The Impact of the New Tax Law on M&A Activity

The bill introduced as Tax Cuts and Jobs Act, (TCJA) created new levels of complexity through several new provisions that will directly affect merger and acquisition (M&A) transactions and planning activities.

Businesses and their owners have new and unique considerations to take into account as they optimize M&A decisions under these new provisions. Significant M&A considerations now involve:

- Proper entity selection to either utilize the new reduced C corporation tax rate or to take advantage of the new deduction for qualified business income from entities other than C corporations;
- Planning for taxation under the new net operating loss provisions;
- Analyzing optimal financing and capitalization options as a result of new limitations on the deductibility of interest; and
- Assessing the amount and timing of business infrastructure expansion under the temporary full capital expensing provisions.

Examining any one of these provisions in a vacuum only serves to skew decision-making; instead, these changes must be evaluated in conjunction with each other in order to fully gauge their impact on M&A decisions.

Corporation & Pass-Through Entity Provisions

TThe TCJA lowered the maximum rates for both C corporations and individuals to 21 and 37 percent, respectively. In addition to the rate reductions, the TCJA introduced the Section 199A deduction for qualified business income (QBI). The deduction is available to individuals and trusts that hold interests in qualifying

businesses, including sole proprietorships, partnerships, LLC, or S corporations (collectively PTEs). QBI is best understood as all income other than investment income—income from interest, dividends, capital gains, and foreign currency transactions are all excluded. Additionally, payments made to S corporation owners as reasonable compensation and guaranteed payments for services to LLC members do not create QBI.

QBI essentially is the ordinary income, less ordinary deductions, of a qualified business. Gain from the sale of a business is not considered QBI and is therefore ineligible for the 20 percent deduction. These items are qualified only to the extent they are effectively connected with the conduct of a trade or business in the United States (which includes Puerto Rico for this purpose).

A qualified business excludes employees and any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing or investment management services, or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees or owners.

The QBI deduction is equal to the *lesser* of (a) 20 percent of QBI, or (b) the amount that is the greater of (i) 50 percent of W-2 wages paid by the qualified business or (ii) 25 percent of W-2 wages paid plus 2.5 percent of the unadjusted basis of qualified depreciable property used in the qualified business.

W-2 wages for purposes of the limitation against the 20 percent deduction generally is the amount reported as such for employment tax purposes. Hence, a common form of compensating partners or LLC members—guaranteed payments—does not qualify as W-2 wages for this purpose. Compensation for shareholders also appears to be excluded from W-2 wages on the basis that is not properly allocable to QBI. Commentators on the tax reform law are divided over this observation, and it may require clarification in a technical corrections bill or new regulations to remedy the uncertainty.

The QBI deduction adds another layer of complexity to the determination of whether PTEs maintain their historical advantage arising from the avoidance of double taxation—the QBI deduction effectively reduces the top individual rate from 37 to 29.6 percent (33.4 percent if the net investment income tax applies). Depending on the situation, a C corporation may be advantageous under the new tax law. This could be the case, for instance, if dividends or distributions from the business are limited, and the business is not planning an exit from the business in the near future. In these situations (and assuming in all examples that the individual is in the maximum 37 percent rate), the 36.8 percent effective tax rate for individual shareholders of C corporations after dividends would not apply (39.8 percent with the net investment income tax). Instead, the 21 percent corporate tax rate would apply. Compared to the 29.6 percent effective tax rate for QBI (33.4 percent with the net investment income tax) that applies regardless of distributions, the decision to select a pass-through entity in an M&A transaction is no longer so clear cut.

Carried Interests

Private equity managers will have to contend with new rules regarding carried interests. Politicians engaged in a great deal of discussion over the past few years about preventing the holders of carried interests from enjoying capital gains tax treatment as the value of such carried interests is monetized. Ultimately, the TCJA made a fairly modest change in this area by increasing the holding period of an applicable partnership interest to qualify for the long term capital gains tax rate from the normal one year to three years. In this context, an applicable partnership interest subject to the carried interest rule is a partnership interest received or held in connection with the performance of substantial services within the field of investing in or developing securities, commodities, rental or investment real estate, cash or cash equivalents, or options or derivative contracts. And

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while estimates have stated that the new rules would have affected slightly less than a quarter of all deals since 2000, the provision could affect deals in progress because there is no provision that exempts an applicable partnership interest acquired before the tax bill was enacted.

Thus, a private equity manager who received his or her interest in January 2016 and disposes of it in 2018 will be subject to the three-year rule, even though the law is otherwise generally not effective until 2018. Selecting an entity that is subject to the carried interest rule in an M&A transaction must be weighed against the new potential for short-term capital gain under the three-year holding period requirement.

Net Operating Losses, AMT and Excess Business Losses

Another significant change under the TCJA affects both the calculation and utility of net operating losses (NOLs). Previously, NOLs could be carried back two years and carried forward twenty years; however, the TCJA eliminates the ability to carryback NOLs and expands the carryforward indefinitely. Additionally, the utilization of NOLs is limited to 80 percent for losses arising after Dec. 31, 2017. This limitation was brought about, in part, because the law eliminates the corporate AMT. Under prior law, NOLs could only be deducted against 90 percent of AMT income. The new law for NOLs applies to both individuals and corporations.

Business losses for individuals and other non-corporate taxpayers are limited to $250,000 per year ($500,000 for joint returns) for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026. The limitation applies to the aggregate of all personal and pass-through losses generated for the year. As a result, this provision effectively prevents individuals from deducting losses from partnerships and S corporations in excess of these levels. Disallowed losses are added to the individual's net operating loss carryforward. Individual net operating losses are also limited to 80 percent of taxable income.

