

Tax Reform's Impact on Private Equity and M&A

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Introduction

On December 22, 2017, the President signed the bill formerly known as the Tax Cuts and Jobs Act (the "Act"). The Act has far-ranging implications for domestic and multinational businesses. The headline reforms are a large cut in the corporate tax rate from 35% to 21% and a shift from an international tax system where tax on overseas profits is deferred until the profits are repatriated to a modified territorial system in which overseas profits are not subject to U.S. federal income tax when repatriated. The Act also contains a new deduction for individual owners of pass-through entities that effectively lowers the tax rate for owners of certain businesses that operate in pass-through form, such as LLCs treated as partnerships for tax purposes. Other new tax breaks include the ability for taxpayers to deduct up to 100% of capital expenditures made to acquire tangible, depreciable property in the year of the expenditure.

As widely reported, in order to satisfy Senate rules relating to increases in the budget deficit, there are a number of provisions in the Act that are intended to raise revenue. Many of these provisions will have a particular impact on the private equity industry and on M&A activity in general. These include a new three-year holding period to be eligible for long-term capital gains treatment with respect to carried interests, a new limitation on the deductibility of interest, the repeal of the ability to carryback net operating losses (and a limitation on the use of net operating loss carryforwards), and a minimum tax on large corporations making deductible payment to affiliates.

Set forth below is a high-level analysis of the portions of the Act that have particular relevance to the private equity industry and to M&A activity more generally.

Reduction in the Corporate Tax Rate

Under the Act, the highest corporate tax rate is reduced from 35% to 21%. The corporate alternative minimum tax has been repealed. These changes are effective for a corporation's first taxable year beginning after December 31, 2017 (with a "blended" rate applying for the tax year of a fiscal year corporation that includes December 31, 2017).

The lower corporate tax rate has several implications for M&A activity. For example, disposing of unwanted assets in the context of a corporate acquisition will become less expensive because the resulting corporate tax will be lower. On the other hand, a lower tax rate means that any tax attributes of a target corporation (including tax attributes resulting from transaction-related deductions accrued at closing such as option cancellation payments and bankers' fees) will be less valuable. See "Net Operating Losses" below for additional implications of the Act on tax attributes.

The lower tax rate also reduces (but does not eliminate) the value to a corporate buyer of structuring an acquisition so that the tax basis of the target's assets is stepped-up. This effect on "step-up" transactions may be partially offset by the immediate expensing allowed for certain capital expenditures discussed below under "Expensing," at least for the next five years. Whether these provisions provide a net increase or net decrease in the benefit of a step-up transaction to a buyer (compared to current law) will depend on the particular facts and circumstances of the transaction.

Under Section 1202, gross income does not include gain from the sale or exchange of "qualified business stock" held more than five years. Thus, no federal income tax is paid on the sale of qualified business stock held for more than five years. Qualified business stock generally includes stock of a C corporation acquired by the taxpayer at its original issue if the gross assets of the corporation are below a certain threshold, the corporation engages in a qualified trade or business (as specially defined), and certain other requirements are satisfied. The Act does not modify Section 1202. Thus, the combination of the reduced corporate tax rate for C corporations under the Act and the exclusion of gain on the sale of stock under Section 1202 may make Section 1202 especially beneficial where its requirements can be satisfied.

Special Pass-Thru Deduction

The Act provides for a maximum 20% deduction for non-corporate owners of pass-through entities on the qualified business income allocated to them from the entity (the "pass-through deduction"). The deduction does not apply to entities in certain types of service businesses or to investment management businesses. The deduction is therefore not available with respect to management fees earned by the investment manager of a private equity fund. It is, however, available with respect to the income earned by non-corporate taxpayers through a fund's portfolio companies that are owned in pass-through form.

