Client Alert

January 18, 2018

Tax Reform: Key Considerations for M&A, Private Equity & Venture Capital Transactions

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Act").[1] The Act was ostensibly promoted as a means to encourage investment and to promote growth in the U.S. economy, while reducing harmful "loopholes" and potential incentives to move profitable business operations offshore. Although the actual economic impact remains to be seen, there is no question that the Act dramatically alters the federal government's historical approach to both domestic and international taxation in a variety of highly meaningful ways.[2] Moreover, given the relatively short time frame in which the Act was negotiated, drafted, and ultimately passed, we believe that time will reveal not only potential opportunities for tax minimization but also possible traps for the unwary.

In a previous Client Alert, we provided a general overview of the wide range of individual, business, and international changes accomplished by the Act.[3] In this Client Alert, we focus on the impact of the Act on mergers and acquisitions ("M&A"), private equity ("PE"), and venture capital ("VC") transactions. As discussed in more detail below, key changes brought about by the Act include:

- *Reduction In the Corporate Tax Rate* -- a dramatic reduction in the corporate tax rate to 21%, which will affect a variety of basic operational and transactional considerations, including choice of entity, deal structure, and related financial modeling and valuation exercises;

- *100% Asset Expensing* -- the potential for the immediate (100%) expensing of certain kinds of tangible assets, whether placed in service by the original user, or by a subsequent purchaser, which will affect capital expenditure decisions, as well as deal structure in certain circumstances;

- *Deductibility of Interest Expense* -- limitations on the deductibility of interest expense, including debt that was outstanding prior to the passage of the Act, which will affect leveraged acquisitions and general capital raising decisions;

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1 Pub. L. 115-97. The Act was originally known as the "Tax Cuts and Jobs Act," but that title was dropped on a point of order in the Senate. Although it is still commonly referred to as the Tax Cuts and Jobs Act, it is actually entitled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

2 The text of the Act, the Conference Report for the Act, our previous Client Alerts, and other tax reform resources are available on our tax reform website at: http://www.mofotaxreform.com. Our prior Client Alerts are also available on our website at: http://www.mofo.com

3 Our previous general Client Alert is available on our tax reform website, as well as on our regular website at: https://media2.mofo.com/documents/171221-us-tax-reform-bill.pdf.

- *Taxation of Previously Untaxed Foreign Earnings* -- the imposition of a one-time "deemed repatriation" tax on certain previously untaxed foreign earnings, coupled with the ability to repatriate these earnings in cash without additional U.S. tax, which may result in foreign cash pools moving back into the U.S. and fueling further domestic M&A activity (especially by strategic buyers that engage in significant overseas manufacturing activities or other foreign operations);

- *NOL Limitations* -- restrictions on the use of net operating losses ("NOLs") generated in 2018 or later tax years, and the inability to carryback these NOLs, which will generally affect the valuation and use of NOLs by buyers and sellers (including any NOLs that may be generated in connection with an acquisition as a result of extraordinary transaction expenses); and

- *Ordinary Income Treatment for Sales of Certain Self-Created Intangibles* -- the elimination of favorable capital gains treatment for certain patents and other intellectual property created by the "personal efforts" of the taxpayer.

In addition, as also discussed in more detail below, the changes created by the Act are likely to affect deal documentation, including traditional tax and financial representations, as well as due diligence processes, financial models and post-closing administrative requirements.

We have divided the remainder of this Client Alert into two Parts. Part I provides a summary overview of the key changes brought about by the Act in relation to M&A, PE, and VC activity. Part II then identifies some broader themes and potential future implications for deal professionals to consider in 2018 and beyond as deal dynamics begin to evolve in response to the Act.

I. Overview of Key Changes

A. Tax Rates

(i) Lower Corporate Tax Rate and Elimination of Corporate AMT

The Act reduces the general corporate tax rate from a maximum graduated rate of 35% to a flat rate of 21% for taxable years beginning after December 31, 2017.[4] The Act also repealed the corporate alternative minimum tax ("AMT").

With a flat corporate tax rate of 21%, the U.S. should now generally present a more competitive and attractive investment environment as compared to other major developed economies throughout the world.[5] In addition, as discussed in more detail in Part II below, the reduction in the corporate tax rate is expected to affect the way in which taxpayers structure investments, business operations, and exit events going forward.

