The Impact of 2017 Tax Reform: Industry Winners and Losers

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Tax Cuts and Jobs Act of 2017

- Enacted into law on December 22, 2017
- Most significant change to the Internal Revenue Code since the Tax Reform Act of 1986
- Changes made to both individual and corporate tax law
- Changes impact both domestic and international tax planning for company mergers and acquisitions and property acquisitions and divestitures

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Areas for Tax Planning in Restructuring

- Domestic taxation
  - Reduction in corporate and individual tax rates, along with the 20% deduction for "Qualified Business Income" earned by entities classified as passthrough entities forces a re-examination of choice of entity
  - 100% expensing for acquisition of certain tangible personal property
  - Limitations on the deductibility of interest expense
  - Limitation on the deductibility of net operating losses

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Income Tax Rate Reductions

Corporations

- Highest corporate tax rate reduced from 35% to 21%
- Highest effective tax rate for individuals receiving qualifying corporate dividends
  - 21% + (100 – 21) x 23.8% = 39.8%

Note: (23.8% = 20% qualifying dividends rate + 3.8% net investment income tax)

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Income Tax Rate Reductions

Individuals

- Highest individual rate reduced to 39.6% to 37%
- New 20% Qualified Business Income (“QBI”) deduction for passthrough entities
  - Subject to limitation based on W-2 payroll and assets
- Highest effective rate for individuals receiving QBI from a passthrough entity
  - (100 – 20) x .37 = 29.6%

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Choice of Business Entity is Complicated for Business Owners

- All-in highest tax rate on business income derived from corporate entity = 39.8%
- All-in highest tax rate on business income derived from passthroughs (assuming all income is QBI) = 29.6%
- For short term investments with a high percentage of QBI and anticipated near term cash distributions to owners, the passthrough entity looks to be more efficient
- For businesses requiring reinvestment of profits for a number of years, the corporate entity can still be attractive due to the 21% rate applying during the reinvestment years

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Effect of Lower Income Tax Rates on Asset Valuations

- Lower income taxes for businesses means more cash for investment in:
  - Property, plant and equipment
  - Equity repurchases
  - Compensation increases
- Increased business investment in property, plant and equipment should lead to increased valuations in business acquisitions of such property
- What have the business valuation firms experienced so far?

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100% Expensing for Acquisition of Tangible Personal Property

- Prior law – investments in most tangible personal property recovered through 5-year and 7-year MACRS accelerated depreciation
- 2017 Tax Reform
  - for new or used tangible personal property with qualifying class lives (20 years or less) placed in service after 9/27/17 and before 1/1/23, 100% of investment recovered in the year the property is placed in service
    - Taxpayer may elect not to take advantage of 100% expensing
  - 20% per year phase-down of 100% expensing beginning with property placed in service after 12/31/22
- 100% expensing increases the NPV of the tax recovery benefit for 7-year MACRS property by approximately 25%

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Impact of 100% Expensing on Transactional Structuring

- 100% expensing places the focus squarely on asset purchases rather than stock purchases
  - Generally no step-up in tax basis of depreciable assets inside the acquired corporation
  - Acquirers will look more closely at section 338(h)(10) elections to treat corporate stock purchases as asset purchases but these elections likely still will be rare
- Due to certain rules applicable to purchases of interests in entities classified as partnerships for tax purposes, in the near term businesses with significant depreciable assets and a short horizon prior to sale may choose to organize as a passthrough entity rather than as a corporation
  - Future purchasers of the partnership interest may be able to claim the benefit of 100% expensing for amounts allocated to qualifying assets

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Impacts of 100% Expensing on Allocations of Purchase Price

- Prior law – Bias toward allocating as much of the acquisition price to depreciable property and away from slower recovery amortizable and depletable property as possible
- 2017 Tax Reform – with 100% expensing available for new and used tangible personal property purchased in an acquisition, the bias toward allocating as much of the acquisition price to tangible personal property is even stronger
  - For sellers, increased NPV of expensing can mean an increased FMV for the depreciable asset and thus higher selling prices in the M & A transaction if the tax benefit is not shared with the buyer
  - For buyers, increased NPV of expensing can mean an increased IRR on the purchased business if the tax benefit is not shared with seller
  - How does the tax benefit end up being split between seller and buyer?