Historically, a target company's NOLs may have been considered an important and valuable asset, even though the acquisition itself may have limited usage of the NOLs going forward. These limitation rules were not changed under the new law, but the value of the NOLs has decreased due to the 80 percent limitation. Again, this value has to be balanced against the repeal of the corporate AMT to determine how the new law has truly affected the value of a target's NOLs to an acquirer.

Capital Expensing and Partnership Terminations

Probably the biggest boon to businesses after the 40 percent rate reduction for C corporations (from 35 percent to 21 percent) is the ability to fully expense capital acquisitions. Under the new law, bonus depreciation is increased to 100 percent for certain property placed in service after Sept. 27, 2017, and before Jan. 1, 2023. The 100 percent rate drops by 20 percent per year beginning in 2023, until it is eliminated in 2027. And for the first time, the 100 percent expensing is available for both new and used property. Eligible assets are those with a depreciable life of 20 years or less and are expected to include the expanded definition of qualified improvement property. A significant drafting error, however, failed to grant qualified improvement property the reduced 15-year class life (from the 39-year class life it had under the prior law) and therefore, it will also not qualify for 100 percent expensing without correction. This is expected to be addressed in a future technical corrections bill, although that is not certain.

An additional depreciation benefit for commercial property is available under Section 179, which permits expensing of assets that otherwise would need to be capitalized and depreciated. TCJA expands the annual Section 179 limitation for qualifying assets from

$500,000 to $1 million, with a phase out beginning at $2.5 million. Section 179 is available for qualifying improvement property, property that is required to be depreciated under the Alternative Depreciation System (ADS), and property that includes roofs, HVACs, fire protection and alarm systems, and security systems. Cost segregation studies will be more valuable than ever as a result of these changes to 100 percent bonus depreciation and Section 179.

Also, a little spoken of change will potentially impact the ability to use bonus depreciation in acquisitions. Technical terminations of partnerships, which can occur when more than 50 percent of a partnership's interests are transferred, required a host of attendant income tax consequences under the former law. One such consequence required the partnership to "restart" its depreciation with respect to the remaining net book value of its tangible assets. This had the effect of slowing down cost recovery under the former law, as the depreciable lives of tangible assets essentially were renewed instead of being permitted to complete their remaining terms. The TCJA repealed the technical termination rules, and so this depreciation restart rule has been repealed as well. Although bonus depreciation rules under the former law would not have permitted used property to qualify, the TCJA does make used property eligible for bonus depreciation. Hence, the repeal of the technical termination rules removed the potential new ability to claim bonus depreciation as a result of the depreciation restart.

These changes may have important effects in the context of M&A negotiations. Not only should both buyers and sellers consider opportunities to structure acquisitions as asset sales—either actual, constructive or deemed under section 338—but, also, the new capital expensing rules further underscore the importance of purchase price allocations in negotiating transaction terms. And furthermore, the new rules will impact the timing of investments in capital expenditures necessary to expand the infrastructure of a business.

Business Interest Deductions

The trade-off for 100 percent bonus depreciation is the newly enacted limitation on business interest deductions. This will be one of the most important provisions of the new law affecting M&A deals. Leverage is not a new concept, but can be critical in M&A transactions. Large amounts of debt on corporate balance sheets proliferated starting in the early 1980s as a result of the High Yield Bond Market, Leveraged Buyouts (LBOs) and bootstrap acquisitions, among other types of deals. This practice was subsidized in part, of course, by allowing corporations to fully deduct interest payments.

Now, any business whose average annual gross receipts for the prior three years exceeds $25 million, regardless of whether it is a C corporation, PTE or self-employed, is limited in the amount of business interest it can deduct. The TCJA imposes a new limitation on the interest expense deduction for any business, equal to its interest income plus 30 percent of its adjusted taxable income (essentially EBITDA). For tax years beginning after Jan. 1, 2022, adjusted taxable income will be determined according to EBIT—generally representing a smaller number and, therefore, a smaller deduction. Real property trade or businesses also have the option to elect out of the limitation altogether, but as a trade-off, must depreciate property using ADS rules (where bonus depreciation is not available). Excess unused business interest can be carried forward indefinitely.

Additionally, outstanding debt is not excluded from the rules. So it appears that a highly leveraged company will suffer, as its interest deductions for existing debt will be limited, the benefit of the deduction will be limited by the lower rates for C corporations, and the company may not have the liquidity or need to take advantage of

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the new 100 percent bonus depreciation rules. These considerations will weigh heavily on decisions to finance M&A transactions with debt or equity.

International Provisions

Several changes to international provisions will also impact structuring, such as the 100 percent deduction for foreign source dividends, and changes to global intangible low-taxed income and foreign-derived intangible income. For an in-depth look at these and other international planning provisions, see How U.S. Tax Reform Affects International Tax Considerations.

Consider Each Provision Carefully

The M&A landscape has changed in the wake of the TCJA. Understanding the nuance and complexity of the above sections will be important as businesses and private equity alike approach potential transactions. While no one change will destroy the viability of a transaction in and of itself, an oversight in financial modeling which fails to consider the moving pieces of this legislation could have significant financial consequences. These sweeping changes will very likely affect traditional transaction structures and purchase prices in the years to come.

For more information on the tax reform bill and the implications for M&A, please contact:

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