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[4] Before the passage of the Act, the rate was 15% for taxable income up to $50,000; 25% for taxable income between $50,000 and $75,000; 34% for taxable income between $75,000 and $10,000,000; and 35% for taxable income above $10,000,000.

[5] As a point of comparison, the UK corporate tax rate is currently 19%, but is scheduled to be reduced to 17% beginning in 2020.

(ii) 29.6% Top Marginal Rate for "Qualified Business Income"

The Act gives non-corporate taxpayers a deduction from gross income equal to 20% of domestic "qualified business income" ("QBI") from a partnership, S corporation, sole proprietorship, estate, or trust, and to ordinary dividends paid from real estate investment trusts ("REITs"), and certain kinds of income derived from publicly traded partnerships ("PTPs"). In addition, for taxpayers at the highest marginal individual rate of 37% (starting at $600,000 of taxable income for joint returns), the 20% deduction effectively reduces an individual's maximum tax rate on the taxable portion of QBI to 29.6%.[6] For purposes of the QBI provision, the deduction equals 20% of the QBI amount for each qualified trade or business carried on by the taxpayer. The deduction for QBI is generally limited, however, to the greater of (i) 50% of the taxpayer's share of W-2 wages paid to employees of the qualified trade or business or (ii) the sum of 25% of W-2 wages and 2.5% of investments in qualified property.[7] The QBI deduction is also currently set to expire after 2025.

The rules related to the QBI deduction are complex, and we expect that some businesses may attempt to restructure their operations in an effort to take advantage of the lower marginal rate available to QBI. However, the deduction will not generally be available to high income owners of most service partnerships.

(iii) Capital Gains / Carried Interest

The Act imposes a three-year holding period requirement for gains from certain partnership interests to qualify for long-term capital gain treatment. Amounts that are disqualified under this rule are instead treated as short-term capital gain, which is subject to taxation at ordinary income rates (but can be offset by long-term capital losses). The restriction applies to partnership profits interests that are received in connection with performing services (commonly referred to as "carried interests") for a business that consists in whole or in part of (1) raising or returning capital and (2) either (i) investing in (or disposing of) specified assets (or identifying specified assets for investment or disposition) or (ii) developing specified assets.[8]

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[6] QBI does not include income from a business involving certain "specified services" trades or businesses including health, law, consulting, athletics, financial services, brokerage services, or any trade or business whose principal asset is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, or trading or dealing in certain financial assets. However, architecture and engineering are not treated as specified services and therefore are eligible for the deduction.

[7] The wage or wage and capital investment limitation and the specified services exclusion do not apply to taxpayers with annual taxable incomes under certain threshold amounts (equal to $207,500 for individual returns and $415,000 for joint returns). The wage or capital investment limitation does not apply to REIT dividends or to income from PTPs.

[8] "Specified assets" include securities, commodities, real estate held for rental or investment, cash or cash equivalents, and derivatives that reference any of the foregoing.

Because many investment funds typically already hold their investment assets for three or more years, we do not generally expect this provision to have a significant impact on the way in which PE and VC fund investments are managed or the way in which investment managers are compensated. In particular, we note that many VC funds already have an incentive to hold stock investments in certain "qualified small businesses" for at least five years in order to claim the 100% gain exclusion that is potentially available under Section 1202.[9]

B. Tax Deductions / Tax Preferences / Tax Attributes

(i) 100% Asset Expensing

The Act allows taxpayers to take a bonus depreciation deduction equal to 100% of the adjusted basis of "qualified property" acquired and placed in service after September 27, 2017 and before January 1, 2023.[10] The term "qualified property" is generally defined as (i) tangible personal property with a depreciation recovery period of 20 years or less, (ii) certain limited types of computer software,[11] and (iii) property used in qualified film, television, and theatrical productions. The deduction is available for both new and used property, and the deduction percentage will be reduced annually for purchases of property between January 1, 2023, through December 31, 2026, and will not be available after 2026.

The allowance for 100% expensing of qualified property is significant and is generally expected to promote capital investment in businesses with tangible property. The 100% deduction will also have the effect of further lowering effective tax rates in the near term, and as explained in Part II, may help to reduce the general tax disadvantage of certain corporate asset acquisitions relative to corporate stock acquisitions.

