DEAL LAWYERS

Vol. 11, No. 3 May-June 2017

Tax Reform: Transaction Strategies for Uncertain Times

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As is readily apparent in the press, Congress, President Trump and the business community are intensely focused on tax reform in 2017. Multinational corporations, small businesses, financial services entities and investment and private equity funds are all surveying proposed changes, and many are involved directly or through industry associations in efforts to shape the policy discussion.

While the House Ways & Means Committee and the Trump Administration are working on further developing these proposals, business leaders and in-house counsel are faced with the question of how to approach transactions (and, for listed issuers, public disclosures as well) in the face of such uncertainty.

Overview of Tax Reform Proposals

In June 2016, the House Ways & Means Committee released a report entitled "A Better Way—Our Vision for a Confident America" (the Blueprint) proposing fundamental changes to the US Internal Revenue Code (the Code). In addition, the President released a high-level plan entitled "Trump—Tax Reform that Will Make America Great Again" (the Trump Plan) during the presidential campaign.

The below chart provides an overview of the five key issues of concerns to businesses.

Blueprint	Trump Plan
1. Lower Corporate / Investment / Pass-Through Income Tax Rates	
Corporate tax rate of 20% and elimination of corporate alternative minimum tax (AMT).	Corporate tax rate of 15% and elimination of corporate AMT.
Investment income generally taxed at 16.5% and elimination of 3.8% net investment income tax for individuals.	Maximum rate of 20% on long term capital gains and qualified dividend income for individuals.
Special 25% rate on distributive share of business income allocable to partners/members in pass-through entities.	Unclear, but indications of an elective 15% entity level tax for at least some pass-through entities.

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ISSN 1944-7590

Blueprint	Trump Plan
2. Interest and Other Deductions	
Investments in tangible and intangible assets (other than land) can be fully expensed in the year incurred.	Manufacturing firms may elect to fully expense capital investments in the year incurred.
No net interest deduction, for related or unrelated party debt, with net interest expense instead being carried forward indefinitely to offset interest income.	A manufacturer that elects to immediately expense capital investments may not deduct interest.
"Special interest" deductions are eliminated, but the R&D credit remains in place.	Domestic production and other business credits are eliminated, but the R&D credit remains in place.
3. Territorial System	
Going forward, foreign earnings of US multinationals are generally exempt from US tax regardless of whether those earnings are held offshore or repatriated.	It is not clear that a traditional territorial system would be enacted under the Trump Plan.
4. One-Time Tax	
The existing, deferred foreign earnings of US multinationals are subject to a one-time tax of 8.75% (for earnings held in cash and cash equivalents) and 3.5% (for other earnings), each payable over eight years.	The existing, deferred foreign earnings of US multinationals are subject to a one-time tax of 10% (for earnings held in cash) and 4% (for other earnings), each payable over 10 years.
5. Destination-Based Cash Flow Tax (DBCFT)	
Businesses are taxed on cash flow rather than income. Border adjustments are imposed that are intended to subject imports to full tax while exempting exports. Net effect is a business tax that is akin to a tax on US consumption.	There is no indication in the Trump Plan that a similar border adjustment tax would be enacted, though possibly a border adjustment tax would dovetail with some of the trade concerns the Trump Administration has raised.

The proposals in the Blueprint reflect a potential sweeping overhaul of the US corporate tax system. While uncertainty remains regarding which, if any, of the proposals will be enacted, there is a high expectation in the business community that some form of tax reform will become a reality in the near term.

The remainder of this article summarizes the key considerations for executing capital markets, finance, private equity and M&A transactions, and for complying with SEC disclosure requirements, in light of this uncertainty. It also considers the impact on certain industries.

Key Considerations for Capital Markets & Finance

The proposed reforms would impact the factors issuers consider when they determine where to raise capital and whether to do so by issuing debt or equity. The lower stakes of recasting debt as equity (and vice

versa), may result in the use of more hybrid instruments tailored to meet the specific economic needs of the issuer and the market rather than to satisfy traditional definitions of debt or equity.