The pass-through deduction available for an individual owner with respect to each eligible pass-through business is capped at the greater of (i) 50% of the individual's share of the W-2 wages paid by the business to employees and (ii) 25% of such W-2 wages plus 2.5% of the unadjusted cost basis of the business's "qualified property" (generally depreciable assets used in the business). This cap does not apply to taxpayers below certain income thresholds. In addition, there are special rules for REIT dividends but not for income from other real estate investments. Finally, an individual's total pass-through deduction is capped at 20% of the excess of the taxpayer's taxable income for the year over the taxpayer's net capital gain for the year.

The pass-through deduction will lower the effective tax rate for individuals on income earned through most private equity portfolio companies that operate in pass-through form, such as LLCs taxed as partnerships. Because the pass-through deduction is capped based on W-2 wages paid by the portfolio company, it will be important to structure compensation arrangements in a manner that qualifies as W-2 wages, rather than through independent contractor or guaranteed payment relationships.

The pass-through deduction applies at the partner level. Thus, existing tax distribution provisions in the operating agreements of limited liability companies and partnerships generally will not account for the deduction. Therefore, such provisions would need to be amended if it is desired that tax distributions take the deduction into account.

We believe that, although the Act significantly lowers the corporate tax rate, the Act generally will not impact the decision to operate portfolio companies as pass-throughs, where possible (with blocker corporations where necessary). This is because the pass-through deduction, along with traditional factors such as one layer of tax and the ability to structure an exit in a manner that gives the buyer the benefit of a tax basis step-up on the company's assets, would seem to still be more valuable than the lower corporate tax rate. In addition, if a future administration were to increase the corporate rate, the cost of converting to a flow-through could be prohibitive. It also should be

noted, however, that other factors will have to be considered in making these decisions, including the virtual elimination of the state and local tax deduction for individuals (but not corporations) and the different rules for corporations and flow-throughs contained in the international tax provisions, where relevant. In addition, future guidance on the application of the pass-through deduction may further alter the analysis of whether to own a business in pass-through or corporate form.

Carried Interests

The Act increases the holding period of assets to three years, up from one year, before a taxpayer would be eligible for the application of long-term capital gain rates with respect to gain attributable to certain partnership interests. Such partnership interests would include partnership interests received in connection with the performance of substantial services in a trade or business relating to (i) raising or returning capital and (ii) either investing in (or disposing of) certain securities, commodities, real estate, cash or cash equivalents, or derivatives or developing such assets. There are no grandfathering provisions for current investments.

The three-year holding period would apply to traditional carried interests in private equity funds as well as fund interests acquired through management fee waivers. It would not apply with respect to a sponsor's actual cash investment into a fund. Although several questions remain regarding the application of the Act's carried interest provision, it clearly establishes a framework where the long-term holding period relevant for investors is different than for sponsors, a situation that has never before existed.

Interest Deductibility

Under current law, business interest is generally allowed as a deduction in the taxable year in which it is paid or accrued, subject to a number of limitations. These limitations mostly apply to interest paid to related parties (for example, under the earnings stripping rules) and to certain high-yield debt instruments (so-called AHYDOs). In many cases, the current limitations on interest deductibility are either completely inapplicable or of little significance.

Under the Act, for taxable years beginning after December 31, 2017, the current earnings stripping rules would be repealed, and under an amended Code Section 163(j), every business (other than certain small businesses with average gross receipts of \$25 million or less) would be subject to a disallowance of a deduction for net interest expense in excess of 30% of the sum of a business's adjusted taxable income (computed without regard to any item of income, gain, deduction, or loss not properly allocable to a trade or business, deductions for interest, net operating loss deductions, and, for taxable years beginning before January 1, 2022, depreciation, amortization, and depletion). Any disallowed interest expense under this provision can be carried forward indefinitely. In the case of pass-through entities such as LLCs taxed as partnerships, the 30% limitation generally is applied at the entity level.

Essentially, the interest deductions that businesses will be able to take under the Act will be limited to 30% of EBITDA through 2021 and 30% of EBIT thereafter. This limitation may impact the mix of debt and equity used in leveraged buyouts and the most efficient capitalization of businesses in general. For example, subordinated debt currently used in leveraged acquisitions may be replaced by preferred equity in some cases. From a purely tax perspective, debt will be much less favorable than preferred equity in the partnership context. Of course, non-tax factors will continue to be important in capitalization decisions, but the tax advantage of debt may not be as important of a factor for businesses going forward.