(ii) Limitation on Deductibility of Interest Expense

The Act limits interest expense deductions by providing that most businesses, regardless of form, may deduct net business interest expense in any year only up to 30% of "adjusted taxable income" ("ATI").[12] In general, for taxable years beginning after December 31, 2017, and before January 1, 2022, ATI is equivalent to earnings as computed before interest deductions and taxes and without regard to deductions allowable for depreciation or amortization (approximating what is commonly referred to as "EBITDA"). Starting with taxable years beginning in 2022, the ATI limitation will become more restrictive, because ATI will be further reduced by depreciation or

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[9] Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"). For further discussion of Section 1202, see our previous article on Section 1202 qualified small business stock, available at https://media2.mofo.com/documents/110811-section-1202-qualified-small-business-stock.pdf, as well as our prior coverage of certain recent changes to Section 1202 at www.mofo.com.

[10] The provision excludes from the definition of "qualified property" any property used in a real property trade or business (i.e., any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade business), among other exclusions. The provision also does not generally apply to intangibles.

[11] In general, qualifying computer software is of a type that is available to the public and subject to a nonexclusive license (so-called "off the shelf" type software).

[12] Under the Act, interest deductions by certain businesses that do not exceed a $25,000,000 average 3-year gross receipts ceiling are exempt from the limitation. The interest deduction limitation provision also does not apply to certain electing real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trades or businesses.

amortization (approximating "EBIT" rather than "EBITDA"). These changes became effective on January 1, 2018, and do not include any grandfathering provision for interest on existing debt. Disallowed interest deductions can be carried forward indefinitely.

The interest limitation is generally expected to have a potential chilling effect on highly leveraged M&A, PE, and VC transactions and investments by making such transactions more costly on an after-tax basis. The provision will also create a new compliance burden, even for business enterprises with existing debt that do not incur new debt following the January 1, 2018 effective date.

(iii) Reduced Dividends Received Deduction

The Act reduces the corporate dividends received deduction ("DRD") from 70% to 50% (in the case of subsidiary equity interests of less than 20%) and from 80% to 65% (in the case of subsidiary equity interests of at least 20% but less than 80%). In effect, the reduced DRD prevents the general rate reduction to 21% from reducing the effective tax rate on such dividend income, and thus makes it relatively less desirable to distribute cash or other assets out of a corporation to its shareholders in connection with an M&A, PE, or VC transaction (e.g., either in an attempt to get cash off the balance sheet or to "tailor" or "right size" a target company).

(iv) Sales of Certain Self-Created Intangibles

Effective for dispositions after December 31, 2017, the Act amends Section 1221(a)(3) to exclude certain patents and other intellectual property assets created by the "personal efforts" of a taxpayer from being classified as capital assets, thereby eliminating the potential for preferential long-term capital gain treatment upon their sale or exchange. As a result, gains or losses from the sale or exchange of such intangibles which are held by the taxpayer whose personal efforts created such property (or held by a transferee that received such property in a carryover basis transfer from such a taxpayer) will be treated as ordinary income or loss. Although the interplay of this new provision with old Section 1235 (applicable to certain patents created by individuals) is perhaps not entirely clear on its face, presumably the sale or exchange of a patent that would otherwise qualify for favorable capital gains treatment under Section 1235 will not now be disqualified by reason of the new rules under Section 1221(a)(3).[13]

(v) Retention of R&D Tax Credit

The Act preserves the research and development ("R&D") credit. The original Senate version of the Act would have preserved both the R&D credit and the corporate AMT. At the time, some companies were concerned that the intended purpose of the R&D tax credit would have been effectively undermined by the preservation of the corporate AMT and placed certain industries at a relative disadvantage.[14] As noted above, the Act completely repeals the corporate AMT, which generally will enable certain corporate taxpayers (e.g., manufacturers, technology firms, and pharmaceutical companies) to lower their effective tax rates even further.

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[13] In this regard, we note that the House version of the Act would have repealed Section 1235, however, the Act did not ultimately follow that approach and Section 1235 was retained.

[14] See Richard Rubin, Passage of Senate Tax Bill Puts R&D Tax Credit in Doubt, available at https://www.wsj.com/articles/passage-of-senate-tax-bill-puts-r-d-tax-credit-in-doubt-1512328243.

