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Decoding the Tax Cuts and Jobs Act – Part IX: Impact on M&A Transactions

By Larry Brant and Steven Nofziger on 4.6.18 | Posted in Legislation, qualified business income, Real Estate, repatriation, stock, Tax Cuts and Jobs Act, Tax Laws, Tax Planning, Tax Procedure, Tax Reform

INTRODUCTION[1]

The Tax Cuts and Jobs Act ("TCJA") will significantly impact merger and acquisition ("M&A") activity. Although billed as tax reform, the TCJA did not reform or simplify the Internal Revenue Code ("Code").

Virtually none of the provisions of the TCJA directly impact M&A transactions. Rather, the TCJA added or modified several sections of the Code that indirectly impact transaction structuring, pricing, negotiations and due diligence. Making matters more complex, some of these provisions of the TCJA are temporary.

This blog post briefly highlights several key provisions of the TCJA and the impact on M&A.

Reduced Tax Rates and 100% Expensing

The TCJA reduces the corporate tax rate from 35% to 21% (a 40% reduction) and repeals the corporate alternative minimum tax. It also reduces individual tax rates and retains the 20% capital gains tax rate, thus maintaining a tax preference for individuals selling stock, real estate or other capital assets.

The TCJA (through 2022) allows buyers of assets acquired in M&A transactions the potential to immediately expense 100% of the cost of depreciable tangible assets (e.g., equipment) in the year the transaction closes and the assets are placed in service. After 2022, the pre-TCJA "original use" requirement springs back to life, under which only the first owner of depreciable tangible assets may qualify to use immediate expensing.

These two changes to the Code clearly impact transaction structuring of M&A. Lower tax rates mean potential sellers may be more willing to sell assets, since they may end up with more money in their pockets than they would have in prior years. Likewise, buyers will likely favor asset purchases if they are able to immediately deduct the cost of equipment and other depreciable assets. The ability to immediately expense such assets without an "original use" requirement will almost certainly result in more transactions being structured as asset

purchases than we saw in previous years.

Additionally, even in a stock purchase, buyers will be more motivated to negotiate for and utilize tax elections under Code Sections 338(h)(10) or 336(e) whenever possible. Taxpayers that qualify to make these elections are able to treat a stock sale transaction as if it was an asset sale for tax purposes. In doing so, buyers may obtain the tax benefits of immediately deducting the cost of equipment and other depreciable assets purchased in an M&A transaction.

Finally, lower tax rates mean sellers have less desire to structure a transaction as a "tax-free" reorganization. So, the use of these nifty provisions of the Code could very well diminish.

Pass-through Deduction

Under the TCJA, non-corporate taxpayers may deduct up to 20% of "qualified business income" received from a "pass-through" trade or business, such as an S corporation, partnership, LLC or sole proprietorship. This change to the Code places most owners of pass-through business entities on par with owners of C corporations who now have the benefit of the 21% top corporate income tax rate. Consequently, buyers may now be motivated to structure transactions so that a pass-through entity will purchase and own the post-transaction business assets and operations.

1031 Exchanges Are Now Limited to Real Estate

The TCJA limits Code Section 1031 to exchanges of real property. Personal property is no longer eligible for tax deferral. Taxpayers wanting to exchange real property that also includes personal property need to be keenly aware of this change to the Code. Consider a taxpayer selling a 300-unit apartment complex and buying a 450-unit apartment complex in a Code Section 1031 exchange. Under the TCJA, all of the attendant personal property (e.g., washers, dryers, dishwashers, stoves, drapes, tools, landscaping equipment, office equipment and furniture, recreation and pool equipment) is now taxable "boot" in the exchange. The taxpayer must now allocate part of the transaction proceeds to the personal property and report income accordingly. This change will significantly impact many transactions involving real estate.

Interest Deduction Limitation

The TCJA effectively limits business interest deductions to 30% of EBITDA (changing to EBIT in 2022). Disallowed amounts can be carried forward. This change will affect many debt-financed transactions and could ultimately lead to fewer highly-leveraged M&A deals. Time will tell.

NOLs

The TCJA limits the use of net operating losses ("NOLs") arising after 2017 to offset income. NOLs arising in 2018 and later years cannot be carried back to prior years and can only offset up to 80% of taxable income, but they can be carried forward indefinitely.

NOLs arising prior to 2018, however, are grandfathered in and may be used to offset income in the manner provided under pre-TCJA law—i.e., they may be carried back 2 years and used to offset 100% of taxable income.

Thus, pre-2018 NOLs are essentially more valuable than NOLs arising in 2018 and later years. The existence of pre-2018 NOLs may enhance the value of an M&A target to buyers, resulting in higher pricing and more significant due diligence to ensure the existence of the NOLs. Be aware of Code Section 382. It still may impact a buyer's use of a target's NOLs.

Repatriation Impacts

The TCJA's changes to the federal taxation of multinational businesses is essentially triggering the "repatriation" of a significant amount of funds that had previously been earned and held overseas. Companies that are repatriating funds now have an additional "war chest" to use for business and investment purposes. It has been estimated that between $1.5 and $2 *trillion* dollars may be repatriated. Companies repatriating funds from overseas may choose to use those funds for M&A purposes. Thus, we are likely to see an increase in domestic M&A activity over the next several years merely as a side-effect of the repatriation of funds formerly held overseas.

CONCLUSION

We have only mentioned a few of the TCJA's provisions that may impact M&A transactions. As has always been the case, any M&A transaction should be thoroughly analyzed by qualified tax professionals before it is structured and carried out. This is even more important with the enactment of the TCJA.

Stay tuned for more posts on the TCJA. Its broad breadth requires additional reporting.

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[1] A condensed version of this blog post was published in the *Portland Business Journal* on April 6, 2018. (subscription required)

Tags: Code Section 1031, Corporate Tax, Decoding the Tax Cuts and Jobs Act, deductions, depreciable tangible assets, expensing, interest deduction limitation, Internal Revenue Code, Internal Revenue Service, mergers and acquisitions, net operating losses, pass-through deduction