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US Tax Reform Will Have a Significant Impact on M&A and Financing Transactions

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On December 22, 2017, President Trump signed into law H.R. 1 (introduced as the Tax Cuts and Jobs Act) (the "**New Tax Law**"). The New Tax Law dramatically alters the US tax landscape and will have a significant impact on structuring and financing of M&A transactions. Several of the key changes that will be of particular interest to private equity fund sponsors and investors are discussed below.

Summary of Key Points

- The tax efficiency of fully blocked structures should be reevaluated in light of the permanent reduction in the corporate tax rate to 21% for taxable years beginning after December 31, 2017 and other relevant changes under the New Tax Law.
- Net business interest expense deductions will be limited to 30% of adjusted taxable income for taxable years beginning after December 31, 2017 (initially generally keyed to EBITDA and later to EBIT for taxable years beginning on or after January 1, 2022, possibly resulting in a further increase in disallowance of interest expense). Debt incurred prior to the enactment of the New Tax Law is not grandfathered.
- The deductibility of NOLs arising in taxable years beginning after December 31, 2017 will be capped at 80% of taxable income. NOLs arising in taxable years ending after December 31, 2017 that are not deductible in a taxable year can be carried forward indefinitely but can no longer be carried back to prior taxable years.
- The full cost of investment in certain tangible property and computer software generally will be immediately deductible if acquired and placed in service after September 27, 2017 and before January 1, 2023, even if acquired used.
- Contrary to the House and the Senate versions of the legislation , the New Tax Law continues to require that domestic corporations which are US shareholders of a CFC recognize income when the assets of the CFC serve as direct or indirect collateral security for the obligation of a US person or the CFC otherwise increases its investment in US property.
- A foreign person's gain on sales occurring after November 27, 2017 of certain interests in a partnership that is engaged in a US trade or business will be taxed as effectively connected income and sales occurring after December 31, 2017 will be subject to a new 10% withholding tax.

- Carried interest generally will be subject to a 3-year holding period requirement to be eligible for long-term capital gain treatment for taxable years beginning after December 31, 2017, regardless of any Section 83(b) election. Partnership interests issued prior to such date are not grandfathered.
- Private company employees generally can defer income from stock transferred after December 31, 2017 pursuant to the settlement of RSUs or exercise of stock options for up to 5 years from the earlier of the first date the employee's stock rights are transferable or substantially vested.

The New Tax Law also revamps the taxation of US based multinational companies through numerous changes designed to reduce the benefit of shifting earnings to offshore affiliates and of holding intellectual property in non-US structures, a topic that will be addressed in a separate client alert.

Reevaluating Blocker Structures

Among the signature features of the New Tax Law are:

- the permanent reduction in the corporate tax rate to 21% for taxable years beginning after December 31, 2017,
- the repeal of the corporate alternative minimum tax, and
- the qualified business income deduction available to certain pass-through entities until January 1, 2026.

The qualified business income deduction generally provides that non-corporate taxpayers can deduct up to 20% of certain business income. This deduction, however, is not available for, among other items, compensation for certain services, short-term capital gains, dividends and dividend equivalents, interest income that is not allocable to a trade or business, certain other passive income, and income from investment management services.

Private equity sponsors should assess whether making portfolio investments through flow-through structures with upper-tier blockers, as compared to fully-blocked structures, remains an efficient tax strategy. In making this determination, fund sponsors should take into consideration not only the tax profile of a fund’s limited partners (e.g., the proportions of limited partners that are US taxpayers, ECI sensitive, US tax-exempt, or Section 892[1] eligible), the tax attributes of the target company, and the manner and timing of the expected exit, but also additional considerations arising under the New Tax Law, including the new limitations on interest deductibility and net operating losses, and the ability to immediately expense certain acquisition costs, as discussed below.

When evaluating a transaction, purchasers may want to compare the potential benefits of a single layer of taxation from flow-through structures for some investors and a potential purchase price premium upon exit for delivering (at least in part) a stepped up basis in assets (the value of which will be reduced for corporate purchasers due to the reduced corporate tax rate) against the simplicity of a fully-blocked structure that benefits from the reduced 21% corporate tax rate.

