GODFREY KAHN S.C.

Tax Flash

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Jim Phillips
414.287.9522
jphillips@gklaw.com

Kieran Coe
414.287.9453
kcoe@gklaw.com

Important changes in the Tax Cuts and Jobs Act that may affect M&A transactions

At the end of 2017, the President signed into law the Tax Cuts and Job Act (Act), with many provisions effective for tax years beginning after Dec. 31, 2017. Below is a brief summary of a number of provisions that may affect the structure, financing and agreements related to M&A transactions:

Tax rate and certain deduction changes

- **Corporate rates.** The Act changes the federal income tax rate applicable to C corporations to a flat rate of 21 percent (down from a maximum of 35 percent), effective for taxable years beginning after Dec. 31, 2017 (with fiscal year taxpayers straddling Dec. 31 generally receiving a blended rate).

- **Individual rates.** The Act changes the maximum individual income tax rate on ordinary income from 39.6 percent to 37 percent. The maximum income tax rate on long-term capital gain and qualified dividends remains unchanged at 20 percent and the net investment income (NII) tax rate remains unchanged at 3.8 percent. The section 1202 exclusion of 100 percent of the gain on the sale of qualified small business stock (among other requirements, C corporation stock) held for more than five years remains unchanged.

- **Individual deductions.** Itemized deductions for state and local taxes for individuals are now limited to $10,000 in combined income and property taxes for tax years 2018 through 2025, provided that the deduction for state and local taxes incurred in carrying on a trade or business or for the production of income is retained (such as business taxes imposed on pass-through entities and taxes on Schedules C and E).

- **Pass-through business rate.** The Act provides for a deduction of up to 20 percent of "qualified business income" earned through partnerships, S corporations and sole proprietorships (including single member LLCs). There are a number of special rules and limitations. This deduction is not available for capital gains, dividends and interest (other than interest allocable to a trade or business). Owners of certain service businesses are subject to phase-out rules, and the deduction can be limited to a percentage of wages and depreciable property. This deduction can result in an effective marginal income tax rate of 29.6 percent on qualifying income (plus the 3.8 percent NII if applicable).

- **Choice of entity.** The new lower corporate income tax rate and the continued deductibility of state income taxes by C corporations but not flow-through entities will require more analysis of the preferable way to conduct business operations and structures transactions. The lower corporate rate permits businesses to grow their equity and pay down debt at a faster rate. In many circumstances the ability to avoid the higher shareholder rate applicable to a pass-through, the benefit of shareholders not being involved in corporate tax planning and compliance, the ability to capture net operating losses at the corporate level for carryforward, the potential for the 1202 capital gain exclusion upon a stock sale, the new foreign tax regime, the decrease in the value of a step up in asset basis upon a sale due to the lower corporate income tax rate, the deductibility of state taxes, and others, will make C corporations more desirable. On the other hand, if a business is likely to produce high cash flow to the owners on a current basis, or a sale is likely to be structured for tax purposes as an asset sale in the not too distant future, pass-through structures may continue to be preferable, although potentially more costly in the short run.

- **Blocker entities.** The new lower corporate income tax rate may make blocker entities much more common in a variety of situations.
- **Valuation.** The change in the income tax rates could result in a change in the value of a variety of assets, but how it will affect transactions is unclear. Some changes could increase value (larger after-tax cash flow due to lower rates), but some changes could decrease value (a reduction in value of tax assets). For example, the value of a step up in basis upon a transaction structured as an asset purchase for tax purposes is worth less with lower income tax rates.

Interest deduction limitations

In general, net business interest expense deductions will be limited to 30 percent of "adjusted taxable income," plus business interest income. ATI is initially related to EBIDTA, but after 2022 be will more closely related to EBIT. The amount of interest not allowed as a deduction for a year is treated as paid in the succeeding year, subject to that year's limitation.

- **Adjusted taxable income.** ATI means the taxable income of the taxpayer computed without regard to any item of income, gain, deduction, or loss which is not properly allocable to a trade or business and by adding back (1) any business interest expense or business interest income, (2) the amount of any net operating loss deduction, (3) the 20 percent deduction for pass-through income, and (4) for taxable years beginning before Jan. 1, 2022, any deduction allowable for depreciation, amortization, or depletion.
- **Exceptions.** The interest expense limitation does not apply in certain cases, including taxpayers whose average annual gross receipts for the three tax year period ending with the prior tax period do not exceed $25 million, and electing real estate activities for which the taxpayer must then use a longer depreciation life.
- **Flow-throughs.** In the case of partnerships and S corporations the limitation is computed at the entity level, with rules that limit carryovers to offsetting only the income of that entity.
- **Debt versus equity.** The lower corporate rate tax, which reduces the benefit of interest deductions, combined with the potential for deferral of interest deductions and the more favorable individual income tax rate for dividends, is designed to decrease the benefit of debt compared to equity, and in certain cases may lead to less leverage.

