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Sarah-Jane Morin, Gregory Hartker, and Daniel A. Nelson of Morgan, Lewis & Bockius LLP discuss the impact of the new tax provisions on structuring mergers and acquisitions. These provisions include the limitations on the use of NOLs, the transition tax on certain deferred foreign income, and immediate capital expensing.

M&A and Tax Reform—New Tax Considerations with Wide-Ranging Implications

BY SARAH-JANE MORIN, GREGORY HARTKER, AND DANIEL A. NELSON

In light of the recent passage of H.R. 1 (the Act) and ensuing sweeping changes to tax law in the U.S., certain tax-related aspects of merger and acquisition negotiations are changing. Here are some important considerations for M&A transactions that stem from the new law.

Limitations on Use of Net Operating Losses

The Act limits the deductibility of net operating losses (NOLs) arising in tax years beginning after Dec. 31, 2017. Under the new law, NOLs arising in those years are capped at 80 percent of taxable income. The new 80 percent limitation does not apply to NOLs arising in tax years ending on or before Dec. 31, 2017. NOLs arising in tax years ending after Dec. 31, 2017, can be carried forward indefinitely but can no longer be carried back to prior tax years. The effect of the new 80 percent limitation is that taxpayers will not be able to fully offset their taxable income going forward with post-2017 NOL carryforwards and will effectively pay a 4.2 percent minimum rate of tax on profit. The prior 90 percent limitation on a corporation's use of NOLs for alternative minimum tax (AMT) purposes was repealed as part of the overall repeal of the corporate AMT.

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A buyer will need to take these new limitations into account in valuing NOLs of a target company as part of the overall pricing for a transaction, in addition to other limitations on post-closing NOL utilization. A seller will need to evaluate the economic cost of providing a pre-closing tax indemnity if the target company cannot carry back NOLs generated in tax years ending after Dec. 31, 2017, to offset pre-closing income and thereby mitigate the seller's indemnification obligations.

We note that parties to M&A transactions frequently try to monetize deductible transaction expenses. These deductions often create an NOL for the short tax period ending on the closing date of the transaction. Under prior law, this short period NOL could be carried back to a prior tax year and give rise to a refund claim, creating an economic benefit—the parties could then negotiate over how to share that benefit. Under the Act, NOLs arising from post-2017 transaction expense deductions may only be carried forward, which would prevent the benefit from being captured in the pre-closing period. We expect that sellers may seek to be compensated for these NOL carryforwards accordingly through increases in the purchase price or other similar mechanisms.

Transition Tax on Deemed Income Inclusions

The Act imposes a one-time mandatory transition tax on certain deferred foreign income held by certain foreign corporations with one or more "United States shareholders" (*i.e.*, U.S. persons that own a 10 percent or greater voting interest in the foreign corporation).

Generally, for post-2017 periods the definition of ''United States shareholders'' is amended by the Act to mean U.S. persons that own 10 percent or greater of the voting interest or value in the foreign corporation. As a practical matter, this rule may result in a tax liability for a U.S. company that is a target in an M&A transaction and owns foreign subsidiaries or other interests in foreign corporations. This transition tax is based on the U.S. shareholder's share of the greater of the aggregate post-1986 accumulated foreign earnings and profits of the foreign corporation as of Nov. 2, 2017, or Dec. 31, 2017, generally without reduction by any distributions made during the tax year ending with or including the measurement date. The taxpayer may elect to pay the transition tax in installments over eight tax years—as a result, a target company liable for the transition tax may have ongoing payment obligations that would extend beyond the closing date of an M&A transaction that occurs over the next few years. Buyers will likely want to shift economic responsibility for this tax (to the extent applicable) to the sellers of U.S. companies that hold applicable interests in foreign corporations. This may be effected through a purchase price reduction, tax escrow, or other payment mechanism. We expect that buyers will seek comfort through due diligence and through purchase agreement representations and warranties that the tax does not apply or, if it does, the manner in which it was determined and the degree to which any ongoing payment obligations or residual exposure for underpayments of the tax remain.

Immediate Capital Expensing

The Act allows taxpayers to immediately expense 100 percent of the cost of certain property acquired and placed in service through 2022. This new cost recovery rule applies to both new and used property. The 100 percent write-off is generally reduced by 20 percent per year beginning in 2023, with a one-year grace period for certain property with longer production periods. We expect that this provision, by accelerating the timing of cost recovery as compared to prior law, could further incentivize a buyer to press for an asset sale structure as opposed to a stock sale structure, particularly in manufacturing and other equipment-heavy industries. However, buyers will want to be mindful that they will be allowed correspondingly reduced depreciation deductions in future years and that any NOLs created through expensing would be subject to the limitations on deductibility described above.

New Withholding Tax on Sales of Partnerships Engaged in U.S. Trades or Businesses

The Act provides that with respect to sales of partnership interests on or after Nov. 27, 2017, gain or loss from the sale of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the seller of the interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of sale. The Act further imposes a new withholding requirement, under which the buyer of a partnership interest must withhold a 10 percent tax on the ''amount realized'' by the seller on the sale of a partnership interest occurring after Dec. 31, 2017, if any portion of the seller's gain on the sale of the interest would be effectively connected income as described above and the seller does not provide a certification of non-foreign status. Buyers of partnership interests in M&A transactions need to take into account this potential withholding obligation and seek appropriate certifications and other contractual protections, and foreign sellers need to ensure that they comply with any applicable reporting and tax payment obligations with respect to sales of partnership interests.

New Limitations on Business Interest Expense Deductions

Under the Act, business interest expense—*i.e.*, interest expense allocable to a trade or business (with certain exceptions)—is now limited to only 30 percent of adjusted taxable income of a taxpayer. Adjusted taxable income generally means for this purpose the taxpayer's income computed without including (i) items not allocable to a trade or business, (ii) business interest or business interest income, (iii) NOLs, (iv) deductions for qualified business income under new tax code Section 199A, (v) for tax years beginning before Jan. 1, 2022, any deduction allowed for depreciation, amortization or depletion, and (vi) any other adjustments provided by the Internal Revenue Service (which are not yet known). Disallowed business interest generally may be carried forward indefinitely. We anticipate that buyers and sellers will model the pricing impact of this new limitation on their transactions. This new provision may cause some slowdown in deals in the buyout market and other markets that rely heavily on debt to make investments. In particular, private equity funds that capitalize their portfolio companies with a combination of equity and debt may wish to further examine the appropriate interest rate on the debt and associated limits on deductibility in light of this new law. In addition, we anticipate that integration structures using debt may be affected, and buyers may wish to consider their integration strategies accordingly and whether an alternative to debt, such as preferred stock, may be beneficial.

Next Steps

We expect that strategic and private equity buyers and sellers will be proactively analyzing how the Act affects their M&A transactions as they pursue them over the coming weeks and months.

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