(vi) Carrybacks / Carryforwards of NOLs

The Act modifies the rules for net operating losses ("NOLs"). First, for losses generated in 2018 or later, the Act generally eliminates the prior ability of corporations to carry back NOLs for two years and instead permits an unlimited NOL carryforward period (rather than the former maximum of 20 years), with some limited exceptions. In addition, again for losses generated in 2018 or later, not more than 80% of the current year's taxable income of the taxpayer can be offset by otherwise available NOL carryforwards.

The provision does not affect losses generated prior to 2018, such that NOL carryforwards from pre-2018 years will be more valuable than losses generated in 2018 or later and taxpayers will have the added compliance burden of separately tracking two different "pools" of NOLs. Since NOLs must be utilized on a first-in-first-out basis, pre-2018 NOLs also generally will be ordered and absorbed before losses generated in 2018 or later.

C. International Provisions

(i) Deemed Repatriation of Previously Untaxed Foreign Earnings

The Act moves toward a territorial system of taxation primarily by granting U.S. corporations a "participation exemption" for 100% of the foreign source portion of dividends received from most foreign corporations where the U.S. corporation owns at least a 10% interest. It also imposes on each U.S. shareholder owning at least 10% of a foreign corporation (other than passive foreign investment companies that are not controlled foreign corporations ("CFCs") and other non-CFCs having no U.S. corporate shareholders) a one-time transition tax on all deferred post-1986 foreign earnings. The tax is imposed at a reduced tax rate of 15.5% for offshore earnings held as cash and cash equivalents and 8% for noncash assets. The tax is payable over up to 8 years at the taxpayer's election, subject to certain events that accelerate the tax. However, any U.S. shareholder that becomes an expatriated entity ("inverts") within 10 years after the enactment date of the Act will be retroactively denied the benefit of the reduced rates of tax with respect to the income inclusion and will be unable to use foreign tax credits to offset the additional tax due.

It is expected that this one-time "deemed repatriation" tax may well result in the return of substantial overseas capital to the U.S., and fuel significant domestic M&A activity. At the same time, the tax may result in significant additional target liabilities and compliance burdens. Consequently, acquiring companies may require new representations from target companies in acquisition agreements to ensure that any repatriation-related liabilities are adequately disclosed and that appropriate reporting and payment requirements have been complied with. In addition, acquiring companies may specifically include any "deemed repatriation" tax as a pre-closing tax liability.

It is important to note that the U.S. move to a territorial system of taxation is only partial, because only foreign-source dividends, and not capital gains, are tax-exempt. This may give rise to opportunities for creative planning when a company is disposed of to convert what would have been (taxable) capital gain into (exempt) dividend income. Well advised taxpayers will turn to their advisors to consult on available strategies.

(ii) Global Intangible Low-Taxed Income

The Act requires a "U.S. shareholder" of a CFC to include in income currently its share of global intangible low-taxed income ("GILTI"), which is the shareholder's pro rata share of (x) the excess of the CFC's net income over (y) a deemed routine return (10%) on specified tangible property of the CFC that is used in a trade or business (determined using the average of the aggregate adjusted basis in such property).

In addition to potentially creating a disincentive for moving (or even keeping) intangible property offshore, new representations from target companies may emerge in acquisition agreements in order to ensure both disclosure and compliance with the GILTI provisions.

(iii) Partnership Withholding on Sales of Interests by Non-U.S. Persons

Beginning in 2018, a buyer is required to withhold 10% of the amount realized in connection with a sale or exchange of an interest in a partnership (or LLC taxed as a partnership) that conducts business in the U.S., unless the seller certifies that it is not a non-U.S. person. The new rule is intended to ensure that non-U.S. sellers of interests in partnerships pay tax on the portion of the gain that is deemed to be connected with a U.S. trade or business. The provision was enacted in response to a recent Tax Court case which held that a non-U.S. holder of an interest in a domestic partnership was not subject to U.S. tax upon the redemption of its interest in the partnership.[15]

(iv) Base Erosion and Anti-abuse Tax ("BEAT")

The Act imposes a new 10% minimum tax on corporations that both (a) have $500 million or more in average annual gross receipts and (b) make "base eroding payments" to related foreign persons in an amount equal to 3% or more of their deductible expenses (2% or more for banks and securities dealers). The minimum tax base is taxable income computed without the benefit of the base erosion payments less the amount of any regular tax liability (and certain credits).