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Cost Segregation in Mixed-Asset Transactions

- Cost segregation studies historically used to identify and distinguish units of property with shorter depreciable recovery periods from units of property with longer depreciable recovery periods
  – Example: Study identifies components of an acquired building that have recovery periods qualifying for 100% expensing even though the building itself does not qualify for 100% expensing
  – Result is an improved after-tax IRR for the investment in the building

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Acquisition Financing – Limitations on <u>Deductibility of Interest Expense</u>

- Prior law – limitation placed on deductibility of interest on certain loans from related parties
  - Ex: foreign parent companies stripping interest out of US subsidiaries
- 2017 Tax Reform – business interest deduction generally limited to the sum of (i) business interest income, and (ii) 30% of the "adjusted taxable income" for the taxable year
  - Applies to all loans, whether or not from related parties
- "Adjusted taxable income" for taxable years beginning before 1/1/22 is approximated by EBITDA
  - For taxable years beginning on or after 1/1/22, "adjusted taxable income" is approximated by EBIT
- Any business interest expense disallowed for the taxable year is added to interest expense for the next taxable year and tested for limitation in such year

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Impact of Limitations on Deductibility of Interest Expense on M & A Activity

- Highly-leveraged taxpayers that are limited on interest expense deductions may choose to defer M & A activity until leverage is reduced
- Highly-leveraged taxpayers that are limited on interest expense deductions may choose to employ more equity in acquisitions
- Highly-leveraged taxpayers that are limited on interest expense deductions may choose to employ creative structured finance transactions to avoid the interest expense limitation

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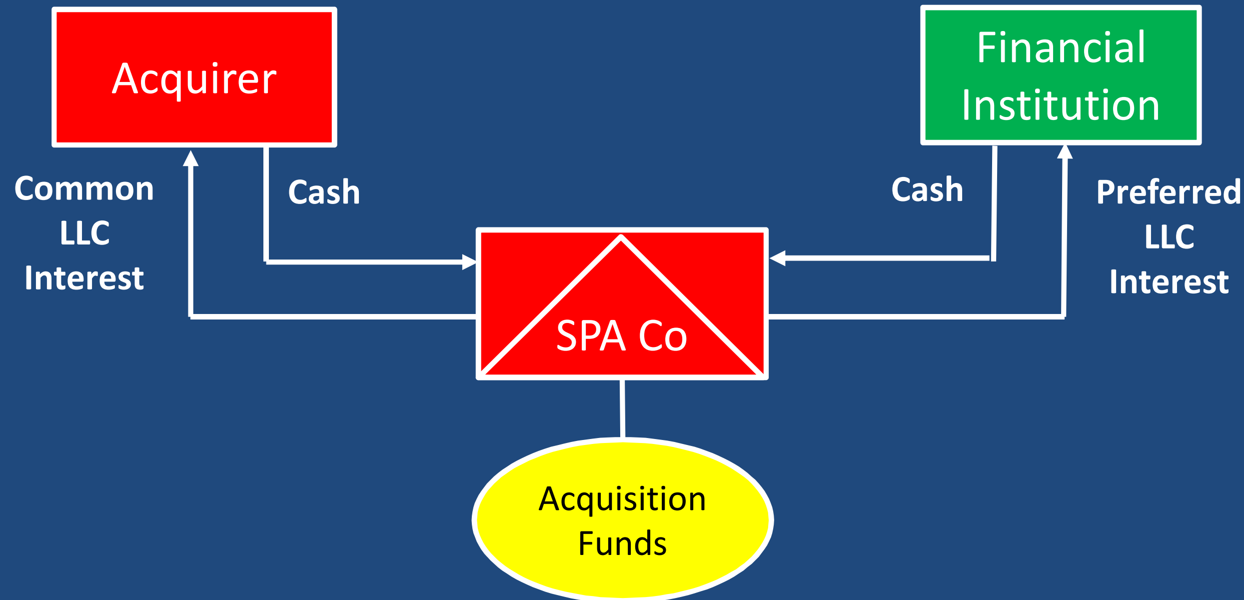
Creative Solutions to the Interest Expense Limitation



