Mergers, Acquisitions, and Integration in Light of Tax Reform

by Sarah-Jane Morin

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In this article, Morin examines issues that should be reconsidered from a tax perspective in mergers and acquisitions and integration in light of the Tax Cuts and Jobs Act.

Like so many things tax-related these days, many tax practitioners have tried-and-true ways to handle the tax aspects of mergers and acquisitions: Using a U.S. buyer to make an offshore acquisition? Consider a section 338(g) election. If selling a U.S. corporation with significant net operating losses, make sure the buyer pays for that benefit or that the sellers can carry back NOLs generated in the deal to get a pre-closing tax refund. If using a U.S. buyer to purchase intellectual property owned offshore, leave those IP rights offshore if possible, as opposed to bringing them into the United States. Of course, those were general rules of thumb only, but they provided a basic framework to start a discussion of M&A structuring issues and integration strategies.

The law known as the Tax Cuts and Jobs Act (P.L. 115-97) has changed all that — or at least, if it hasn't changed all those general rules, it has thrown them off. Now tax practitioners must rethink the basic guidelines for every M&A transaction and related integration. This article examines issues that should be reconsidered from a tax perspective in M&A deals and integration.

Deal Valuations

Let's start with basic valuations for M&A deals. It is not atypical for a U.S. multinational to value a target acquisition by taking into account any tax inefficiencies that may result from the target's tax classification. Most notably, a target that operates a U.S. business through an association taxable as a corporation for U.S. federal income tax purposes often results in a double taxation. Income tax is imposed at the corporate level, and a second tax is imposed on dividends paid out to shareholders. Further, the purchase of this type of entity does not result in a basis step-up in the target's assets without the availability of a special election that allows otherwise, such as a section 338(h)(10) or (g) election.

The TCJA lessens the impact of this double tax, given the new 21 percent U.S. federal corporate tax rate for corporations in lieu of the prior highest graduated rate of 35 percent. The corporate rate drop was a headline change of the TCJA. This reduced double tax impact is notable for target businesses that operate in corporate form and that would not otherwise be able to take advantage of the new 20 percent deduction that applies to some passthrough business income were the businesses operated in qualifying passthrough form. Because of these changes, projected after-tax flows in buyer modeling regarding corporate targets should in most, if not all, cases be affected. In fact, some buyers in recent months have considered or have in fact incorporated passthrough targets post-acquisition because the aggregate tax result from such incorporation was preferable to leaving the target as a passthrough. 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.

Several other changes to our usual tax mantras flow from this headline rate drop. For example, a tax practitioner often had a chance pre-TCJA to be a bit of a "tax superhero" when introducing the concept of an UP-C transaction and tax receivable agreement (TRA) to passthrough clients wishing to go public. Because of the corporate statutory rate drop, the benefits of a TRA, including any basis step-up, may not be as high in magnitude to either the public company or the TRA payment recipients as before the rate change. However, an UP-C transaction structure may allow the replacement of leverage with alternative financing structures to avoid the new section 163(j) business interest deduction limitation discussed further below. Further, as owners of a passthrough vehicle, the historic noncorporate owners of the UP-C operating partnership may be able to take advantage of the new 199A passthrough deduction for qualifying business income (although this deduction phases out, so this phaseout needs to be considered as well). In other words, perhaps superhero status is maintained in new form.

In another example, acquiring a passthrough target via a corporate "blocker" entity should generally be less burdensome from a tax perspective than pre-TCJA (although the cost of corporate blockers also needs to take into account the new section 163(j) business interest deduction limitations described later in this discussion).

While the effects of the U.S. federal corporate tax rate drop are significant, the TCJA also offsets the rate drop with the introduction of new tax regimes. In particular, the new base erosion and antiabuse tax under section 59A serves in many cases to increase the U.S. federal income tax payable when deductions would otherwise minimize tax. Deal valuations should also take this new BEAT into account, although accurately predicting the precise impact of BEAT for future years may be challenging. In short, it's back to the drawing board in undertaking tax-effected valuations for targets. And of course, the TCJA did not simply change the federal corporate income tax rate with consequences to only M&A deals. Any buyer and any seller need to think more broadly across their finance, supply chain, integration, acquisition, disposition, treasury, and tax operations and functions to see what has changed globally — no small feat. With that caveat, let's move on to funding purchase price with debt.

