TAX-INFLUENCED STRATEGIES FOR END-OF-YEAR DEALS

November 19, 2018

I. Executive Summary. On December 22, 2017, the Tax Cut and Jobs Act (the "Act"), the most significant U.S. tax legislation since 1986, was signed into law. Many of the Act's substantial amendments to the U.S. tax code (the "Code") affect business transaction structuring. As we approach the usual rush to get deals done by year-end 2018, the first year in which the Act is substantially affecting deal structuring decisions, reviewing some of the Act's provisions and influences on deal-making is timely.

II. Principal Tax Cut and Jobs Act Corporate Provisions and Likely Influences on Deal Structuring.

a. Corporate Tax Rate. The corporate tax rate has been reduced from a four-bracket progressive tax with a highest bracket of 35% on taxable income of over $10 million to a single, permanent flat tax of 21%, effective 2018. Unlike reductions to the individual tax rate brackets, the corporate tax rate reduction is permanent. Among the effects the new, lower flat corporate tax is likely to have:

- Make C-corporations a more attractive business entity form, compared with limited liability companies ("LLCs") and limited partnerships ("LPs"), which feature "pass-through" taxation (no taxation at the entity level; business owners are taxed at ordinary income rates for their *pro rata* share of profits and losses);

- The Act's lower flat corporate tax may also encourage asset sales. All other things being equal, the seller, or "Target" in a business combination transaction traditionally prefers to structure the deal as a stock purchase because the purchaser thereby succeeds to all of the Target's assets and liabilities. The purchaser traditionally prefers asset purchase structures because it can pick and choose among the Target's assets and liabilities, and because they receive no tax "step-up" of assets, even if the fair market value of those assets is greater than the Target's basis in them. The Act's lowered flat corporate tax rate may encourage the use of asset sale structures.

b. New Pass-Through Business Deduction. Effective 2018, non-incorporated investors in businesses structured as pass-through entities (U.S. LLCs, LPs, S-corporations) and sole proprietorships can deduct approximately 20% of their qualified business income, in a temporary

amendment that expires in 2025. There are some restrictions based on W-2 wages paid to non-sole proprietorship employees. Specified service industries, such as law practice, healthcare, and other professional services are excluded from the deduction, BUT joint filers in the excluded industries with individual income from the business below $315,000 and other filers with income below $157,500 can claim the full deduction. The service business limitation on the pass-through deduction phases in at higher incomes. Among the effects the new, pass-through business deduction is likely to have:

- The pass-through business deduction substantially reduces the taxation on the owners of pass through entities and should make their use for private companies even more popular. The deduction also is a counter to the corporate tax reduction, to the extent that C-corporations may be expected to develop new popularity on account of their lowered taxation.

c. Limitations on Business Interest Expense Deduction. Prior to the Act, interest paid or accrued by a business was in general fully deductible. Effective 2018, the Act limits the deduction of net interest expense to 30% of EBITDA (earnings before interest, taxes, depreciation, and amortization) for four years, 2018 – 2021, and 30% of EBIT thereafter. For pass-through entities, the interest expense deduction is applied at the entity level, not the shareholder/owner level. Interest that cannot be deducted in the current tax year can be carried forward indefinitely. Some businesses are exempt; for example, real property businesses can continue to fully deduct interest, but must use the alternative depreciation method. Among the effects the limitation on business interest expense deduction is likely to have:

- The limitation on business interest expense deduction should disfavor debt financing as a general matter in a time when interest rates are rising after over a decade of hovering near zero. A generation of corporate finance has grown in the extraordinary environment of virtually free money at negligible interest at low inflation. That period may be coming to an end, and the end of full business interest deductibility should be considered when arranging the corporate finance structure. Among other things, convertible debt instruments, term loans, revolving credit facilities, debentures and short-term notes will all change in relation to each other and to equity as a result of the loss of the full deduction, with the incurring of debt by a business a more expensive proposition than hitherto. The relative availability of debt finance may also be affected.

d. Expensing. The Act permits the immediate, full expensing of short-term capital investments. Code s. 179 allows the full expensing of the full cost of new or used depreciable property, previously limited to $510,000. For qualifying assets put in service before 2018, the maximum deduction is $510,000, with the deduction phased out for costs over $2.03 million. For assets put in service in 2018, the maximum s.179 deduction is $1 million, to be phased out with costs over $2.5 million. In future years, the amounts will be adjusted for inflation. Among the effects the expensing amendments is likely to have:

- The expensing amendments should also favor the use of asset acquisition structures for purchasers in business combinations.

e. Executive Compensation. The Act increases the limitations on deductibility of executive compensation. The “performance” exception is also ended. Among the effects the executive compensation deduction changes are likely to have:

- A sharper pencil and a better rationale for high end executive compensation, since it will now cost the company dollar-for-dollar.

f. Anti-Inversion/Territorial Tax Measures. The Act provides initial steps to discourage the widely criticized practice of U.S. businesses with substantial multinational operations maintaining cash income in overseas tax havens like the Republic of Ireland to avoid U.S. taxation if and when the cash was “repatriated” to the United States. The Act deters so-called “inversions” with the “deemed” repatriation over eight years of currently deferred foreign profits at a rate of 15.5% for liquid (cash and cash equivalent) profits and 8% for illiquid (reinvested foreign) profits. This is a step towards “territorial” taxation, in which earnings are taxed where earned, as most tax jurisdictions do, and are not subject to U.S. worldwide taxation, as practiced now. The Act also eliminates federal income tax on dividends received by a U.S. corporation from a 10% owned non-U.S. subsidiary. The Act also discourages inversions by imposing excise taxes on insiders of U.S. corporations that expatriate non-U.S. jurisdictions, and taxes dividends paid to domestic shareholders of the foreign company at ordinary income rates. Finally, the Act imposes a minimum tax of 10% (5% in 2018) on income of certain domestic corporations before allowing deductions for interest, royalties, and other payments by the domestic corporation to foreign affiliates. Among the effects the anti-inversion and territorial tax measures is likely to have:

- Discouragement of inversion practices, including hoarding of cash overseas and payments of royalties and interest to foreign affiliates as a means of U.S. tax avoidance.

g. Carried Interest. The Act requires a three year holding period for availability of long term capital gains treatment to "carried interest" a favorite political whipping boy for critics of the private equity sector, and the investment/money management sector generally. Among the effects the carried interest holding period is likely to have:

- The carried interest holding period will probably be of limited effect since most private equity and venture capital investors typically hold investments for more than three years anyway; nevertheless, short term (less than three years) "flipping is discouraged.

III. Conclusion.

The Act is the most significant change to business and personal taxation in over thirty years. Its provisions must be considered in most business transactions, as what the pre-Act strategy and structure for a given transaction might have been may be materially changed by the Act's provisions.

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