- Special Purpose Acquisition Company ("SPA Co") is organized as an LLC
- Acquirer contributes cash in exchange for a common LLC interest
- Financial Institution contributes cash in exchanges for a redeemable preferred LLC interest
- SPA Co makes the acquisition of property
- Spa Co allocates income and cash to Financial Institution to pay the periodic preferred return
- Allocation of income to Financial Institution works like deductible interest expense
- Preferred LLC interest structured to work nearly like debt while still retaining equity treatment

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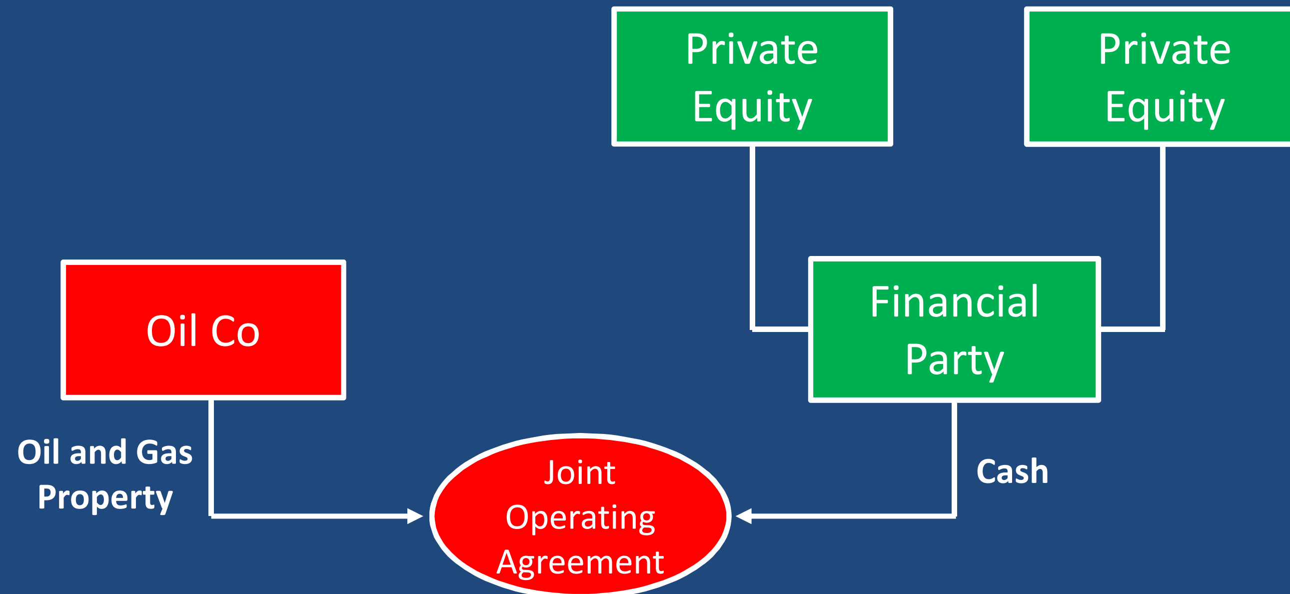
Creative Solutions to the Interest Expense Limitation



- Rather than enter into a reserve-based lending facility, Oil Co raises capital to develop its oil and gas property by entering into a joint operating agreement ("JOA") with a Financial Party (created by private equity sponsors), which joins the JOA as a non-operator
- Financial Party's interest in the JOA is set at a stated working interest percentage until say 120 % of its investment has been returned, with a flip to a much lower percentage thereafter
- The return of capital and return on capital works like debt financing while the residual interest after the flip works like an equity kicker in a mezzanine finance transaction
- Result of the financing is that there is no interest expense for tax purposes