Use of Leverage in Deals

It has been common for years for buyers to use leverage in whole or in part to finance acquisitions. In cross-border deals, the repayment of principal is often an easy, tax-free payment mechanism. The interest deductions on the debt would generally be meaningful from a U.S. tax perspective, even though limited in some cases by the earnings-stripping rules of former section 163(j) and similar provisions. The TCJA has created new limitations on these interest deductions under revised section 163(j). As revised, section 163(j) imposes a new limitation on business interest deductions by capping them at 30 percent of adjusted taxable income. In many cases, this new limitation will make the use of debt in target purchases less efficient from a tax perspective than pre-TCJA, and buyers may seek alternative financing structures (such as preferred stock — although, as always in preferred-equity transactions, a buyer should be cognizant in structuring the stock terms and instruments in that manner to provide that the stock should be respected as equity for tax purposes, if that is the desired tax answer).

The general 30 percent gross basis withholding tax on passive U.S. source interest payments paid to non-U.S. taxpayers has not changed under the TCJA. If the debt is serviced offshore, a U.S. buyer will want to make sure that the use of debt is worthwhile, taking into account not only any interest deduction limitations under section 163(j) as revised but also any withholding tax imposed on the interest payments paid to the offshore lender. This will especially concern the U.S. borrower that has a gross-up obligation for the withholding taxes.

In sum, leverage may still be worthwhile from a tax perspective, but perhaps not worth as much as pre-TCJA. Plus, there may still be non-U.S. reasons to consider leverage, such as tax-free repayment opportunities outside the United States.

On a similar "well, it was once arguably better" note, let's turn to NOLs.

Negotiating Over NOLs

M&A transaction-related deductions, such as payments of transaction bonuses and investment banker fees, often give rise to NOLs, which could, pre-TCJA, be carried back to a prior tax year and provide the seller a refund. This carryback created in many cases a real economic benefit for sellers. I've lost count of the number of times I've fought over how to properly monetize the economic benefit of NOLs and other tax attributes when representing sellers and buyers. This was an expected battle, especially because payment or indemnification for tax attributes (or reduction thereof) is often not discussed at the letter-of-intent stage of a deal. Will that battle continue in light of the changes to NOL limitations, carrybacks, and carryforwards under the TCJA?

The TCJA limits the deductibility of NOLs arising in tax years beginning after December 31, 2017. Under the new law, NOLs arising in those years are capped at 80 percent of taxable income. Also, NOLs arising in tax years ending after December 31, 2017, can be carried forward indefinitely, but they can no longer be carried back to prior tax years. What this means is that those transaction-related deductions can no longer give rise to an NOL carryback for a prior tax period to the M&A deal closing. Instead, they can only be carried forward. What is a seller to do? Sellers should consider asking for purchase price increases to offset the lack of refund claim, or seek not to bear some transaction-related expenses in the first instance. Of course, on the buy-side, one might say that buyers are not to be blamed for a change in tax law and need not make special accommodations to sellers in this regard. Moreover, one might argue that buyers may not potentially ever see a benefit from these NOLs because the NOLs cannot be recovered until there is sufficient income generated after the closing of the acquisition to use the NOLs. Plus, the benefit is limited to 80 percent of taxable income. So, should these NOLs really be included in the deal economics?

Thus, the battle continues, albeit on a new battleground.

Negotiating Over Partnership Interest Purchases

When a buyer acquires a partnership interest, many tax issues can be implicated, including the disguised sale rule and basis step-up considerations. Many of these issues are left largely, if not entirely, unchanged by the TCJA. Some important new rules are in place, however, that are relevant to M&A deals involving partnerships.

Pre-TCJA, under the "technical termination" rule of section 708(b)(1)(B), a partnership was considered terminated if there was a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within any 12-month period. This technical termination would give rise to a deemed contribution of all of the partnership's assets and liabilities to a new partnership in exchange for interests in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners. Because of the technical termination, some tax attributes of the old partnership terminated. Also, the partnership's tax year closed. Further, most partnership-level elections generally ceased to apply. Importantly, the partnership depreciation recovery periods restarted (happily, this often made any arguments over the use of the curative versus remedial method less contentious).