Net Operating Losses

Under current law, net operating losses (NOLs) could be carried back for two years and carried forward for 20 years. Under the Act, NOLs arising in tax years ending after December 31, 2017 generally cannot be carried back, but can be carried forward indefinitely. In addition, the maximum amount of the deduction for a net operating loss carryforward would be limited to 80% of a taxpayer's taxable income (determined without regard to the net operating loss deduction), effective with respect to tax years beginning after December 31, 2017.

As discussed above in the context of the lower corporate tax rate, corporate NOLs will have less value in a lower tax rate environment. It is common for an M&A transaction to generate extraordinary tax deductions that create an NOL for the target corporation's year that ends on the closing date, which previously could be carried back to receive refunds of prior year income taxes.¹ Selling shareholders frequently are compensated for the tax benefit to the target corporation arising from the NOL generated by these transaction-related deductions, either through an increase in the purchase price paid at closing or through post-closing payments as the tax benefits produce tax savings for the buyer (whether in the form of tax refunds or credits against taxes). The Act may change the dynamic of these negotiations because the resulting NOL of the target corporation will no longer be able to be carried back to obtain quick tax refunds from the IRS. Moreover, the 80% of taxable income limitation on the use of NOL carryforwards will further delay their full utilization. These changes may impact how, and whether, sellers get compensated for tax benefits arising from transaction-related tax deductions.

Expensing

For the next five years, the Act provides an immediate deduction for 100% of the cost of "qualified property" placed in service by a taxpayer. Qualified property generally includes any tangible property with a depreciable life of 20 years or less as well as computer software. Unlike the current "bonus" depreciation rules, the immediate deduction is available not only for new property but also used property acquired from an unrelated taxpayer. After the five years of immediate expensing under this provision, there is a gradual 20% per year phase-out. Finally, in the case of a taxpayer's first tax year ending after September 27, 2017, a taxpayer may elect to use a 50%-expensing rate in lieu of the 100% deduction available. This election may be beneficial if full expensing would create an NOL carryforward subject to the 80% of taxable income limitation discussed above.

The expensing provisions of the Act will benefit a buyer in an M&A transaction that is able to structure its acquisition in a way to obtain a step-up in the tax basis of assets, particularly where the target owns a large amount of capital assets. It also will incentivize buyers to allocate a larger percentage of purchase price to qualified property, which will likely be inconsistent with the seller's goals. The amount of purchase price allocable to tangible assets will be fully deductible in the first year after the closing, immediately increasing the target's cash flow. Immediate expensing in the right circumstances, therefore, may mitigate any negative effect on cash flow of the limitations on interest deductibility and use of NOLs discussed above.

Repatriation of Existing Earnings and a Modified Territorial International Tax System

In connection with the transition to a territorial system, the Act imposes a one-time tax on a deemed repatriation of foreign earnings. Any 10% U.S. shareholder of a foreign corporation is required to include in income the earnings and profits of the foreign corporation (as of November 2, 2017 and December 31, 2017, whichever is higher). Importantly, although many of the benefits of the new territorial system apply only to corporate taxpayers, the deemed repatriation tax applies to all taxpayers, not just corporations. The earnings and profits are taxed at a 15.5% rate to the extent invested in cash or cash equivalents and an 8% rate to the extent invested in other assets. The one-time inclusion is with respect to the last taxable year of the foreign corporation beginning before January 1, 2018 (i.e., the 2017 tax year for a calendar year taxable year). Foreign tax credits may be available to mitigate the resulting tax liability.

