Paul|Weiss

Private Equity Digest

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Key Considerations for Private Equity Transactions Resulting from New Tax Law – Part II

As we noted in our last issue, the new U.S. tax law passed at the end of 2017 includes a number of major changes to the federal income taxation of both individuals and businesses, generally effective for taxable years beginning after December 31, 2017. Changes made by Public Law No. 115-97, formerly known as the "Tax Cuts and Jobs Act" (the "Act"), result in several key considerations for private equity transactions, including:

- *Whether pass-through structures, including UP-C structures, continue to be advantageous,*
- *The new 30% limitation on deductibility of business interest expense,*
- *Potential changes to financing collateral packages,*
- *The value of transaction tax deductions and bonus depreciation, and*
- *The potential impact of the mandatory transition tax and GILTI.*

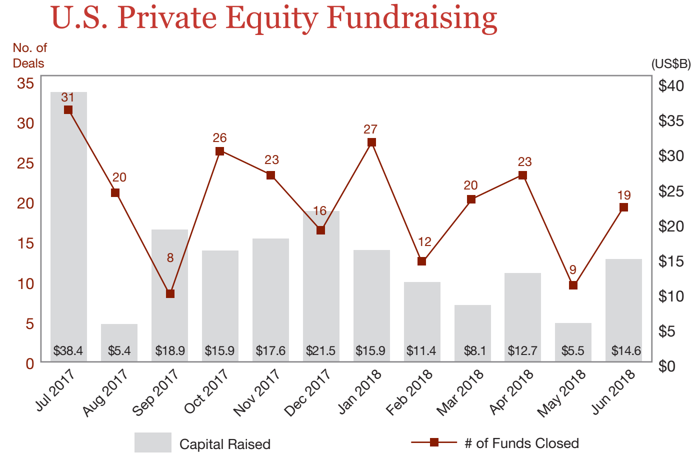
In our last issue (see link), we discussed the first three topics above. In this, the second article on these changes, we will discuss the last two topics.

Acquisition Agreement Considerations

NOLs and Transaction Tax Deductions

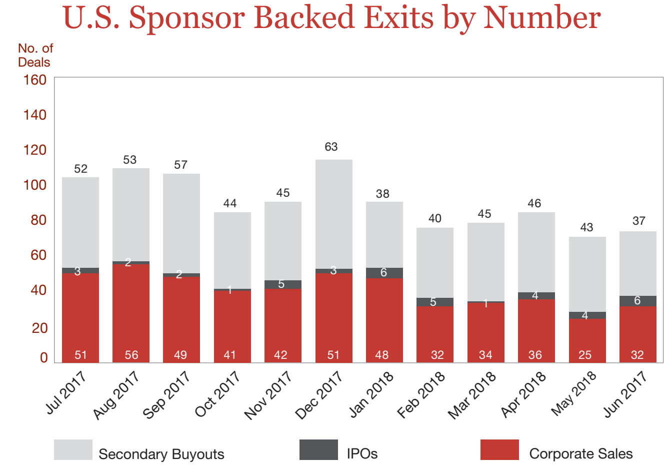
Before the Act, net operating losses ("NOLs") could be carried back for two years and forward for twenty years, and NOL carrybacks and carryforwards were available to offset up to all of a taxpayer's taxable income in a taxable year, except taxpayers subject to the alternative minimum tax ("AMT") prior to the Act were subject to a limitation on NOL deductions to 90% of alternative minimum taxable income in a taxable year. The Act generally eliminates NOL carrybacks for NOLs generated in taxable years ending after December 31, 2017, and allows NOLs to be carried forward indefinitely. Although the Act repealed the corporate AMT, current law now limits NOL carryforward deductions for all taxpayers to 80% of taxable income in a taxable year.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor Backed Exits by Number



Source: Pitchbook

Deal Implications: Before the Act, the market had evolved with sellers requesting and often receiving additional consideration from buyers for tax savings resulting from NOLs generated by transaction tax deductions, which included transaction expenses such as banker fees, debt breakage and option payouts. Such transaction expenses typically reduced the purchase price received by the seller but also created tax benefits for the target company. Historically, companies that were taxpayers during the two years prior to closing and that received large transaction tax deductions at closing could carry back NOLs generated by those transaction tax deductions for such years and claim tax refunds that effectively immediately increased the purchase price. Payments to sellers for tax reductions realized in future periods were also the subject of negotiations.

We expect that buyers will continue to request compensation for transaction tax deductions, but the value of transaction tax deductions has decreased as a result of the lower corporate tax rate and the elimination of NOL carrybacks.

Immediate Expensing for Qualified Property

Under the Act, "qualified property," generally tangible depreciable property, placed in service after September 27, 2017 and before January 1, 2023 is eligible for a depreciation deduction equal to 100% of the adjusted basis of the relevant property. Used property is eligible for the deduction if it is the taxpayer's first use, subject to certain limitations for property held by the taxpayer on September 27, 2017 and for certain related party acquisitions.

