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# What the New Tax Rules Mean for M&A

President Trump has signed into law the most sweeping changes to business-related federal income tax in over three decades. The new law, referred to as the Tax Cuts and Jobs Act (the "Act"), is expected to have far-reaching implications for domestic and multinational businesses as well as domestic and cross-border transactions, impacting the structure, pricing and, in some cases, viability of broad categories of deals. Among other things, the Act lowers tax rates on corporations and income from pass-through entities, permits full expensing of certain property, imposes additional limits on the deduction of business interest and adopts certain features of a "territorial" tax regime. By lowering tax rates, the new law makes conducting business in the United States more attractive. But, to pay for the reduced rates, the Act includes numerous revenue-raising provisions as well. The changes will shift transaction dynamics in complex and potentially unanticipated ways that will unfold over time, raising challenging interpretive questions that taxpayers and advisors will be grappling with for years to come. By vastly reducing the incentive for U.S.-parented multinationals to hold cash offshore, the new law is expected to free up cash for M&A activity, capital expenditures, debt repayment or stock buybacks.

*Reduced Corporate Tax Rate*. The Act makes the United States far more hospitable to multinationals and removes perceived incentives to re-domicile by permanently reducing the corporate federal income tax rate to 21% effective in 2018 (and, relatedly, repealing the corporate alternative minimum tax). As a result, the corporate federal income tax rate will be lower than the corporate income tax rates imposed by many major trading partners of the United States.

We expect this reduced rate, coupled with the accelerated recovery of capital expenditures and changes to the international tax regime described below, to influence transaction structures. For example, asset purchases may become more attractive relative to purchases of stock, the tax-free treatment of spin-offs may become less important, and "inversions" will be less attractive.

*Pass-Through Tax Changes*. In conjunction with the reduction in the corporate rate, the new law permits noncorporate investors in businesses (other than specified service businesses) conducted through partnerships, S-corporations or sole proprietorships to deduct approximately 20% of their business income. As

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a result, private equity funds may prefer to own portfolio companies in partnership form (with appropriate blocker corporations for tax exempt and foreign investors).

*Expensing*. Taxpayers will be entitled to deduct immediately 100% of the cost of depreciable tangible assets, including (in a change from current law relating to bonus depreciation deductions) assets acquired from a third party, for the next five years. The move to expensing will certainly influence transaction structures. In a carve-out transaction or other acquisition of a privately held domestic business, the immediate expensing rule is likely to make asset acquisitions more attractive to a buyer than acquisitions of stock.

*Limitations on Interest Expense*. The Act limits deductions for net business interest expense to 30% of an amount that approximates EBITDA (and, beginning in 2022, EBIT). This limitation will change the calculus for debt-financed acquisitions of domestic corporations by domestic or foreign acquirors. These limitations could force private equity buyers to write larger equity checks and could lead to fewer highly leveraged deals generally.

*Executive Compensation*. The new law further limits the deductibility of executive compensation and eliminates the performance-based exception to this limitation (see our memo of December 4, 2017 for a discussion of these changes and their implications). In light of the corporate tax rate reduction in 2018 and the tightening of the limitation on executive compensation deductibility, companies should consult with their tax advisors prior to year-end to ensure that 2017 bonuses payable in 2018 will be deductible this tax year.

*Participation Exemption*. In a move toward a "territorial" tax regime (*i.e.*, a regime that exempts income from foreign sources) akin to that of major trading partners of the United States, the new law generally eliminates federal income tax on dividends received by a domestic corporation from a 10% owned foreign corporation and may eliminate tax on a portion of the gain realized by a domestic corporation on the sale of a 10% owned foreign subsidiary.

The new law transitions to territoriality by requiring a one-time income inclusion by 10% U.S. shareholders of historic earnings of a foreign subsidiary generally at a tax rate of 15.5% or 8%, depending on whether the foreign subsidiary's earnings were invested in cash or other assets, respectively. Although this transition tax may be paid in installments over a period of eight years, U.S.-parented multinationals that historically have treated earnings of their foreign subsidiaries as permanently reinvested for financial accounting purposes may face a more immediate financial statement impact.

The new international tax regime also includes rules that are intended to deter domestic corporations from shifting profits out of the United States. To this end, the Act taxes 10% U.S. shareholders on the "global intangible low-taxed income" of a foreign subsidiary (generally, the foreign subsidiary's earnings in excess of a deemed 10% return on tangible assets of the foreign subsidiary) and provides a favorable deduction relating to a domestic corporation's exports.

*Enhanced Inversion Deterrence.* The Act specifically deters "inversions." For domestic corporations that expatriate after enactment, the Act increases the excise tax on stock compensation of insiders from 15% to 20%, increases the tax on the one-time inclusion of foreign subsidiary earnings described above to 35%, and taxes dividends paid to noncorporate domestic shareholders of the foreign parent as ordinary income.

*Earnings Stripping*. The Act also targets deductible payments made to non-U.S. affiliates in multinational groups by imposing a minimum 10% tax (5% in 2018) on income of large domestic corporations before any deductions for payments to related foreign parties, and by prohibiting deductions for certain interest and royalty payments by a domestic taxpayer to related foreign parties. Multinational groups will need to review their intra-group financing structures to assess the impact of these rules and the new limitations on interest expense deductions described above.

*Carried Interest*. Finally, the Act contains a constraint on "carried" interests issued in connection with the performance of investment services, requiring a three-year holding period in order for the service provider to obtain the long-term capital gain rate. Given the typical holding period for most private equity investments, we don't expect this change to have much, if any, impact on M&A activity.

The Act makes fundamental changes to the U.S. taxation of domestic and multinational businesses and will affect transaction structures and financing in a variety of contexts. Careful planning and analysis of each transaction will be required in light of the changed landscape brought about by the Act.

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