that the tax bill due as calculated by Company X was correct. Second, after confirming that the amount of the tax bill was properly calculated, a buyer of Company X would want to make sure that its purchase price factored in that Company X will be paying this tax over time—this is a liability of Company X like any other liability that is paid out over time.

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Participation exemption

Future earnings of foreign subsidiaries can be repatriated as dividends to U.S. corporate shareholders free from U.S. tax.

To qualify for this tax exemption, the U.S. corporate shareholder must own at least 10 percent of the stock of the foreign subsidiary for at least one year prior to the dividend being paid. Note that the country of formation of the foreign subsidiary may charge a withholding tax on payment of the dividend, but the U.S. tax cost of up to 35 percent that applied to such payments prior to the Act will no longer apply. Instead, the U.S. corporate shareholder would generally receive a dividends received deduction to offset the dividend income. The participation exemption does not apply to dividends from certain special categories of foreign corporations, such as passive foreign investment companies that are not also CFCs.

For a U.S. acquirer of a non-U.S. business, or an acquirer of a U.S. business with significant foreign operations, the ability to repatriate foreign earnings to the U.S. without paying significant taxes has often been a structuring challenge. With the participation exemption, acquirers can model for intercompany cross-border cash flows in a more tax-efficient manner than in the past, and potentially without significant tax structuring.

As a result of the repatriation tax and the participation exemption, according to a Goldman Sachs report, approximately $250 billion (approximately 25 percent of estimated overseas earnings) could come back to the United States in 2018. Since stock prices remain high despite recent volatility, less of the repatriated cash may be used for share buybacks and arguably more could go toward investing. A portion could go towards organic investments that take advantage of the accelerated capex tax deduction—and a portion is expected to be used to drive M&A activity. (Some corporations have also announced employee pay increases, one-time employee bonuses, and/or increased 401K and pension contributions in response to the tax law.)

According to a Goldman Sachs report, the technology and healthcare sectors account for the vast majority (approximately 85 percent) of total S&P 500 untaxed cash currently held overseas. Data for the first few months of 2018 confirms that technology companies will be active deal-makers; technology companies were the most active in terms of both value and volume, according to Thomson-Reuters.

The Act also included various other complex international provisions. Among these are a provision taxing 10-percent U.S. shareholders of CFCs annually on their share of the earnings of the CFCs above a specified rate of return on their tangible depreciable assets regardless of whether those earnings are distributed (although for corporate U.S. shareholders the tax is at a reduced rate), and an anti-base- erosion minimum tax focused on large U.S. corporations that make significant deductible payments to foreign affiliates.

These international provisions may cause companies to re-evaluate their overseas holdings, supply chain arrangements, and arrangements with foreign affiliates. As part of this strategic evaluation, companies may decide not only to reorganize parts of their businesses, but also to consider acquisitions to improve their global competitiveness. The impact of these provisions also should be taken into account in evaluating potential acquisitions of target companies with foreign subsidiaries or operations.

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Conclusion

The provisions discussed above are a small, but significant, part of the Act that directly affect M&A transactions. The administration's focus on deregulation, coupled with the new tax laws, and healthy growth rates indicate that M&A activity will remain robust in the near future.

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