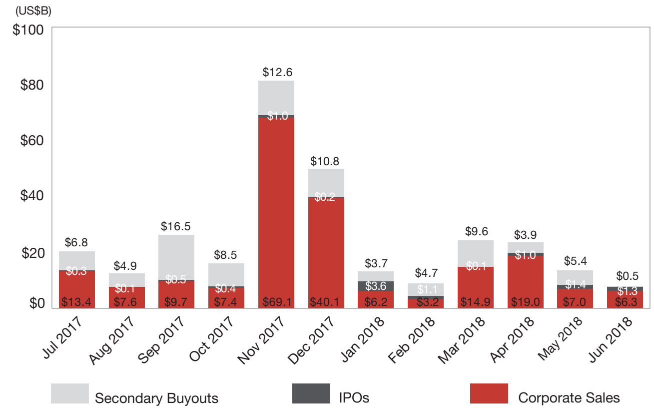
Deal Implications: The value of the basis step-up attributable to "qualified property" is more valuable under current law. If a buyer is willing to pay for the increased value of the basis step-up, it reduces the cost to a seller of an asset sale compared to a stock sale. However, the benefit in a given transaction will depend on the share of purchase price allocated to tangible assets vs. goodwill and other intangible assets. We expect increased attention to purchase price allocation by deal parties as a result.

Mandatory Transition Tax

The Act imposes a one-time mandatory transition tax on any 10% U.S. shareholder's pro rata share of the undistributed, untaxed earnings of a controlled foreign corporation (a "CFC") or other "specified foreign corporation," defined as a corporation with at least one 10% U.S. corporate shareholder.

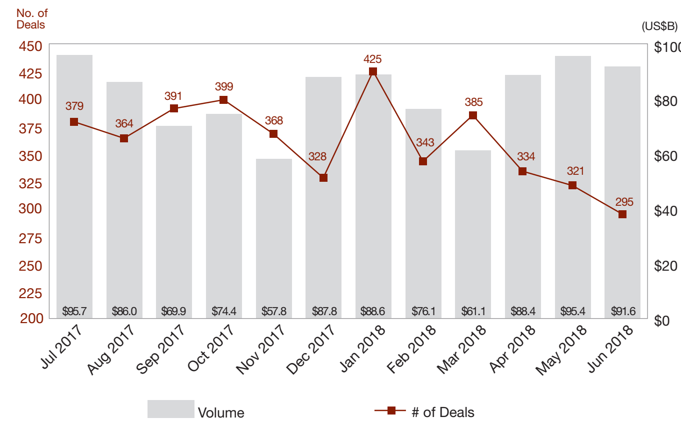
Deal Implications: 10% U.S. shareholders may elect to pay the mandatory transition tax in installments over a period of eight years, creating an additional debt-like item in a purchase of a parent corporation with foreign subsidiaries.

U.S. Sponsor Backed Exits by Dollar Volume



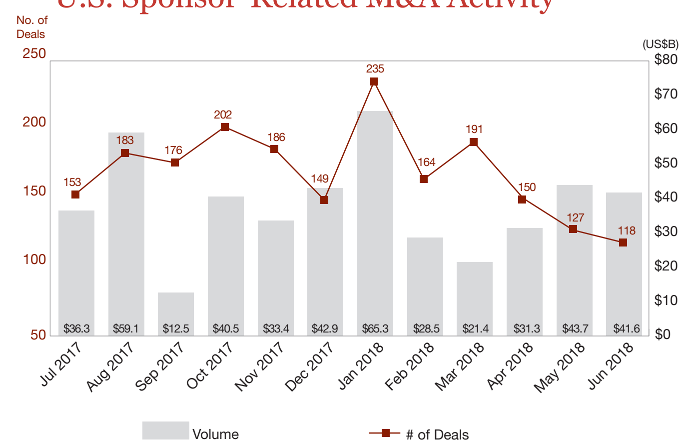
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

GILTI

The Act introduces an annual tax on "global intangible low-taxed income" ("GILTI"). The tax is broader than the name might suggest and is imposed on the excess of a 10% U.S. shareholder's pro-rata share of CFC net income over 10% of its share of the adjusted tax basis of the CFC's depreciable tangible property used in the production of such income. Corporate U.S. shareholders can deduct 50% of GILTI (reduced to 37.5% in 2026) and can use 80% of deemed paid foreign tax credits against GILTI. As a result, the residual U.S. tax on GILTI for corporate U.S. shareholders would be fully eliminated if foreign taxes are paid at a rate of at least 13.125%. An individual, trust or estate with a GILTI inclusion would not be eligible to deduct 50% of GILTI or use deemed paid foreign tax credits against GILTI.

Deal Implications: While U.S. parent holding companies may initially seem appealing given the reduction in the U.S. corporate rate, GILTI may reduce the benefit of such a structure for multinational groups. Sponsors may also want to consider potential GILTI inclusions if a fund will be a 10% U.S. shareholder of a CFC or a fund partner will be an indirect 10% U.S. shareholder of a CFC and consider providing for tax distributions for such taxes.

Takeaway

As a result of a number of major changes to the tax law introduced by the Act, many conventional wisdoms in structuring transactions need to be revisited, including payments for tax assets such as transaction tax deductions and basis step-up and choice of entity and holding company structures. We expect that deal modeling will become more detailed as a result and tax models that previously may have been prepared by deal professionals may require more involvement from tax advisors.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content.
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