January 2, 2018

U.S. Tax Reform

Mergers and Acquisitions Considerations

SUMMARY

On December 20, 2017, Congress voted to pass a comprehensive tax reform bill (the "Act"), and the President signed the Act into law two days later. The Act represents the most significant reform of the U.S. tax code in over 30 years.

This memorandum includes some observations on the Act's potential impact on mergers and acquisitions activity going forward.

Generally, we would expect the lowered corporate tax rate to have a positive effect on M&A activity. A lower tax rate is likely to enhance the after-tax return of synergies from combining or separating entities. The enhanced return may help facilitate M&A transactions, and potentially "bridge" the pricing gap between buyer and seller.

TAXABLE VS. TAX-FREE TRANSACTIONS:

- **Increased Available Cash.** There should be significantly more cash available for acquisitions of U.S. companies and assets due to the mandatory deemed repatriation of offshore earnings and profits, combined with the 100% dividends received deduction from a U.S. corporation's foreign subsidiaries. (As a technical matter, this "participation exemption" applies to the foreign-source portion of dividends distributed from a controlled foreign corporation to a "10% shareholder." For this purpose, a 10% shareholder is a shareholder that owns 10% or more of the vote or value of any foreign corporation, and a controlled foreign corporation is a foreign corporation more than 50%-owned by 10% shareholders.)
- **Effect of Immediate Expensing of Capital Expenditures.** Although the immediate expensing of capital expenditures makes taxable transactions more attractive, we do not expect to see a significant shift away from the paradigm wherein sellers favor tax-free transactions and buyers favor taxable transactions. The immediate 100% deduction mostly applies to property that was already subject to an immediate 50% deduction under prior law (mostly machinery and tangible goods), and not to property like real property, intellectual property, and goodwill. As a result, a taxable transaction is still a trade-off between immediate

tax to the seller and a future benefit to the buyer. Moreover, there may be limited financial statement benefit (other than timing) to the accelerated depreciation of properties otherwise entitled to bonus depreciation.

- **Reduced Benefit of Tax-Free Spinoffs.** The benefit of tax-free spinoffs is significantly reduced. As a result, there are likely to be more taxable separations (including spinoffs electing to be treated like sales under Section 336(e)). Splitoffs and debt-for-stock exchanges in the context of spinoffs may also appear incrementally less attractive relative to taxable separations (e.g., a sale) in the lower tax rate environment.

- **Tax Due Diligence.** M&A tax due diligence procedures should be reviewed in light of the changes in the Act. For example, until balance sheets and income statements catch up to the changes in the Act, acquirors should carefully examine the current and deferred tax accounts on a target's financial statements.

FINANCING:

- **Availability of Offshore Cash.** Although foreign subsidiaries still cannot guarantee the debt of a U.S. parent, such subsidiaries may generally distribute cash to the U.S. parent as a tax-free dividend. As "offshore" cash becomes "untrapped," takeovers (particularly leveraged buyouts) relying on the "cash pile" of targets may become more prominent and frequent.

- **Debt Limitations in Leveraged Deals.** Although the 30% of adjusted taxable income limitation on interest deductibility (EBITDA for five years, EBIT thereafter) is expected to hurt only a minority of publicly traded U.S. corporations, this limitation will have a significant impact on leveraged buyouts and other debt-intensive deals (especially those in private equity). The use of alternatives to debt will become more frequent.

- **Effect of Base Erosion Anti-Abuse Tax on Certain Acquisitions.** Multinational corporations that make payments to foreign affiliates resulting in deductions equal to 3% or more of their total deductions may be subject to a base erosion anti-abuse tax ("BEAT"). Planning will be essential when financing U.S. acquisitions with debt from a related foreign party. In addition, BEAT will have to be considered in the context of cross-border M&A to the extent that post-combination planning would involve payments from the United States to foreign affiliates.

- **Decreased Attractiveness of "Debt" Financing.** Corporations that may be affected by the interest deductibility limitation are likely to structure certain acquisitions as leases, swaps, derivatives, etc., rather than as debt, so as to avoid interest deductions that exceed 30% of taxable income. The use of preferred partnership interests in Up-C types of structures may also become more prevalent.

ENTITY CHOICE:

- **Tax Inefficiency of Corporate Form Reduced.** The overall corporate marginal rate (combining the corporate tax rate and the top 20% individual rate on dividend income) is reduced from 48% to 36.8%, a 21.5% increase in after-tax cash. The overall passthrough marginal rate (assuming full benefit of the new 20% passthrough deduction) is reduced from 39.6% to 29.6%, a 16.6% increase in after-tax cash.[1] The relative tax inefficiency of the corporate form (measured in terms of after-tax cash) is somewhat reduced, so the Act is unlikely to create a wave of conversions from corporate to partnership form. In addition, many publicly traded partnerships (other than in real estate or oil & gas) must sit on top of a corporation, making the rate differences irrelevant. Partnerships may instead contemplate conversion to corporations to take advantage of the lower-taxed compounding of earnings inside a corporation, but such conversions must consider the impact of the accumulated

[1] These calculations do not include the 3.8% Medicare tax on net investment income, which may not apply to certain passthrough entities.

earnings tax (a 20% tax on earnings that accumulate "beyond the reasonable needs of the business") and the possibility of future legislative change that increases the corporate rate.