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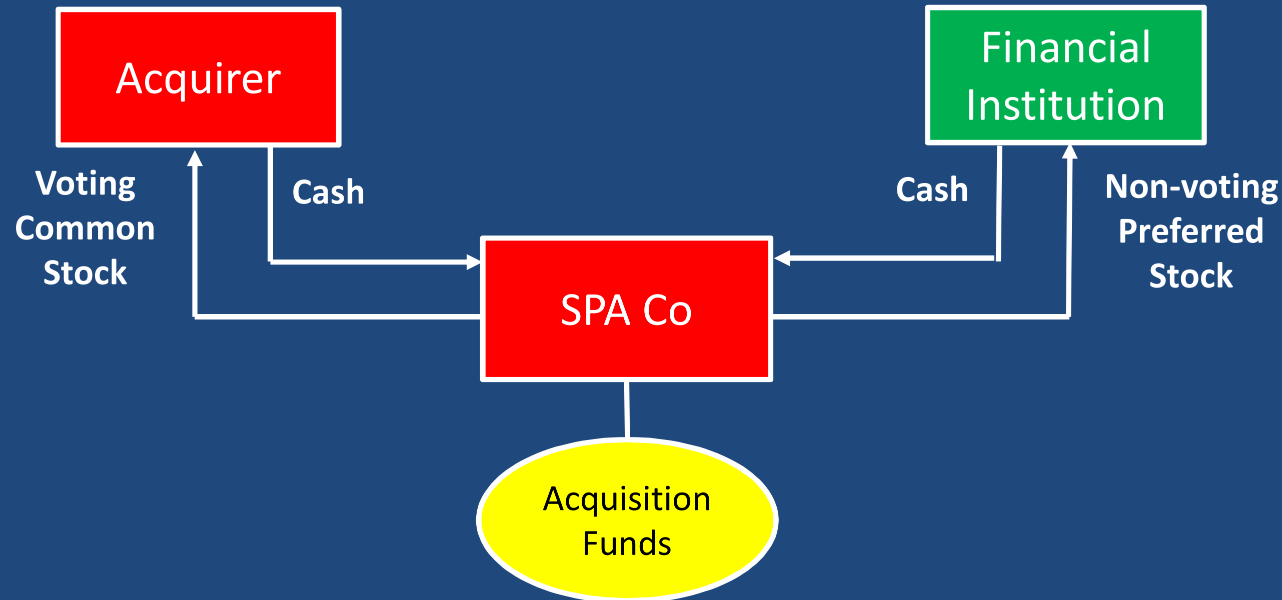
Creative Solutions to the Interest Expense Limitation



- Acquirer and Financial Institution organize Special Purpose Acquisition Company ("SPA Co") as a corporation
- Acquirer contributes cash in exchange for voting common stock
- Financial Institution contributes cash in exchange for redeemable non-voting preferred stock
- SPA Co is the acquiring entity and is a member of Acquirer's consolidated tax return
- SPA Co pays non-deductible preferred dividends rather than interest expense, which is determined to have a reduced value as a deduction

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Acquisitions – Limitation on Deductibility of Net Operating Losses

- Prior law – Net operating losses generally were able to be carried back to the two previous taxable years and forward for twenty taxable years
  - For GAAP accounting purposes, the deferred tax asset generated by the net operating loss carried forward would be examined each year to determine whether the business could be expected to generate sufficient taxable income to absorb the net operating loss during the carried forward period
  - Valuation allowances were made against the deferred tax asset in the event sufficient future taxable income was not expected to be available
- 2017 Tax Reform – Net operating losses arising in taxable years beginning after December 31, 2017 may be carried forward for an unlimited number of years, but the net operating loss carried forward may offset only 80 % of the taxable income for the year, with the balance carried forward to the next taxable year
  - Fewer valuation allowances expected for GAAP accounting purposes for net operating losses arising in taxable years beginning after December 31, 2017

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Impact of Limitation on NOLs on M & A Activity

- Avoid the creation of an NOL by managing timing of deductions – take taxable income down to $1
  - Limit 100% expensing by electing to depreciate certain tangible personal property
  - Limit IDC deductions by electing to capitalize certain IDC
- Due to 80% of taxable income limitation, NPV of post-2017 NOLs used in later years is decreased, which could negatively impact valuation of early-stage target companies (with anticipated NOLs)

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