February 14, 2017

US Tax Reform: Understanding the Proposals and Executing Transactions in the Face of Uncertainty

Focusing on Issues for Legal, Business Development and other non-Tax Executives

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Agenda

- Welcome and Introduction
- Logistics and Today's Panel
- Today's Topics
  - Overview of key terms in the House GOP Blueprint and the Administration's views
  - Understanding the possible impact on existing and future debt financing terms and structures
  - Best means of mitigating the impact of tax uncertainty while executing on M&A transactions
  - Managing forward-looking disclosure in a dynamic tax environment
- Questions

Prospects for Tax Reform – Are the Stars Aligning?

- Since the last significant tax reform (1986), the US corporate tax system has increasingly become an outlier as other countries have lowered corporate rates and adopted territorial tax systems and a heavier reliance on VAT; various reform attempts (Camp Bills)
- Tax reform was identified as key agenda item during the campaign by President Trump ("Trump Plan")
- Ways & Means Committee released tax reform blueprint in June 2016 ("Blueprint") – this is the principal focus of the Business Community, and this program

Key Elements of Blueprint (Big 5)

- Lowers corporate tax rate from 35% to 20% (Trump Plan rate – 15%)
- Disallows deduction for interest expense, except to extent of interest income
- Territorial system – Future overseas earnings of US multinationals exempt (as opposed to current system of worldwide tax with deferral, and foreign tax credit)
- One time mandatory tax on accumulated overseas earnings
- Businesses subject to cash flow tax (border adjusted)

Key Elements of Blueprint: Other

- Beyond the “Big 5” changes:
  - 25% tax on pass through income
  - For individuals: investment income taxed at 16.5% (Note: this equalizes taxation of interest and dividends); repeal of estate and gift taxes; Other changes for business and individuals
- More questions than answers on many issues
- Process: Congress, President, Timing, Transition
- Clear that impact of these fundamental changes significant beyond just tax world, including on M&A, finance, securities disclosures and structuring global platform and supply chain

Corporate Capital Structure

- Blueprint disallows deduction for interest expense, except to extent of interest income
  - Seen as tradeoff for immediate expensing of investments (Trump Plan – elect full expensing ***or*** interest deductibility)
  - Blueprint: Special rules for financial services companies
- Impact
  - Incentivize companies to push debt overseas (where interest deduction may be available and beneficial)