It will be important in the M&A context to examine the overall structure of an international corporate group to determine the extent to which a U.S. member may be subject to the 10% BEAT by reason of otherwise deductible interest, royalty, services and similar payments made to related foreign group members. Additionally, acquiring companies may require representations in acquisition agreements relating to BEAT liability and compliance with the BEAT provisions.

[15] *See generally,* Grecian Magnesite Mining Co. v. Comm'r, 149 T.C. No. 3 (July 13, 2017).

D. *Executive Compensation & Benefits*[16]

(i) Retention of Section 409A

Despite potential changes that were proposed in both the Senate and the House during the negotiation process, the Act retains Section 409A without change.

(ii) Deferral Election for Companies With Broad-Based Equity Incentive Plans

Under new Section 83(i), eligible employees of qualifying private companies may elect to defer federal income taxes that would otherwise arise in connection with an option exercise or RSU settlement for up to five years, subject to early acceleration upon certain triggering events. In order to qualify, among other requirements, a company must make its equity incentive plan available to 80% or more of its employees. The new rule is intended to promote broad-based employee stock ownership and to relieve companies and their employees from the tax burden that can apply to cashless compensatory transactions. However, given the eligibility restrictions, it is unclear how widely used the new deferral election will actually become.

(iii) Exclusions from $1 Million Limit in Section 162(m)

The exception under Section 162(m), which allows for the deduction of qualified performance-based compensation that exceeds $1 million, has been eliminated. Accordingly, all compensation that exceeds $1 million paid to a corporation's principal executive and financial officers and other highest paid employees will be non-deductible. Section 162(m) will also be expanded to include not only corporations with a class of stock that is publicly traded, but also corporations that have registered a debt offering and all foreign companies that are publicly traded through American Depositary Receipts. The inclusion of corporations with public debt could negatively affect portfolio companies held by PE sponsors.

II. Potential Impact on Current Market Practice

The Act is generally expected to have a material impact upon current market practices in relation to raising investment capital, organizing and managing business operations, and the structuring, financing, and negotiation of M&A, PE, and VC transactions. The following discussion highlights some of our key preliminary observations, which will continue to evolve as deal dynamics take shape in response to the Act. Although we focus below on the impact of tax considerations, non-tax considerations will of course also remain exceedingly important and must be evaluated in connection with any potential transaction.

[16] For further discussion of the executive compensation elements of the Act, see our recent Client Alert, available at https://www.mofo.com/resources/publications/180108-tax-act-compensation-benefit.pdf?#zoom=100.

A. Choice of Entity Considerations

(i) Corporation v. Pass-Through

A complete discussion of the wide range of factors that should be considered when deciding to organize as either a taxable corporation or as a pass-through entity (partnership, LLC taxed as a partnership, or S corporation) is beyond the scope of this Client Alert. However, in general, we anticipate that the use of a taxable corporate entity may become relatively more attractive than was previously the case prior to the passage of the Act.

The potential increased relative attractiveness of the taxable corporate form is due to a variety of considerations, including the following:

- The flat 21% corporate tax rate;
- The elimination of the corporate AMT;
- The continued ability of corporations to deduct state and local income taxes; and
- The continued availability of the Section 1202 exclusion for "qualified small business stock" and the reorganization provisions under Section 368.

The flat 21% corporate tax rate will generally present less of a potential tax drag on earnings from operations, as compared with the 29.6% rate applicable to QBI derived from qualifying pass-through entities or the top 37% marginal rate applicable to individuals. This differential could prove particularly advantageous for businesses that intend to reinvest after-tax cash flow into operations, rather than make distributions to equity owners on a current basis.

The elimination of the corporate AMT and the continued ability to deduct corporate state and local income taxes may also prove beneficial relative to potential limitations that may arise for individuals who remain subject to the individual AMT provisions and face a new annual cap of $10,000 on the deductibility of state and local income taxes.

The potential ability to utilize the 100% exclusion from federal income tax under Section 1202, as well as the tax-free rollover provisions of Section 368 on exit, may also prove beneficial to holders of stock in C corporations relative to pass-through equity interests. On this last point, we further note that, given the 21% corporate tax rate, the tax benefits derived from certain transaction structures, including a sale of 100% of the interests in a pass-through entity or an “Up-C” structure, as discussed below, may be less valuable.