Limitation on Interest Deductibility

Under the New Tax Law for taxable years beginning after December 31, 2017, a taxpayer’s ability to deduct net business interest (i.e., business interest expenses minus business interest income) generally is limited to 30% of the taxpayer’s adjusted taxable income (generally speaking, EBITDA). In general, for taxable years beginning before January 1, 2022, a taxpayer’s adjusted taxable income is the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) any deduction allowable for depreciation, amortization, or depletion. However for taxable years beginning on or after January 1, 2022, the 30% limitation is keyed to EBIT. Therefore, the limit on deductions for net business interest may be lower. Importantly, debt incurred prior to the date of enactment of the New Tax Law is not grandfathered. The new rules, however, generally will not apply to taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year of less than $25 million (determined by applying certain aggregation rules for related persons).

[1] All “Section” references herein are to the Internal Revenue Code of 1986, as amended.

With respect to partnerships, the limitation of interest deduction is applied at the partnership level, although "excess" adjusted taxable income is allocated to the partners for purposes of calculating their own adjusted taxable income. Excess business interest (i.e., interest for which a deduction was disallowed at the partnership level as a result of this limitation) would be allocated to the partners and may be utilized only against future taxable income of the partnership.

Interest deductions that are not allowed under this provision generally may be carried forward indefinitely to future taxable years.

Given the lack of grandfathering of outstanding debt, any taxpayer that is subject to the new limits on the deductibility of interest will need to model projected adjusted taxable income and business interest expense for each taxable year to take into account the potential impact of the limitation. These new rules can be expected to have a significant effect on highly leveraged businesses.

Limitations on Deductibility of Net Operating Losses

Under the New Tax Law, a taxpayer's ability to deduct net operating losses generally is capped at 80% of the taxpayer's taxable income (determined without taking into account the deduction of net operating losses). Further, a taxpayer will no longer be able to carry back net operating losses to prior taxable years, though net operating losses may be carried forward indefinitely to future taxable years. In general, the 80% limitation applies to net operating losses arising in taxable years beginning after December 31, 2017, while the carry back and carry forward changes apply with respect to net operating losses arising in taxable years ending after December 31, 2017.

The limitation on carrying back net operating losses to prior taxable periods has implications for the negotiation of M&A transaction deal terms. Net operating losses arising in connection with an M&A transaction (often referred to as transaction tax benefits) may no longer be carried back to offset taxable income in prior taxable years, which may impact negotiations related to the compensation a seller might receive for such transaction tax benefits. Further, a purchaser will not be able to rely on a target's historic net operating losses (to the extent arising in taxable years ending after December 31, 2017) to mitigate the cash tax impact of tax issues that may arise with respect to taxable years prior to the year in which such net operating losses were generated, which may impact the negotiation of pre-closing tax indemnities.

Immediate Expensing of 100% of Cost of Certain Property

Under the New Tax Law, a taxpayer generally is able to deduct the full cost of investment in certain tangible property and computer software, if such property is acquired and placed in service after September 27, 2017 and before January 1, 2023 (or January 1, 2024 for certain aircraft, transportation, and other property). This immediate deduction is available even if the property was acquired used from an unrelated person. Thus, the full acquisition cost of certain assets acquired from third parties may be immediately deductible by the acquiror. While this accelerated deduction remains in effect (generally through January 1, 2023), M&A buyers and sellers should explore opportunities to structure transactions as asset acquisitions (or deemed asset acquisitions, such as under Section 338 or Section 336) in a manner that is mutually beneficial to all parties.

Continued Application of Section 956 to Corporations that are US Shareholders of Controlled Foreign Corporations

The versions of the New Tax Law initially passed by the House and the Senate both eliminated the requirement that domestic corporations that are US shareholders of a "controlled foreign corporation" ("CFC") recognize income (i.e., a so-called, "deemed dividend") when the assets of a CFC serve as direct or indirect collateral security for the obligation of a US person or the CFC otherwise increases its investment in US property. The elimination of this requirement would have obviated the need under current law to limit credit support attributable to a CFC owned by a US borrower or its affiliates to a pledge of less than 66 and 2/3rds of the voting stock of the CFC. The final version of the New Tax Law passed by both the House and the Senate, without any elaboration or explanation, did not contain the provision eliminating this requirement. Consequently, absent further clarification, financing parties should assume that current market practice of limiting credit support attributable to CFCs owned by a US borrower or its affiliates is not affected by the New Tax Law.