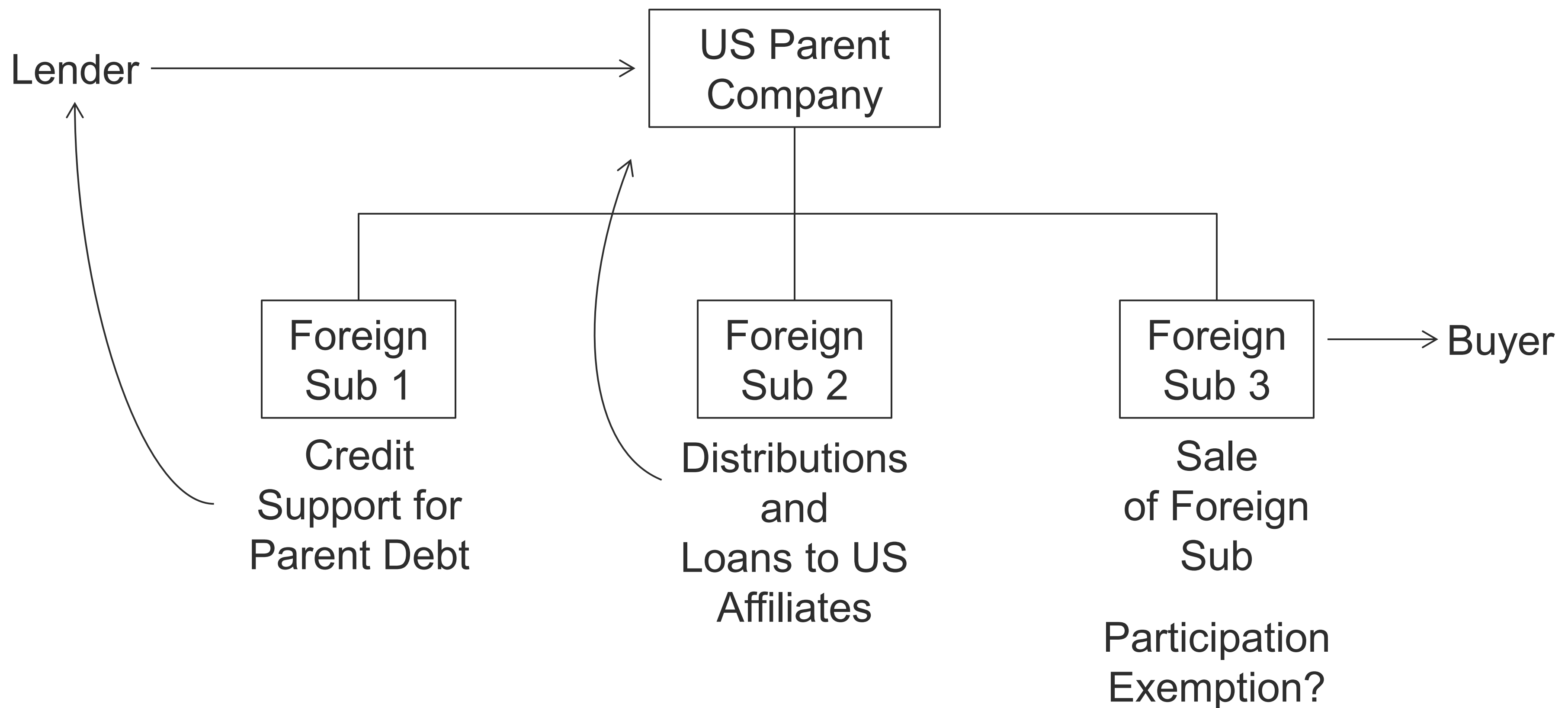
Corporate Capital Structure

- Loss of tax benefit from interest expense; but…
- Investors may prefer debt:
  - US Investor – rates on interest and dividends equalized
  - Non-US Investor – withholding tax considerations (portfolio interest exemption, lower treaty rate)
  - Creditor's rights

Territorial System

- Future overseas earnings exempt when earned and repatriated (except narrow category of passive income)
- Blueprint is not specific, but it seems reasonable to expect most of "CFC rules" would disappear
  - Repeal section 956?
  - Eliminates "Lockout effect" on foreign earnings
  - Will there be a participation exemption on sale of CFC?
    - Prior territorial tax bills have differed

Territorial System – Consequences



Repatriation – Territorial System

- Blueprint: one-time tax on deferred earnings – mandatory deemed repatriation (Trump Plan similar – slightly higher rates)
  - This is not a repatriation holiday (such as 2005), but rather a one time tax imposed on historic earnings
  - 8.75% for cash and cash equivalents
  - 3.5% for invested earnings
  - Payable over 8 years
- Unlocking $2.5 trillion of earnings
  - Pressure for buybacks and one-time dividends?
  - More domestic M&A?
  - SEC Disclosure Issues

Destination-Based Cash Flow Tax

- Revolutionary and controversial – based on "cash flows" and would be "border adjustable"
- Cash-flow tax on business activity
  - Immediate expensing (so no basis)
- Border Adjustments
  - Exempts US Exports from Tax. Revenue (not just profit) from exports (products, services)
  - Fully Taxes US Imports. Cost of imports not deductible; when USCo sells an imported good in US, tax imposed on full revenue received
  - Similar to border adjustments in VAT's

Destination-Based Cash Flow Tax

- Observations
  - Net effect is to impose tax on goods/services consumed in US, regardless of where produced
  - Potential WTO Issues – border adjustments allowed only for indirect taxes (e.g., VAT)
  - Is it still “income tax” for purposes of income tax treaties?
- Impact
  - US exporting business more valuable, and conversely US importing business less valuable?
  - Economists assume currency prices will adjust
  - Application to complex supply chains?

Territorial Regime Coupled with Border-Adjusted Cash-Flow Tax: Upends Certain Fundamentals

Current Law Strategy	Blueprint Strategy?
1. Migrate IP to Low Tax Jurisdiction	1. Consider keeping IP in US?
2. Deferral of overseas earnings, with an eye toward eventual foreign tax credit maximization	2. Accumulate earnings in US to avoid: host country “friction” of income taxes and repatriation (W/H Taxes, etc.) and concerns over issues like EU State Aid ? (FTC irrelevant?)
3. Local sales sourced to low tax manufacturing locations (Ireland, Singapore)	3. Local sales sourced to US manufacturing locations
4. Deal with fact that US exports taxed at relatively high rate	4. US exports exempt
	5. Also, consider impact of territorial system without border adjusted cash flow tax?

Will Changes Impact Choice for Place of Incorporation?

- Lower rate / territorial system expected to make US much more competitive
- Cross border mergers take into account tax, but other factors (cultural, market perception) also drive choice of Holding Company Jurisdiction
- For time being, trend may continue for Non-US Holding Company (subject to Anti-Inversion rules) when available
- But consider impact of (i) loss of interest deduction (for related and unrelated party debt), and (ii) DBCFT
- Revamp of a century of law – time to adjust

Possible M&A Transactions Matters and Attributes that may be Affected by Tax Reform

- Value of Tax Attributes
  - Net operating losses
  - Step-up in basis vs. immediate deduction
  - Tax advantaged industries or structures
- Structural Costs of Operating Structures
  - Border Adjustment Tax implications
  - Tax base and profit allocation
  - Changing value of "trapped cash"
- Financing Implications
  - Tax related conditions in financing commitments
  - Allocation of debt for deal financing
- Deal Structure
  - Stock vs. asset acquisitions
  - Domicile of HoldCos for cross-border combinations