(ii) Up-C / Hybrid Structures

A so-called “Up-C” structure, which generally resembles the use of an “Up-REIT” structure in the real estate context, typically involves the admission of a newly-formed, publicly-traded corporate partner to an existing operating partnership as part of an initial public offering (“IPO”) of stock. The primary tax benefits of the Up-C structure generally entail the continued pass-through tax treatment of taxable operating income, coupled with the creation of significant tax assets in the newly formed public company that can effectively deliver substantial additional value back to the historic owners of the operating partnership through what is commonly referred to as a “Tax Receivable Agreement” (“TRA”).

However, the relative benefits associated with Up-C structures may be somewhat diminished in light of the new corporate tax rate of 21%, as compared with the 29.6% rate applicable to QBI derived from qualifying pass-through entities, or the top 37% marginal rate applicable to individuals. As a result, there may be less of an incentive to pursue a "hybrid" Up-C structure in connection with an IPO of a historic operating partnership, as compared with effectively converting the partnership to a corporation that offers newly issued stock to public shareholders (especially in a case where the historic partners in the operating partnership are corporations that would be entitled to the DRD on any future corporate distributions that might be made in respect of their retained equity interests).

B. Deal Structure / Terms

(i) Stock Purchases v. Asset Purchases

Historically, because of the existence of the so-called corporate "double-level tax,"[17] the amount of after-tax consideration that would generally result from a fully taxable corporate stock purchase would most often materially exceed the after-tax proceeds associated with a potential taxable corporate asset purchase (or deemed taxable corporate asset purchase effected under Section 338(g)). However, following the passage of the Act, the effective rate of corporate double-level tax has been substantially reduced due to the existence of the new corporate tax rate of 21%.

As a result, buyers and sellers should carefully examine corporate acquisition transactions in order to see if a taxable asset sale (or deemed taxable asset sale under Section 338(h)(10) or Section 338(g)), and related step-up in amortizable or depreciable asset tax basis, might be feasible without creating an undue incremental tax cost for the selling shareholders. This will be particularly true in situations where the buyer can benefit from a step-up in asset basis and where there are either potential NOLs (especially pre-2018 NOLs) in the target corporation that can shield a portion of the corporate-level tax and/or target assets that would qualify for the new 100% tangible asset expensing provisions when acquired by the buyer. Again, as previously noted, non-tax considerations related to an actual asset transfer must be considered, such as the need for contractual assignments or title transfers, which may often make an asset sale impractical, unless the "asset" acquisition can be accomplished as a "deemed" asset acquisition for tax purposes.

[17] In general, the federal corporate "double-level tax" refers to: (i) the corporate-level tax that is first imposed on corporate gains in connection with an asset sale by the corporation (previously, at a top marginal federal rate of 35% and now at a 21% rate under the Act); and then followed by, (ii) the shareholder-level tax imposed in connection with a distribution of the remaining after-tax proceeds to the corporation's shareholders (most often assumed to be subject to taxation as long-term capital gain or a dividend at a federal rate of 20%, plus the 3.8% net investment income tax, both under old law and now under the Act). Under prior law, this generally resulted in an effective federal "double-level tax" rate of approximately 50.5% in connection with a taxable sale of corporate assets (equal to (1 x 0.35) + ((1 - 0.35) x 0.238)). Following the passage of the Act, this effective federal rate of "double-level tax" on corporate asset sales is generally reduced to about 39.8% (equal to (1 x 0.21) + ((1 - 0.21) x 0.238)), which is materially closer to the assumed long-term federal capital gains rate, plus net investment income tax rate, of 23.8% associated with a taxable corporate stock sale.

(ii) Transaction Expenses / NOLs

It is relatively common for a seller (or, in some cases, for a buyer) to seek the benefits associated with any pre-closing tax deductions that result from the effective payment of certain transaction expenses or possibly from any compensatory amounts that are effectively paid to the target's employees or option holders in connection with an acquisition. Typically, these expenses can be relatively large in relation to the target's current year pre-closing taxable income, and sometimes an NOL is generated that under prior law could be carried back to generate a tax refund for the benefit of the seller.