Corporate alternative minimum tax and net operating losses

The Act repeals the corporate AMT, effective for tax years beginning after Dec. 31, 2017, but puts in place new limitations on NOLs. The Act eliminates NOL carrybacks but allows indefinite carryforwards. NOL deductions can only offset up to 80 percent of taxable income.

- The NOL limitation somewhat offsets the benefit of the repeal of the AMT for those taxpayers that generate a loss in a taxable year, resulting in a minimum tax of 4.2 percent of taxable income before the NOL. Under the AMT an NOL carryover could only offset 90 percent of taxable income, resulting in a minimum tax of 2 percent.
- The inability to carry back a loss means NOLs arising from a transaction, such as extraordinary compensation payments or other transaction-related items, can no longer be carried back to produce a tax benefit for the seller. A carry back of these extraordinary expenses could in the appropriate case generate a sizable refund. And, the

inability to carry back a loss of a target company to offset pre-closing tax liabilities may change the structure of tax indemnities.

Full expensing of certain property

The Act provides for a deduction of the entire cost of certain property placed in service after Sept. 7, 2017, and before Jan. 1, 2023. Thereafter the percentage immediately deductible is phased down over five years. The Act applies to not only new tangible personal property, but also used property and computer software.

- Thus, a purchaser in an acquisition structured as an asset sale for tax purposes (whether direct purchase, forward merger or sections 336 or 338 elections) could purchase tangible personal property at its tax basis and immediatly expense the cost rather than step into the shoes of the seller and inherit the depreciation deductions that would otherwise could have been spread over seven years. Anti-churning rules will apply for certain acquisitions from related parties.

- While asset sale treatment acquisitions will still most likely be driven by purchase prices in excess of tax basis giving rise to increased intangible amortization and fixed asset depreciation, the ability to accelerate the cost of used property due to 100 percent expensing will produce some new and interesting negotiations for sellers and purchasers. The interplay of the 100 percent expensing and NOL and interest limitations for the purchaser, and recapture and tax cost for the seller, will require careful modeling of transactions.

Carried interest

The Act changes the long-term capital gain holding period from one to three years with respect to a carried interest in a business investing in securities or developing real estate held for rental or investment. Partnership interests issued prior to Dec. 31, 2017, are not grandfathered.

- The new provision generally won't apply to management arrangements in operating businesses but will apply to most investment fund partners. The change could influence manager preferences as to timing or structure of a variety of private equity transactions. Interestingly, value removal through a qualified dividend within the three-year period does not appear to be subject to the longer holding period.

Sale of US partnership interest by foreign partner

A foreign person's gain on sales after Nov. 27, 2017, of interests in a partnership engaged in a U.S. trade or business will be taxed as effectively connected income up to the extent a sale of assets would have been so treated, requiring the selling partner to pay U.S. tax on the sale. Sales of such partnership interests after Dec. 31, 2017, will be subject to withholding unless the seller provides an affidavit stating that the seller is a U.S. person. If the purchaser fails to withhold, the partnership is required to withhold from the transferee's distributions the amount the transferee should have withheld.

- Initially, the IRS has delayed the effective date for the withholding for administrative reasons for publicly traded partnerships. The IRS has requested comments on the rules to be issued under the withholding requirement to, among other things, determine how liabilities of the partnership affect the amount realized.

- Much like FIRPTA certificates in the case of the sale of U.S. real property or U.S. real property holding corporations, affidavits will likely become the norm in a sale of a partnership interest.

International taxation

There are significant changes to the taxation of international activity that will require taking a new look at the structure of domestic and foreign operations, and a full explanation is beyond the scope of this summary. There are international clawbacks that tax undistributed foreign earnings and minimize the benefit of offshore deferral, significant reductions in the utility of foreign tax credits, and a base erosion system that effectively amounts to a minimum tax on interest, royalties and other deductible payments to 25 percent or more related foreign payees. M&A transactions often present an opportunity to reorganize international operations in a more tax efficient manner.

The foregoing is a summary and is not tax advice directed at any particular situation. The specific statutory provisions and tax advisors should be consulted before taking any particular action.

Tax Practice Group Members

MADISON OFFICE:

Robert Chritton
rchritton@gklaw.com

Jed Roher
jroher@gklaw.com

MILWAUKEE OFFICE:

Daniel Barnes
dbarnes@gklaw.com

Kieran Coe
kcoe@gklaw.com

John Donahue
jdonahue@gklaw.com

Hanna Hinnawi
hhinnawi@gklaw.com

Lecia Johnson
ljohnson@gklaw.com

Debra Sadow Koenig
dkoenig@gklaw.com

Richard Marcus
rmarcus@gklaw.com

Sarah McNally
smcnally@gklaw.com

Doug Patch
dpatch@gklaw.com

Jim Phillips
jphillips@gklaw.com

Tim Smith
tcsmith@gklaw.com