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New Tax Law's Impact On M&A Coming Into Focus

By **Vidya Kauri**

Law360 (May 10, 2018, 2:34 PM EDT) -- The new federal tax law was expected to change how deals get structured, and four months after its enactment, it is becoming clear how the legislation is having an impact on negotiations and tax planning strategies.

The Tax Cuts and Jobs Act has made acquisitions and asset sales more attractive with its steep reduction of the corporate tax rate from 35 percent to 21 percent. However, this change also reduced the value of tax assets, such as deductions for net operating losses, forcing companies and their attorneys to rethink how to evaluate and price the deals they enter into.

The legislation's new limitations on deducting interest could also make debt-financed transactions less attractive or it could motivate multinational companies to move their debt to other countries, while its provisions for pass-through businesses is spurring their conversion to C corporations, post-acquisition.

"This is quite a sea change from our tried-and-true analysis of how the tax aspects of the valuation of a target corporation should be analyzed," Sarah-Jane Morin, an attorney at Morgan, Lewis & Bockius LLP, said.

Some practitioners say they have noticed an uptick in the number of mergers and acquisitions this year, but one reason for this could simply be that some companies put a pause on deal-making last year under the cloud of uncertainty that came with the prospect of significant changes to the tax code.

According to Stacy Paz, co-chair of the transactional tax practice at DLA Piper, the number of mergers and acquisitions has been especially healthy in the mid- to small-market space.

"The fact that private equity funds and strategic acquirers have access to more cash as a result of tax reform probably is one of the reasons that we're seeing this increase in M&A activity," she said. "There's just been a flurry of deal flow over the first half of the year as compared to last year, and we believe that's going to continue with the steady increased pace."

But the most significant changes have less to do with the volume of transactions than the quantitative exercises businesses must engage in to determine the optimal value of their assets and minimize their tax liability.

For example, sellers had more leverage in asking buyers to pay a premium for tax attributes such as net operating losses before the tax law was passed, Paz said. In cross-border mergers, a foreign company may have been the preferred entity to survive in the past, but this choice is now no longer as clear in light of the reduced U.S. corporate tax rate, she added.

One tax-planning strategy that may change is the use of debt to finance deals. The new tax law limited the deduction available to borrowers for their interest expense to 30 percent of earnings before interest, taxes, depreciation and amortization. The use of debt has typically been an important part of structuring M&A transactions, but the tax benefits of doing so may now be less under the new law.

Practitioners expect that the limitation could bring about a preference for equity-financed transactions. Robert Holo, the head of Simpson Thacher & Bartlett LLP's tax department, said that taxpayers could also shift the location of debt by pushing it into foreign jurisdictions with more friendly interest-deduction provisions.

"In some ways, debt is being a little bit disfavored as compared to the old law," he said. "The other solution or workaround or structural change is still using debt but putting the debt in other applicable jurisdictions where you can get a bigger bang for your buck."

Another change, primarily impacting private-equity-owned companies, is the inability to carry back net operating losses. Prior to the law's passage, the sale of a private-equity-owned company could generate losses from fees paid to investment bankers or from cashing out stock options. These losses could be carried back to recover taxes paid in earlier years, which could then be made payable to the seller, according to Daniel Zucker, a tax attorney at McDermott Will & Emery LLP and co-chair of the firm's acquisitions and restructuring group.

"Now, as a result of tax reform … the NOL gets carried forward and the buyer benefits from it. So the trick for the seller is to try and get the buyer to compensate the seller for the value of this net operating loss carryforward," Zucker said.

There is also an increased appetite for asset sales, where in the past acquisitions tended to be weighted toward stock sales if the target company was a C corporation. The reduced corporate tax on the sale of assets, as well as the ability to immediately write off the purchase price allocated to fixed assets other than real estate, such as machinery and equipment, are contributing to this shift, Zucker said.

The new legislation is also affecting partnership interest purchases since it repealed a rule terminating partnerships if 50 percent or more of the interest in a partnership's capital and profits was sold or exchanged within a year.

Termination did not really present hurdles to completing a deal, and it was generally reviewed in M&A transactions as part of due diligence. But the repeal "creates new headaches," Morin said, "because buyers now need to consider whether the partnership has undesirable tax elections in place that the buyers will be forced to step into as part of the purchase."

Practitioners say they are continuing to sort through the shifting M&A landscape under the new tax law. The international tax provisions that could impact cross-border deals are especially complex, and guidance is needed from the U.S. Department of the Treasury on how to interpret and apply these new rules.

While Treasury has indicated that it is planning on issuing new regulations in this area, the absence of clarity for now is not preventing M&As from being completed, Holo said.

“Everyone is going forward full speed ahead,” he said. “I think people are just trying their best to look at and think about how these rules are going to apply, knowing that there's going to be some uncertainty in the technical application, but I have not seen clients declining to do otherwise good transactions merely because the details of these regimes have not been fully baked.”

--Editing by Robert Rudinger and Neil Cohen.