Importantly, the U.S. shareholder may elect to pay the resulting tax in eight back-loaded annual installments: the first five installments are equal to 8% of the resulting tax liability, the sixth installment is equal to 15%, the seventh installment is equal to 20% and the eighth installment is equal to the remaining 25% of the resulting tax liability. There is no interest charge or other penalty for making such election. If a taxpayer makes such election, there are limited circumstances in which the tax installments would be accelerated, such as upon a liquidation or bankruptcy of the taxpayer, but there is no acceleration upon a change in control.

There are two significant implications of the deemed repatriation tax to the M&A market. First, cash held by low-taxed foreign subsidiaries of U.S. target corporations previously was “trapped” offshore, as there was a material U.S. tax cost to repatriating the cash. Since acquisition debt is usually in the United States, this frequently would create a mismatch between where cash was located and where it was needed. Because of the deemed repatriation under the Act (and the territorial tax system discussed below), it will be possible to repatriate all offshore cash without further tax cost.

Second, the ability to pay the repatriation tax in installments must be taken into account in M&A negotiations where a U.S. target has (or had) foreign subsidiaries. This is because although the inclusion would be in a pre-closing tax year, tax associated with that inclusion will be payable in post-closing tax years (at least for the next eight years), particularly given how the installments are back-loaded. Buyers and sellers will have to negotiate who bears this liability or how it is to be shared between the parties.

The deemed repatriation tax transitions the international tax system into a territorial one in which dividends paid by a foreign subsidiary to its U.S. parent are 100% deductible by the U.S. parent corporation. Curiously, the Act did not repeal Code Section 956, so we do not anticipate widespread revisions to collateral and pledge provisions of credit agreements, despite the new dividend exclusion.

The Act’s territorial system is not a complete one, however. To deter domestic corporations from further shifting profits to their foreign subsidiaries, the Act contains a tax on what is labelled “global intangible low-taxed income” or GILTI. A U.S. parent will be currently taxed at a 10.5% rate on the income of a foreign subsidiary that is above a 10% annual return on the tax basis of its tangible assets. Foreign tax credits may be available to reduce or eliminate the U.S. tax liability. The Act also contains a special deduction for foreign-derived intangible income of a domestic corporation, so that income from intangibles held in the United States effectively is taxed at the 10.5% GILTI rate.

Just as the tax on historic offshore earnings is making the repatriation of those earnings possible, the Act’s modified territorial system allows for future foreign earnings of foreign subsidiaries to be repatriated to their U.S. corporate parents without further U.S. tax, again allowing for more flexibility in using cash domestically, including to pay down acquisition debt or make immediately deductible capital expenditures (or for share buybacks). The GILTI tax encourages taxpayers to structure an acquisition in a manner that achieves a tax basis step-up, which is typically achievable in the foreign context (e.g., by making a Code Section 338(g) election). If an acquisition can be structured in such a manner, the tax basis in tangible assets will be stepped up, which will increase the foreign subsidiary’s permissible return that is not subject to the GILTI tax.

The Act constitutes a comprehensive reform of the U.S. tax system as it relates to businesses. The summary above highlights provisions that we believe will have the most significant impact on the private equity industry and M&A activity generally, but is not meant to be exhaustive. For example, the Act overturned a recent case that had held, contrary to an IRS published ruling, that a foreign partner’s gain from the sale of an interest in a partnership engaged in a U.S. business was not subject to U.S. federal income tax. In addition, buyers of interests in partnerships engaged in a U.S. business from foreign sellers will be required to withhold 10% of the purchase price. These provisions will be of particular importance to buyers and sellers of private equity fund interests in secondary market transactions. The Act also contains numerous provisions that further deter “inversion” transactions, including a minimum tax on so-called base erosion payments to foreign affiliates.

Further Treasury Department and IRS guidance will be required to provide clarity where uncertainties exist in certain provisions of the Act, and we will continue to monitor and provide updates on key developments. What is clear is that each transaction will require careful planning in order to optimize tax efficiencies, and avoid pitfalls, in the new tax system ushered in by the Act.

¹ For example, payments to option holders and 70% of bankers’ fees are generally deductible, and can be significant.

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