- **Increased Attractiveness of "Up-C" Structure.** By using an Up-C structure, private investors can benefit from the passthrough deduction as well as a public "valuation" and liquidity for their investment. The operating partnership can also issue preferred equity interests rather than debt, so as to avoid the interest deductibility limitation. The operating partnership may also avoid the limitation on deductibility of executive compensation above $1 million (under Section 162(m)), which only applies to publicly traded corporations.

- **Potential Conversions of C Corporations to S Corporations.** Because it has become easier to qualify as an S corporation, C corporations that distribute their cash may be more tempted to convert to S corporations. In addition, for C corporations that were already planning to convert to a passthrough structure, there are incentives to do so now while there is a relatively low corporate tax rate levied on exit.

INTERNATIONAL CONSIDERATIONS:

- **"Inversion Percentage" Likely to Stay Below 60%.** Under prior law, where a foreign corporation acquired a U.S. corporation and former shareholders of the U.S. corporation held between 60% and 80% of the stock of the combined entity (the "inversion percentage") the combined entity was respected as a foreign corporation, but certain negative consequences (such as restrictions on "offshore cash" and recognition of gains on certain intercompany transactions) applied. The Act adds a number of further restrictions to such "60-80% corporations," such that it would be even more desirable to keep the inversion percentage under 60%. The benefits of the reduced rates upon the mandatory deemed repatriation of offshore earnings and profits will be recaptured if a U.S. corporation engages in such an inversion transaction within 10 years of the Act's enactment (December 22, 2017), the dividends of a company that "inverts" post-enactment will not qualify for the preferential 20% rate applicable to qualified dividends, and the cost of goods sold to a related party, for company that inverts after November 9, 2017, will not be excepted when calculating the BEAT (certain U.S. corporations could have significant exclusions from income attributable to the cost of goods sold to related foreign parties).

- **Impact on "Topco Choice."** With the lower corporate rate and shift to a quasi-territorial system of taxation, structuring a combination between a U.S. and a foreign corporation with a U.S. corporation as the parent is more appealing than under prior law. However, the new U.S. system is not a true territorial system like that of many other competing jurisdictions—the sale of foreign subsidiaries is still taxable for all gain that is not attributable to earnings and profits, the Act includes two new base erosion regimes, the BEAT and the tax on global intangible low-tax income ("GILTI"), and foreign subsidiaries still cannot directly invest in U.S. property without triggering a current inclusion for their U.S. parent. In addition, the new U.S. tax system is newer than more established regimes, and there could be more risk that it will change in the future (e.g., the corporate tax rate will increase).

- **Base Erosion Deterred but Not Eliminated.** The Act includes several changes that reduce incentives for U.S. corporations to move their operations and income offshore, but some incentives still remain. The new 21% U.S. corporate tax rate, although lower than the previous 35% rate, is still higher than competing corporate rates in countries like the UK and Ireland, and the income that is "stripped" from the United States may result in inclusions that are effectively taxed much lower than the "headline" rate. Multilateral efforts to prevent base erosion and to restrict "hybrid" payments (deductible in one country but not includible in income in another) may have more impact on base erosion in the long run.

TAX BENEFITS AND SPECIAL SITUATIONS:

- **Value of Tax Receivable Agreement Payments Reduced.** The benefit of payments under a tax receivable agreement ("TRA") for Up-Cs is significantly reduced, due to the lower corporate rate. This creates opportunities to acquire entities with outstanding TRA payments.

- **Present Value of Certain Tax Benefits Reduced.** The present value of certain tax benefits such as net operating losses ("NOLs") is reduced in the lower corporate tax rate environment, although future NOLs may only offset 80% of taxable income for a given year. Moreover, new NOLs never expire, which lessens the relevance of some of the ownership limitations regarding NOLs.

Questions regarding the Act may be directed to any member of the Tax Group. Contact information is available on the final page of this memorandum.

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CONTACTS

New York		
Ronald E. Creamer Jr.	+1-212-558-4665	creamerr@sullcrom.com
David P. Hariton	+1-212-558-4248	haritond@sullcrom.com
Jeffrey D. Hochberg	+1-212-558-3266	hochbergj@sullcrom.com
Donald L. Korb	+1-212-558-4822	korbd@sullcrom.com
Andrew S. Mason	+1-212-558-3759	masona@sullcrom.com
Andrew P. Solomon	+1-212-558-3783	solomona@sullcrom.com
David C. Spitzer	+1-212-558-4376	spitzerd@sullcrom.com
Davis J. Wang	+1-212-558-3113	wangd@sullcrom.com
S. Eric Wang	+1-212-558-3328	wangs@sullcrom.com
Isaac J. Wheeler	+1-212-558-7863	wheeleri@sullcrom.com
David M. Simins	+1-212-558-3781	siminsd@sullcrom.com
London		
Ronald E. Creamer Jr.	+44-20-7959-8525	creamerr@sullcrom.com
S. Eric Wang	+44-20-7959-8411	wangs@sullcrom.com
Washington, D.C.		
Donald L. Korb	+1-202-956-7675	korbd@sullcrom.com