Gain on the Sale of Certain Partnership Interests by Foreign Persons Taxed as Effectively Connected Income - New Withholding Tax Obligation Imposed on Purchasers

Recently, the Tax Court in *Grecian Magnesite Mining v. Commissioner*[2] held that a non-US partner's gain or loss on the sale or exchange of an interest in a partnership that is engaged in a US trade or business is foreign-source income and thus not subject to US federal income tax. The New Tax Law, effective for sales or exchanges after November 27, 2017, reverses the Tax Court's decision and provides that, in such circumstances, such non-US partner will be treated as receiving income that is effectively connected with a US trade or business to the extent such non-US partner would have had effectively connected gain or loss had the partnership sold all of its assets at their fair market value.

Further, effective for sales, exchanges or other dispositions after December 31, 2017, the purchaser of such a partnership interest generally is required to withhold 10% of the purchase price unless the purchaser receives an affidavit from the seller stating, among other things, that the seller is a US person. If the purchaser fails to withhold such amount, the partnership is required to withhold such amount (plus interest) from distributions made to the purchaser.

Carried Interest Requires a 3-Year Holding Period for Long-Term Capital Gain Treatment

Under the New Tax Law, gain with respect to partnership interests issued for the performance of certain services are not eligible for long-term capital gain treatment (and thus generally would be subject to ordinary income tax rates), unless the gain producing asset held by the partnership, or potentially the partnership interest itself in the case of a disposition of such interest, was held for more than three years. This 3-year holding period requirement would apply regardless of whether any election was made under Section 83(b) with respect to the partnership interest.

This new requirement specifically targets carried interests received by investment fund sponsors. Thus, various exceptions to this 3-year holding period requirement narrow the scope of this change and exclude, among others, capital interests in a partnership, partnership interests held directly or indirectly by a corporation, and partnership interests held by a person employed by a company (other than the partnership) that is engaged in an "applicable" trade or business (i.e., not an investment management-type business) if such person provides services only for such company.

This 3-year holding period requirement applies to taxable years beginning after December 31, 2017, and there is no grandfathering of partnership interests issued prior to such date.

New Income Deferral Election for Stock Options and Stock-Settled Restricted Stock Units ("RSUs") Granted by Private Companies under a Broad-Based Equity Plan

The New Tax Law includes a provision which allows employees of privately-held companies to defer income from stock transferred after December 31, 2017 pursuant to the settlement of RSUs or the exercise of stock options for up to 5 years from the earlier of the first date the employee's right to the stock is transferable or becomes substantially vested, provided that certain requirements are satisfied. Under current law, income with respect to options generally is taxable in the year of exercise, and, for RSUs, income is taxable in the year of settlement (i.e., the year in which shares are delivered). The amount of income that is so taxable is equal to the excess of the fair market value of the stock received upon exercise of an option or settlement of an RSU, as applicable, over the amount paid, if any, for the stock.

These "qualified equity grants" must be made pursuant to a written plan under which at least 80% of all employees providing services to the private company in the United States are granted qualified RSUs or stock options (which are more than de minimis) with the same rights and privileges in the relevant calendar year. Certain "excluded employees" would not be permitted to make the deferral election, including: (1) 1% owners

2 149 T.C. No. 3 (July 13, 2017).

or individuals who were 1% owners at any time during the 10 preceding calendar years; (2) an employee who is or has been at any prior time, the chief executive officer or chief financial officer; or (3) one of the four highest compensated officers in a taxable year (or any of the 10 preceding taxable years). The deferral applies only for income tax purposes and the application of FICA and FUTA is not affected.

In practice, it may not be practical for many private companies to implement a qualified equity grant program due to the requirement that 80% of the employees providing services in the United States must receive grants. Start-ups, technology companies, and other corporations that provide nearly all employees with equity grants will be the most likely to take advantage of this new potential income deferral election. Additional guidance is needed to see how these deferral elections will work in practice and whether employees will choose to make such elections with respect to qualified equity grants.

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