Similarly, proposed changes to the deductibility of interest expense could also reduce the relative disadvantage of pay-in-kind debt with a maturity longer than 5.5 years (when compared to cash-interest-paying debt), which exists under current tax law.

Whether, during the interim period until adoption of any of the proposed tax reform, bespoke redemption provisions emerge that allow bonds to be redeemed at a reduced premium upon a change in the deductibility of interest expense remains to be seen.

Alternatively, there may be a rush to issue debt in advance of any deadline that may be set for debt to be "grandfathered" (if that is part of an adopted regime). Note the discussion above regarding the challenges policymakers might face in deciding whether to allow grandfathering.

The Blueprint's territorial system would likely eliminate Code Section 956. The elimination of Code Section 956 would allow non-US subsidiaries to both borrow directly and then upstream proceeds of such borrowing or to simply provide guarantees and security for global credit support.

Additionally, the unavailability of a US net interest deduction may cause multinationals to push debt to their foreign affiliates that can benefit, under local tax law, from net interest expense.

The removal of Code Section 956 may also affect existing credit agreements, in that, depending on the wording of the relevant credit documents, additional guarantees or security, or mandatory prepayments, may be triggered.

Key Considerations for M&A: Strategic & Private Equity

In the context of M&A, the implications of pending tax reform may cause difficulty in planning and executing deals. Most commentators attempt to provide guidance for deals that may be agreed to after the effective date of tax reform, as to which the consequences of reform would then be foreseeable, such as offshore cash coming onshore or changes in deductibility.

Of equal concern, however, are pending deals that may be entered into while reform is pending. During this period, the definitive deal terms and timing may be clouded, including as to how the future value of an acquired business may be meaningfully impacted by the contemplated tax reform. The issues to be considered for M&A transactions taking place during this interim period are outlined below.

Tax Attributes. A target's tax attributes can have substantial implications for value and deal structure. Net operating losses, for example, are often used by the acquirer to shelter income. The value of that use is often reflected in the purchase price.

If lower tax rates are implemented, that attribute has less value to the buyer and, as a consequence, will receive less consideration in the value of the purchase price. Conversely, the Blueprint preserves and enhances the notional value of net operating losses which could potentially compensate for any diminished value associated with lower tax rates.

Changes to corporate tax rates create similar valuation implications for depreciation deductions. However, the Blueprint provides for the immediate deduction of investment costs, which may include the cost of acquiring business assets and which would enhance the tax benefits of asset investments/acquisitions and perhaps compensate for any diminished value associated with lower tax rates.

Financing. As commitments begin to reflect the uncertainty and risks associated with tax reform — particularly those commitments that are longer dated — covenant packages and even conditions of closing may become tied to the terms and timing of the implementation of tax reform. Such tying may result in a discontinuity between the conditions of closing for the underlying transaction and the financing, creating uncertainty for the buyer, seller or both.

In the case of private equity buyers, a misalignment of conditions under debt financing commitments and definitive acquisition agreements could increase the likelihood that reverse termination fees become payable to sellers in the event of a financing failure and, consequently, impact the size of reverse termination fees.

As a result, private equity sponsors and other acquirers may seek matching conditionality in acquisition agreements. Further, private equity sponsors may look for optionality to fund additional equity if there is tax reform limiting or eliminating the deductibility of interest on debt financing, and/or negotiate for the ability to prepay outstanding debt at any time without penalty.

Deal Structure. If immediate deduction is obtainable, buyers will prefer asset deals over stock acquisitions. Two elements of friction, however, are worth considering. First, taxation at the corporate and shareholder level will result in an additional tax cost to the seller. Whether the reduction in effective rates will offset this cost sufficient to overcome this friction will depend on the final terms of reform.

Second, there are transaction costs associated with asset transfers as well as commercial concerns regarding assignment of contracts and similar agreements. Even so, the Blueprint's provision for immediate deductibility may drive asset structures in whole or in part.

Structural Costs Associated with Operating Structures. Certain changes included in the Blueprint may have significant implications for the structural costs of operating structures. Among these, the mandatory one-time tax on accumulated earnings, the DBCFT and the implementation of a territorial system may affect the amount and destination of a business' cash flows.

