Capital Markets and Investment Banking
Market Update

Done Deal: M&A Activity to Surge as a Result of the Tax Cuts and Jobs Act

There has been plenty of discussion surrounding the newly signed Tax Cuts and Jobs Act (the “Act”), a new tax bill, signed at the tail end of December 2017. Stipulating the most extensive overhaul of the U.S. tax code in three decades, the Act has made broad changes to tax rules relative to domestic and multinational businesses in an effort to promote business activity and profitability in the U.S.

These changes include the reduction of the corporate tax rate to 21%, from its previous high of 35%, a new deduction for individual owners of pass-through entities, and a 100% deduction of capital expenditures for acquired tangible, depreciable property. In tandem, the Act progresses to a territorial tax regime, where profits from foreign subsidiaries are not taxed when repatriated, allowing for more U.S. corporate spending. There are also changes to the taxation of non-U.S. earnings which will deter inversions (corporations moving outside of the U.S.). Although there are some tax rules in the Act to offset some of these tax cuts, they apply only to certain corporations and dealings pertaining to carried interest, limits on deductions of interest and net operating loss (NOL) implications.

Due to the reduced tax rate and the resulting substantial increase in available cash to fund acquisitions, the number of M&A deals is expected to increase, especially with the continued pressure on companies to merge. As a further incentive, corporations who are selling off unwanted assets from acquisitions will have a lower tax bill from these sales. This is due to the many conglomerates that have been holding onto non-core assets with the expectation of a large tax bill that might incur. Additionally, at this time of elevated stock prices, corporations are less likely to use their ready cash for share buybacks. Furthermore, The Wall Street Journal anticipates that “deal-making should pick up in industries facing pressure from technology, changing consumer tastes or new competitive pressure such as media, consumer brands and health care.”

Another tax benefit to corporations is the Act’s allowance of a maximum 20% deduction of business income for pass-through entities, excluding indicated service or investment management businesses. For example, the deduction is available to non-corporate taxpayers’ income earned, which incentivizes private equity firms to own portfolio companies in partnership form. As a result, private equity funds may prefer this partnership form with appropriate blocker corporations for tax exempt and foreign investors.

For corporate expensing over the next five years, the Act includes an immediate deduction of 100% of the cost of depreciable tangible assets in service to a taxpayer. This provision will immediately benefit buyers undertaking asset acquisitions as a way to obtain a step-up in tax basis of the assets acquired. It will also incentivize buyers to allocate more of the purchase price toward qualified property, or tangible property with a depreciable life of 20 years or less. This will ultimately benefit the buyer more than sellers, as it will be seen as an immediate cash flow positive to buyers within the first year of deductibility.

In another major effort to make conducting business in the U.S. more appealing, the Act favors a territorial tax system, containing an inversion deterrence tax rate (taxes on multinationals before payments can be made to foreign parties), and includes a tax on foreign subsidies. The Act essentially shifts the U.S. from an international tax system to a territorial tax regime that does not tax foreign profits. This is implemented by eliminating federal income tax on a foreign subsidiary’s dividends paid to the U.S. parent corporation in allowing it as 100% deductible. However, before a complete shift to territoriality, there is a one-time repatriation tax for 10% U.S. shareholders of foreign subsidiaries at a 15.5% rate. The 15.5% rate is for the earning and profits invested in cash or cash equivalents, and 8% rate for other assets.
Although multinationals parented by the U.S. have the ability to pay this repatriation tax in installments over a period of eight years, Wachtell points out that having traditionally regarded these earnings as permanently reinvested, it may have an immediate impact on their financial statements. Also, in M&A negotiations where a U.S. target is connected to foreign subsidiaries, buyers and sellers will have to negotiate how to share or who bares the responsibility of future installment payments.  

In another attempt to keep profits in the U.S. that domestic corporations gain from their foreign subsidiaries, the Act includes a tax on termed ‘global intangible low-taxed income (GILTI)’. Coupled with tax free repatriation of foreign earnings, there is a counter tax on U.S. parent corporations at a 10.5% rate on their foreign subsidiary income that is above a 10% annual return on deemed tangible assets. “The GILTI tax encourages taxpayers to structure an acquisition in a manner that achieves a tax basis step-up, which is typically achievable in the foreign context; this will ultimately increase the foreign subsidiary’s permissible return that is not subject to the GILTI tax.”

The Act also contains some government revenue-raising tax changes that may impact M&A deals. First, there are limits on the interest deductions businesses can take to 30% of EBITDA through 2021, and 30% of EBIT starting in 2022, which will negatively impact private equity. As a result, firms that use debt to fund acquisitions may need to supply more cash and may reduce the number of highly leveraged deals, as preferred equity becomes more attractive. Second, for ‘carried’ interest, the Act requires a three-year holding period for the provider of investment services in order to obtain the long-term capital gain rate. Wachtell does not see this having much of an impact on M&A activity due to the usual holding period for most PE investments. Although Winston & Strawn weighs in that this is the first time that the relevant holding period for investors is different than that of the sponsors. Third, in light of the fact that M&A transactions tend to create large tax deductions for sellers, the reduced corporate tax rate may result in net operating losses not being as significant in these deals.

The reduction in corporate tax rates is expected to arm companies with more cash to fund acquisitions and could potentially increase the value of private equity-owned companies. “Many conglomerates have been holding onto non-core assets because they didn’t want to generate a big tax bill on the sale”. Lower tax rates will also make transactions more enticing as the reduced rate, recovery of capital expenditures and changes to the international tax regime start to impact transaction structures. “For example, asset purchases may become more attractive relative to purchases of stock, the tax free treatment of spin-off may become less important, and ‘inversions’ will be less attractive” (Wachtell).

While the long-term effects of the Act on the U.S. economy are yet to be determined, it can be said that in the near-term, domestic M&A will see a boost as a result of several provisions. This includes but is not limited to the reduced incentive of corporations holding cash offshore, of which could be repatriated and put to use for capital expenditures, debt repayment, stock buybacks and M&A.