THOMSON REUTERS

U.S. tax reform: Strategies for executing transactions in the face of uncertainty

By Senet S. Bischoff, Esq., Nicholas J. DeNovio, Esq., Mark D. Gerstein, Esq., and Laurence J. Stein, Esq.
Latham & Watkins

JUNE 2017

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.

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 U.S. Internal Revenue Code.

On April 26, 2017, Secretary of the Treasury Steven Mnuchin and Director of the National Economic Council Gary Cohn held a White House Press Briefing addressing a high-level plan distributed at the Briefing entitled "2017 Tax Reform for Economic Growth and American Jobs" that provides an outline of the goals and principles upon which the Trump Administration will focus in the context of tax reform.

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.

This commentary summarizes the key considerations for executing capital markets, finance and M&A transactions in light of this uncertainty.

SUMMARY OF CERTAIN KEY TRANSACTIONAL CONSIDERATIONS

Capital markets

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).

In the context of M&A, the implications of pending tax reform may cause difficulty in planning and executing deals.

Finance

The Blueprint's territorial system would likely eliminate Code Section 956 pertaining to repatriation of earnings. The elimination of Code Section 956 would allow non-U.S. 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 Blueprint's elimination of a U.S. 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.

M&A

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.

Thomson Reuters is a commercial publisher of content that is general and educational in nature, may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual transactions and cases. Users should consult with qualified legal counsel before acting on any information published by Thomson Reuters online or in print. Thomson Reuters, its affiliates and their editorial staff are not a law firm, do not represent or advise clients in any matter and are not bound by the professional responsibilities and duties of a legal practitioner. Nothing in this publication should be construed as legal advice or creating an attorney-client relationship. The views expressed in this publication by any contributor are not necessarily those of the publisher.

the answer company™
THOMSON REUTERS®

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.

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.

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.

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 U.S. 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 U.K. for a variety of reasons, including tax efficiencies.

Notwithstanding the Brexit uncertainty and the prospect of the U.S. adopting historically low corporate rates, in the near-term, parties will likely continue to utilize non-U.S. domiciles for holding companies.

The U.K. 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 U.S.

HOW SHOULD PRINCIPAL 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.

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 as well as the ability to repatriate trapped cash.

 © 2017 Thomson Reuters

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. However, the seller would likely argue that such changes were foreseeable under the circumstances.

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 U.S. 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.
- 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. 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.

This article first appeared in the June 2017, edition of Westlaw Journal Mergers & Acquisitions

ABOUT THE AUTHORS

(L-R) **Senet S. Bischoff** is a partner in the New York office of **Latham & Watkins** and a member of the firm's corporate department. His practice focuses on corporate finance and general securities and corporate matters. **Nicholas J. DeNovio** is a partner in the firm's Washington office and global chair of its international tax practice. **Mark D. Gerstein**, a partner in the Chicago office, is the past global co-chair of the firm's mergers and acquisitions practice. **Laurence J. Stein**, a tax partner in Latham & Watkins' Los Angeles office, was formerly the global chair of the firm's tax department. His major practice area is transactional tax. This expert analysis is excerpted from a white paper first published on the Latham & Watkins website. Republished with permission.

Thomson Reuters develops and delivers intelligent information and solutions for professionals, connecting and empowering global markets. We enable professionals to make the decisions that matter most, all powered by the world's most trusted news organization.

©2017 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit www.West.Thomson.com.