For example, if a US target has substantial offshore production, its cash flow after taxes could be adversely impacted. Conversely, "trapped cash" — cash and cash equivalents that historically cannot be repatriated except at a substantial tax cost — will be calculated fairly differently, as offshore cash can be repatriated with lesser or no tax cost in the long run (or conversely there will be a near-term one-time significant tax cost associated with legacy offshore profits), and the acquisition agreement will likely want to account for this trapped cash in, for example, the calculation of working capital.

Domicile of Holding Company. The potential for tax reform and Brexit have furnished the proverbial perfect storm as parties in cross-border mergers work to decide on the corporate and tax domicile for the combined companies. Many of the combinations in recent years have chosen the UK for a variety of reasons, including tax efficiencies.

Notwithstanding the Brexit uncertainty and the prospect of the US adopting historically low corporate rates, in the near-term, parties will likely continue to utilize non-US domiciles for holding companies. The UK will likely remain attractive for reasons beyond tax efficiency, including soft considerations associated with governance and other concerns, as well as the uncertainty associated with the specific terms of legislative and regulatory implementation of tax reform in the US.

How Should M&A Agreements Best Address Tax Reform Uncertainty?

The Challenges. From the seller's perspective, it's important to avoid unintended traps in representations and warranties. This concern is more applicable to private deals rather than public, since generally these representations are brought down to closing by way of a material adverse event provision. However, private deal representations can be brought down to closing on a materiality standard, and there is often indemnity.

Purchase price adjustments may also become distorted. A company's working capital may be reduced due to increases in tax costs. Thus, valuation for purposes of working capital adjustments would likely need to be addressed (including the potential for adjusting the net working capital target based on a formula taking into account any relevant tax reform enacted between signing and closing) as well as the ability to repatriate trapped cash.

In addressing fundamental value implications of tax reform, buyers may find the material adverse change (MAC) condition too blunt and unreliable an instrument for instilling confidence in creating an effective buyer termination right. A MAC condition customarily provides exclusions for changes in law, including tax law. Moreover, the seller would likely argue that such changes were foreseeable under the circumstances. Therefore, specificity is important if the parties agree that enactment of tax reform would provide a basis for termination.

Conversely, the "disproportionate effect" exception to industry-wide changes in a MAC condition may create issues for the seller. These carve-outs for similarly situated companies are often limited by the disproportionate effect on a single company.

Viewed through the lens of a MAC condition, a US manufacturing company with substantial offshore production may be affected disproportionately as compared to a company in the same industry but with substantial onshore production.

Alternative Approaches Now. Despite the uncertainty attendant to tax reform, parties may employ the following practical strategies when executing deals in the face of such uncertainty:

- Consider including an affirmative disclaimer specifying that none of the representations and warranties will be deemed breached or any condition failed as a consequence of tax law changes, and paring back any representations or warranties that address the availability of certain types of tax assets in the post-closing period.
- If fundamental elements of value may be impacted by tax reform, the parties may want to negotiate termination rights associated with the enactment of certain changes. Conditions linked to tax treatment of the transactions may require particular scrutiny.
- Even at the earlier stages of the delineation of tax reform, parties may wish to seek good faith covenants on more narrow and manageable issues. For example, an obligation to negotiate or restructure in good faith or to adjust consideration so as to mitigate, reflect or reduce the consequences of tax changes may be prudent.
- If a substantial difference between the purchase price and tax basis arises, a covenant providing for flexibility in opting for a stock or an asset acquisition structure may similarly enhance tax efficiencies.
- As reform progresses and its terms become more specific, some issues may be addressed by alternative formulae in the acquisition agreement, including purchase price adjustments. For example, there may be differing treatments of trapped cash, accumulated and previously untaxed earnings and accrued taxes for circumstances in which either (1) tax reform implements a territorial system and a one-time deemed repatriation or (2) the trapped cash remains subject at closing to an excessively high tax cost if repatriated to the US.
- Private equity sponsors and lenders may look for similar flexibility in their debt commitment letters and definitive agreements.

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