However, the Act eliminates the ability to carryback any NOL that is generated in 2018 or a subsequent tax year. As a result, a seller, for example, may instead attempt to obtain the potential tax benefits associated with pre-closing transaction expenses or compensatory payments through a carryforward mechanism that will depend upon the amount of taxable income generated in the post-closing period (and generally be subject to the new 80% current year taxable income limitation, as well as the potential limitations under Section 382). In general, a buyer may resist such an approach because of a desire to refrain from having to administer such arrangements during some portion of the post-closing period. Nevertheless, in certain circumstances where the target's pre-closing deductions and related tax benefits are material, and where the buyer group would otherwise clearly be subject to tax in the post-closing period, the parties may be able to reach some kind of an agreement with respect to the tax benefits generated in connection with the transaction.

(iii) Financing / Capital Structure

The Act imposes new and potentially material limitations upon a buyer's ability to deduct net business interest expense associated with all of its existing or future indebtedness. In addition, because the limitation is pegged to a newly required calculation (based on EBITDA prior to 2022, and then based on EBIT for 2022 and thereafter), there will be an added compliance burden for companies with highly leveraged capital structures. As a result, strategic M&A participants, as well as PE and VC funds will need to ensure that their compliance function accounts for these new requirements on both a current and ongoing basis.

Deal modeling will also need to be adapted, and the after-tax cost of leveraged acquisitions will generally increase for buyers that bump up against the limitation (including as a result of unforeseen events, such as declining earnings). As a result, parties may need to rethink the desired mix of debt and equity within their capital structures. Furthermore, companies that plan to expense assets will have to model the add-back for depreciation and amortization that will be required beginning in 2022.

(iv) Tax Representations

The changes brought about by the Act create not only incremental tax compliance burdens, in order to properly transition from prior law to new law, but also in certain cases, potential material tax liabilities that will have to be adequately identified and appropriately managed. In particular, the new international provisions present substantial traps for the unwary. We expect that deal documentation, as well as diligence and other related processes, will evolve in a way that results in new representations and warranties that are designed to ensure that non-conforming practices and related potential liabilities are uncovered and addressed. In addition,

this may have a collateral effect on the representation and warranty insurance market as market participants seek insurance for these new tax risks.

(v) Financial Modeling

Financial models typically utilized by buyers and sellers will need to be updated and adapted in response to the changes brought about by the Act. In particular, the various assumptions that buyers typically make in order to estimate the potential cash flow benefits that may be derived from a target's tax attributes (such as NOLs), as well as general operating assumptions typically made in relation to a target's business (such as the applicable tax rate or deductibility of certain items), will need to be materially revised.

C. Impact on Specific Industries

Although beyond the scope of this Client Alert, we generally note that certain industries will be affected in unique and important ways by the Act. For example:

- Technology companies will generally not be able to obtain the benefits associated with 100% asset expensing in connection with potential asset acquisitions, given that qualifying assets generally include only tangible asset classes and do not include goodwill or other types of intangible assets;

- Highly leveraged industries and industries with substantial overseas manufacturing or other foreign operations will face materially higher compliance burdens and planning issues as compared with other market participants; and

- Qualifying corporate taxpayers in certain non-service-based industries that may be able to take advantage of the new 29.6% rate attributable to QBI will need to evaluate whether it makes sense to attempt to restructure all or part of their operations in pass-through form.

We will of course continue to monitor market practices, and future Client Alerts will address specific industries in more detail as matters evolve in response to the Act. Members of our Firm's tax practice are also available to discuss how the changes under the Act may affect your specific current situation or potential future plans.

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If you have any questions regarding this Client Alert, please do not hesitate to contact one of the members of the Firm’s U.S. federal income tax group listed below.

Client Alert

Contact:

David Strong
(303) 592-2241
davidstrong@mofo.com

Thomas A. Humphreys
(212) 468-8006
thumphreys@mofo.com

Bernie Pistillo
(415) 268-7041
bpistillo@mofo.com

Remmelt Reigersman
(415) 268-6259
rreigersman@mofo.com

Shane Shelley
(858) 720-5169
sshelley@mofo.com

Matthew Lau
852 25850850
mlau@mofo.com

John Harper
(703) 760-7321
jharper@mofo.com

Shiukay Hung
(212) 336-4331
shung@mofo.com

Craig Phillips
(212) 336-4419
cphillips@mofo.com

Brennan Young
(212) 336-4233
byoung@mofo.com

Allison Peck
(415) 268-6331
apeck@mofo.com

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