Impact on M&A of Potential Changes In Federal Tax Policy

Michael Schler

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One-Time Changes in Tax Law (1)

- Repeal of recent regulations under Congressional Review Act
  - Could apply to section 385 regulations (debt/equity) and various anti-inversion regulations
  - Standing alone, repeal might encourage inversions of U.S. companies and leveraged cash purchases of U.S. companies by non-U.S. companies
  - However, this may not happen in short term because of uncertainty about the resulting benefits under long-term tax reform

One-Time Changes in Tax Law (2)

- Low-tax repatriation of “trapped” foreign earnings
  - There is currently over $2 trillion of “trapped” untaxed earnings in foreign subsidiaries of U.S. parent corporations. Much of it, but not all, is in cash.
  - The current tax cost on repatriation of such earnings is 35%, reduced by foreign taxes paid on the earnings (often minimal). This tax rate might be reduced to 5-10%.
  - Some say that U.S. parent corporations receiving such cash would likely use the cash to make acquisitions.
  - Others say that shareholder pressure may cause the cash to be used for dividends and stock buybacks instead.

“Basic” Corporate Tax Reform

- Involves (1) lowering of corporate tax rate from 35% to 15-20%, with elimination of some deductions, and (2) adoption of territorial system so that foreign earnings are not taxed.
- Lower tax rate will generally reduce benefits of tax planning, and will free up cash that might be used for acquisitions.
- Territoriality will reduce the benefits of inversions, or other foreign acquisitions of U.S. corporations with foreign operations. Those transactions are designed to reduce U.S. tax on <u>foreign</u> earnings.
  - Some benefits would still exist.
- However, territoriality will increase incentives to shift <u>domestic</u> earnings offshore.
  - The avoidance of tax on shifted earnings is permanent and arises even if the earnings are brought back to the U.S. immediately.

"Intermediate" Corporate Tax Reform: Expensing/No Interest Deduction (1)

- Proposed "cash flow" tax:
  - The cost of all nonfinancial assets except land would be immediately deducted, instead of depreciated over time.
  - No interest deduction would be allowed.
  - This regime might be mandatory or elective.
- This regime would not apply to purchases and sales of financial assets. Presumably the existing rules for stock basis and tax-free reorganizations would still apply.
- Reason for loss of interest deduction: interest deduction plus immediate expensing of assets results in negative tax rate on earnings.

“Intermediate” Corporate Tax Reform: Expensing/No Interest Deduction (2)

- Loss of interest deduction would have significant effects on m&a.
  - Acquisitions would be more expensive
  - Disadvantage for private equity using leverage as opposed to strategic purchasers using retained earnings
  - Additional cost from loss of deduction might be offset by benefit of immediate expensing for asset purchases, but not for stock purchases (see next slide)

“Intermediate” Corporate Tax Reform: Expensing/No Interest Deduction (3)

- Expensing of assets would also have significant effect on m&a
  - Relative benefit of stock and asset purchases would be different than today.
    - All nonfinancial assets except land would have a “zero” tax basis.
    - Presumably, purchase price of such assets would be fully taxable to seller and fully deductible to buyer.
    - Tax trade-offs between stock sales and asset sales would be much different than today.
  - New incentive to make acquisitions
    - Companies with a taxable profit could put off tax indefinitely by reinvesting the profit in new assets or in acquisitions of the assets of existing businesses.
  - Expensing will also create large book/tax differences and deferred tax liabilities.

"Advanced" Corporate Tax Reform: The Destination-Based Cash Flow Tax (DBCFT) (1)

- In addition to the foregoing, under a proposal being considered by the House Ways and Means Committee:
  - A U.S. taxpayer importing goods would not get a deduction for the cost of the goods, but would have gross income equal to the full sale price of the goods
  - A U.S. taxpayer exporting goods could fully deduct the cost of the goods (except for imported components), and would be exempt from tax on the sale price of the goods
- This is designed to encourage exports, discourage imports, and eliminate the tax benefits of shifting intangibles and production outside the U.S.

"Advanced" Corporate Tax Reform: The DBCFT (2)

- Consequences of DBCFT
  - Importers could easily owe more tax than their total profit on the sale. They might raise their prices to the public to cover the extra tax.
  - Exporters could easily have a profit on the sale, yet have a valuable tax loss on the sale that could shelter other income. They could lower their prices and be more competitive abroad.
  - However, many economists believe that these effects would not arise because the value of the dollar would increase due to increased demand by foreigners for U.S. goods (and the dollars to pay for them), and decreased demand by U.S. persons for imports (and the foreign currency to pay for them).
  - If this is correct, the resulting appreciation in the value of the dollar would have large world-wide economic consequences, e.g., it would result in a shift of value to foreigners holding dollar-denominated assets, and away from U.S. persons holding foreign-currency denominated assets.
- Not surprisingly, importers are strongly against DBCFT. President-elect Trump has also recently stated his opposition to it.

“Advanced” Corporate Tax Reform: The DBCFT (3)

- DBCFT eliminates incentives to shift intangibles, factories, etc. offshore.
  - Today, it is better for a U.S. corporation to hold its intangibles offshore.
    - Usually located in low tax jurisdiction
    - Goal is deduction for royalty payments in operating jurisdictions
    - This does not solve the problem of the accumulation of earnings in the offshore jurisdiction.
  - Under DBCFT, it is better for intangibles to be held onshore.
    - If held onshore, no income on receipt of royalty payments from foreign payor, since this is receipt of a payment for an “export”.
    - If held offshore, no deduction by U.S. payor of royalties, since this is a payment for an “import”.
    - In an acquisition transaction, a U.S. onshore purchaser obtains an immediate deduction for full purchase price.

“Advanced” Corporate Tax Reform: The DBCFT (4)

- Effect of DBCFT on m&a.
  - Largely eliminates benefits of inversions and tax planning to shift income offshore, since tax depends on where sales take place, not where assets are located.
  - Appreciation in dollar (if it happens) would make it cheaper for U.S. corporations to buy foreign corporations, and more expensive for foreign corporations to buy U.S. corporations.
  - U.S. exporters would have tax losses. Tax benefits would be achieved if those losses could be used currently within the tax system.
    - Exporters could merge with profitable companies that could use the losses, especially importers that would have nondeductible costs and could use the extra deductions.
    - Alternatively, an exporter X with tax losses might transfer the benefit of the losses to an importer Y by directly buying the imported goods from abroad (nondeductible purchase price) and then reselling the imported goods to Y (so X has income sheltered by its losses and Y has deductible purchase price on a domestic purchase).