Under the TCJA, the technical termination rule under section 708(b)(1)(B) has been repealed for partnership tax years beginning after December 31, 2017. Some might argue that this is a favorable result for taxpayers because it was not unusual for taxpayers to inadvertently engage in a technical termination over a 12-month period without realizing it had happened. Further, restarting the clock on the partnership's depreciation recovery periods could often be a material disadvantage from a tax perspective upon a technical termination, especially for buyers of partnerships with significant depreciable property. Yet, in M&A transactions, generally the technical termination issue is reviewed as part of routine due diligence for a majority-interest purchase in a partnership, and the depreciation restart is known and can be taken into account in purchase price negotiations — so these issues should not have been common hurdles in M&A deals. The repeal creates new headaches in M&A deals involving a majority-interest purchase of a partnership because buyers now must consider whether the partnership has undesirable tax elections in place that the buyers will be forced to step into as part of the purchase. Moreover, the parties to the purchase and sale will need to negotiate how some allocations will be undertaken to properly reflect the deal's economics (for example, transaction bonuses are not specifically listed as an extraordinary item under the section 706 regulations).

In another example, the TCJA instituted a new 10 percent withholding regime on buyers that purchase interests in partnerships that generate effectively connected income with a U.S. trade or business from foreign sellers under new section 1446(f). This new regime applies to purchases of partnership interests occurring after December 31, 2017. In the most straightforward case, a purchase of a minority or majority interest of a partnership engaged in a U.S. business from a foreign seller triggers this rule. In the arguably more surprising case, this rule also appears to be triggered when a buyer purchases 100 percent of a partnership. That might catch some off guard, because a purchase of 100 percent of the interests in a partnership is generally treated for U.S. federal income tax purposes under Rev. Rul. 99-6, 1999-1 C.B. 432 (situation 2), by the buyer as a purchase of all the assets of the partnership. A buyer might not naturally assume that this new withholding obligation applies to what is otherwise considered an asset purchase by the buyer. Yet, there is no reason to believe that it does not apply. In fact, under the same revenue ruling and situation, the selling partners are obligated to treat the sale as a sale of all the partnership interests of the partnership, despite the buyer's treatment as an asset purchase, which bolsters the argument that the new withholding regime should apply because at least one party to the transaction is treating the purchase and sale as a sale of partnership interests (albeit not the buyer). The IRS has released several helpful notices clarifying how this new withholding regime is intended to operate (Notice 2018-8, 2018-7 IRB 352, and Notice 2018-29, 2018-16 IRB 495), which buyers and sellers should review before making any withholding determinations because these notices suspend the withholding obligation in some cases, as well as provide clarity on how to determine an amount to be withheld. If withholding applies, a seller might ask to be grossed up by the buyer to account for the reduction in proceeds. This would be a stretch, in my view, and I doubt most buyers will agree to any gross-up. The withholding obligation acts as a backstop to tax collection under a corresponding newly codified (under the TCJA) tax imposed on foreign sellers of partnership interests that generate ECI who otherwise have a filing obligation and can be entitled to a refund in appropriate circumstances. Thus, foreign sellers of those partnerships are on the hook for the tax regardless of the buyers' withholding obligations. Sellers may however reasonably want to request review rights over the withholding determination made by buyers in an effort to reduce overwithholding.

In light of those new rules, partnership interest purchases in M&A deals have gotten more complicated, and buyers and sellers should be aware of the new issues. Now let's consider some integration issues.

Post-Closing: Integrating Acquired IP

Broadly speaking, non-U.S. IP rights pre-TCJA generally stayed offshore. Two regimes under the TCJA attempt to change this general construct.

First, a new lower tax rate (13.125 percent) is imposed on foreign-derived intangible income (FDII) of a U.S. company. This rate applies generally to intangible income derived by a U.S. company associated with products and services provided to an offshore person for offshore use. Thus, regarding acquired IP, a U.S. buyer would generally need to bring the non-U.S. rights to acquired IP onshore and, in some cases, license the offshore rights back to its foreign affiliates to take advantage of this new lower rate. A cautionary note: Such onshoring could give rise to a BEAT issue under the TCJA's new BEAT regime if research and development payments for development of the IP are made to a foreign affiliate of the U.S. buyer.