How Should the Principal M&A Agreements Best Address these Concerns

- The Buyer's Perspective
  - Fundamental revaluation of assets or cash flows
  - Tax structuring of transaction
  - Financing conditions/termination rights
- The Seller's Perspective
  - Avoiding unintended traps in representations
  - Tax driven aspects of purchase price adjustments
- The Challenges in Relying on the "MAC" Approach
  - Customary exclusions for changes in law
  - Foreseeability of events or circumstances and other case law challenges
  - Caution to the Seller on "disproportionate effects" carve out
- Defining When Tax Reform has Created Risk or Issues

How Should the Principal M&A Agreements Best Address these Concerns

- Alternative Approaches Now
  - Affirmative disclaimer of tax reform impacts
  - Conditions to closing/bringdown risk
  - Termination rights
  - Covenants to seek to restructure certain matters
  - Purchase price adjustments
  - Assessing where tax reform stands at your signing

- A Brief Word on Activism
  - Allocation of repatriated cash
  - Capital structures
  - Sorting out the “winners and losers”

M&A Effects Will Ripple Through Debt Financing Commitment Letters

- Internal credit analysis and modeling by lenders and debt investors
  - Specific proposals will impact certain industries or business segments differently
  - Even if statutory tax rates come down, highly leveraged credits (and industries) may confront significant increases in tax payments due to the loss of net interest deduction
- Conditionality and MAE provisions
  - Lenders will want to understand how parties to an M&A agreement allocate tax reform risk
- Could commitment letters permit issuers to move debt to entities in non-US jurisdictions based on tax reforms enacted post-commitment?
  - Syndication, regulatory and tax issues affecting lenders will limit ability to place debt in other jurisdictions

Repatriation Relief and Abolition of Section 956: Impact on Debt Financing Structures

- Section 956 creates a “deemed dividend” when foreign subsidiaries provide credit support to debt of US parent
  - Elimination permits US debtors to provide a more expansive collateral package from non-US operations as part of a unified credit
    - Borrowers with significant foreign income / assets may benefit from lower cost of capital
    - Alternatively, debt can be placed overseas
  - Existing debt agreements will need review to see how non-US subsidiaries are treated
    - Carve outs to guarantee and collateral requirement may be defined with reference to Section 956
    - Springing guarantee and collateral requirements may conflict with other debt at such entities, may be restricted by applicable local law or may be cost prohibitive

Repatriation Relief and Abolition of Section 956: Impact on Debt Financing Structures

- Elimination / reduction of adverse treatment of repatriation of overseas earnings
  - Many debt agreements contain an "adverse tax consequences" exception to certain mandatory prepayments
  - Prepayments (including with respect to some prior mandatory prepayment events) may result if repatriation is not restricted or penalized
  - Repatriation implementation rules may encourage increased debt levels at non-US subsidiaries, using the proceeds of such debt to make distributions in respect of offshore earnings (subject to local law limitations)

Additional Debt Financing Questions

- Revisiting the use of “EBITDA”?
  - With border adjustments, denial of deduction for net interest expense, and full deduction for expenditures, income tax is becoming more like consumption tax
  - Will credit analysts, buy-side investors or bank regulators revisit their models or covenant metrics?
- Pay-In-Kind (“PIK”) Debt and AHYDO
  - We may see longer-term PIK debt
    - To deduct interest expense on “PIK” debt with a maturity over 5.5 years, a “catch up payment” must be made (typically within 5.5 years after maturity)
    - If interest is not deductible, there is no tax-driven advantage to a “catch up payment” or a 5-6 year maturity
  - Existing agreements will need review to see if catch up payments will still be required (or permitted)
- Implementation effects
  - Grandfathering existing debt will increase desirability of “traveling capital structures”
  - Changes in bond call protection?

Key Takeaways for SEC Disclosure

- Most companies to date have not yet included significant SEC disclosures on potential tax reform
- Many companies already disclose that possible tax reforms could jeopardize expected tax benefits or otherwise affect their business
- Most new disclosures currently note, via incremental changes to risk factors and MD&A, broad potential for tax reform and possible effects on financial results
- Some public companies have addressed possible impact of tax reform outside of periodic reporting, e.g. letters to shareholders, earnings calls, supplemental proxy materials

Recommended Steps

- Review existing disclosure and, where material, consider discussion of how potential reforms may affect the business or financial statements
- Consider effects of reduced tax benefits, changes in industry dynamics or reactive measures by non-US jurisdictions on business and results of operations
- Address uncertainties, if material, relating to potential tax reform in risk factors, MD&A and forward-looking statement disclaimers
- Assess regularly for any necessary updates to disclosure, including financial statement footnotes

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Questions?

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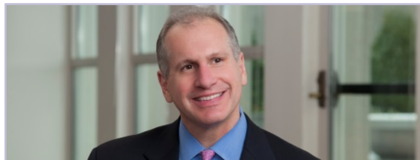

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