Second, despite the availability of a new participation exemption regime under the TCJA, a new minimum tax on offshore earnings applies to a U.S. corporation's global intangible low-taxed income. This new regime generally imposes a maximum 10.5 percent U.S. residual tax on a corporate U.S. shareholder (after taking into account deductions and credits) on the total net income of its controlled foreign corporations in excess of a 10 percent routine return on the CFCs' tax basis in its tangible, depreciable property. This new GILTI regime has been advertised as a way to discourage multinational corporations from offshoring organic and acquired IP, although the tax is not limited to income derived from intangibles. Somewhat surprisingly, the new GILTI tax could render the new participation exemption meaningless (other than the 10 percent routine return on tangible depreciable property) because of the broad categories of income of CFCs that are subject to the GILTI minimum tax.

So what is a buyer of offshore IP to do? Unfortunately, the usual rules may not apply, and buyers will need to "do the math" for each acquisition to see if it makes sense from economic and business perspectives to onshore the acquired IP to take advantage of FDII benefits and help lessen any GILTI minimum tax exposure. In many cases, despite these new regimes, it might not make sense to onshore acquired IP, especially given the uncertainty in the political climate about potential rate changes to the U.S. federal corporate income tax, FDII, and GILTI after the midterm elections or in future years.

What Hasn't Changed

So are any of the old tax mantras still good? In short, yes — some are in whole or in part. In one example, the TCJA did not generally change the requirements for tax-free reorganizations, such as the continuity of interest doctrine and the mix of stock and boot that applies to qualify for a tax-free reorganization. One might rebut that the desirability of tax-free reorganizations will lessen in light of the corporate income tax rate drop described above, but this assumes that no individual shareholders would benefit from the tax-free reorganization. Individuals did not benefit from the same material income tax rate drop at the federal level that corporations did; therefore, individual shareholders may well wish to structure an M&A deal as a tax-free reorganization.

Section 382 has not changed as a standalone section. Recall that section 382 generally limits a loss corporation's ability to use its pre-change NOLs upon a 50 percent or greater ownership change (in broad terms). Because section 382 did not change in the TCJA, it remains a factor in valuing NOLs. Yet, the overall view of NOLs has changed, as discussed above. NOLs generated in 2018 and beyond are quite frankly not as valuable as they would have been if generated before 2018. Thus, the loss trafficking issues that section 382 is intended to address are likely to be less significant post-TCJA than pre-TCJA.

The usual rundown of representations and warranties in M&A purchase and sale agreements has not materially changed. We will continue to negotiate over limiting and expanding the usual suspects in this regard (for example, all tax returns have been filed timely and correctly, all withholding has been properly undertaken, and no extensions to tax return filings have been requested). However, buyers should consider a host of new tax representations and warranties that may be necessary in light of the TCJA, including representations regarding any election made by a target to pay the new transition tax over an eight-year period, any transaction undertaken to avoid or reduce the transition tax, any transaction that might trigger the new anti-hybrid rules under section 267A, any transaction that might trigger a BEAT issue, and any transaction that might trigger a timing mismatch under new section 451(b).

Purchase price allocations are still necessary in asset (or deemed asset) sales and purchases, so sellers and buyers will continue to push for their best tax results in the allocation to the extent permitted by law. Some buyers and sellers may in fact have more contentious negotiations over purchase price allocations because of the TCJA changes to the bonus depreciation regime under section 168(k). This may be especially true for deals involving purchases of businesses with significant tangible depreciation property (such as manufacturing businesses) but will be much less relevant to deals involving significant IP, goodwill, or other intangible asset purchases, which are not subject to bonus depreciation.

Buyers and sellers in private M&A deals will also continue to negotiate over pre-closing tax indemnities, but those indemnities may now need to cover potentially eight years of tax exposure triggered by the transition tax. Is that really practical or collectible?

Conclusion

In sum, while the tax aspects of M&A deals have always been fun, things just got really fun. And this article only touches on some high-level tax issues; many more should be considered. ■