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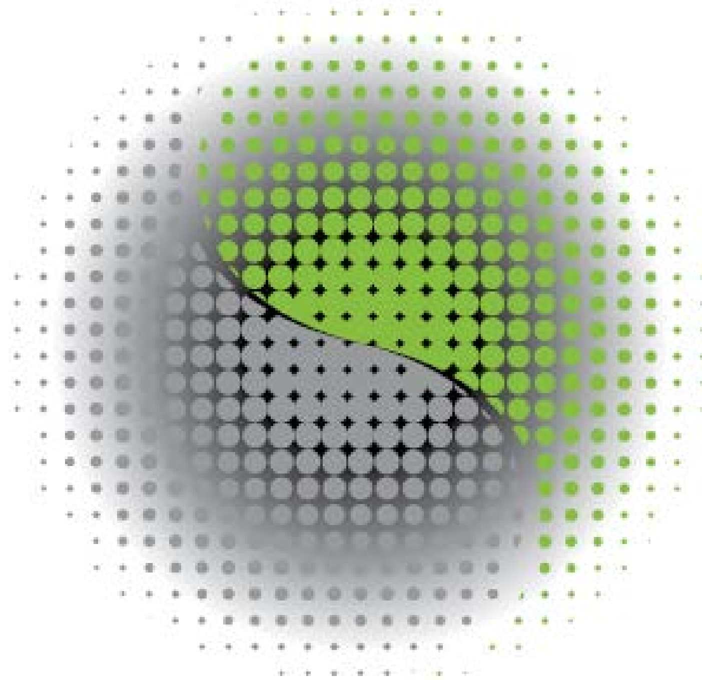

Canadian Tax Alert

US tax reform – impact on M&A and the private equity industry

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President Trump made history on December 22, 2017 when he signed into law the most significant US tax reform to happen in the last 30 plus years. Change is inevitable and challenging, but with change comes opportunity. US tax reform (reform) is no different. This alert will focus on some pertinent reform changes that will have a significant impact on mergers and acquisitions (M&A) and the private equity industry.

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Interest deferral/denial rules

Due to the pre-reform corporate tax rate arbitrage between Canada and the United States, it was common to use acquisition financing to fund US target acquisitions in order to mitigate any tax leakage in the United States while allowing for the tax efficient repatriation of capital.

This financing took on several forms - plain vanilla intercompany debt, the use of foreign intermediaries or the implementation of hybrid transactions to name a few. The latter alternatives were designed to create greater tax efficiency.

Reform will significantly impact this area, not only due to the permanent corporate tax rate reduction which narrowed or in some instances eliminated the tax rate arbitrage, but also due to the introduction of new Internal Revenue Code section 163(j) and the anti-hybrid rule.

New section 163(j) generally limits a taxpayer's interest deduction to 30% of adjusted taxable income - the definition of which is closely linked to earnings before interest, taxes, depreciation and amortization (EBITDA) for the first four years and then to earnings before interest and taxes (EBIT) providing a greater restriction. Key differences between this rule and the former version are the elimination of the 1.5-1 debt-equity safe harbour, the elimination of the excess interest limitation carryforward, the application to all debt whether related or third party, and the application of the rule at the entity level, which means that partnerships, for instance, must consider the same restrictions. Note that there are limited exceptions to this rule; for example, certain real estate taxpayers may choose to be excluded from this new rule in exchange for longer depreciation periods on their real property.

Reform denies the interest expense paid or accrued pursuant to a hybrid transaction or by a hybrid entity. As such, common use of "repo financing" may be eliminated and existing repos may require reconsideration.

Corporate tax rate reduction and AMT repeal

Reform permanently reduced the corporate tax rate to 21% and repealed the alternative minimum tax (AMT). This has put transfer pricing on its head, as it was common to structure organizations such that transfer pricing of transactions involving US companies minimized US profitability to mitigate US tax leakage and manage the global effective tax rate (ETR). As will be discussed below, the introduction of the base erosion anti-abuse tax (BEAT) further reinforced the need to revisit operational structures and global transfer pricing policies.

Another result of the corporate tax rate reduction may be the inclination of taxpayers to use corporate form versus a traditional flow-through structure.

Passthrough deduction and individual tax rate reduction

The top federal individual tax rate is now 37%. This, coupled with the new passthrough deduction of 20% for certain business income, could preserve the preference to use flow-through structures rather than corporate form. That said, the overall tax rate gap between structures has narrowed and the introduction of partnership audit rules may give rise to the increased appetite among taxpayers to

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use what is perceived to be a simpler form of entity. In addition, unlike the corporate tax rate reduction, these provisions sunset after 2025; this may tilt the scale if these provisions are not renewed.

100% Capex Expensing

The concept of “bonus” depreciation is not new; what is different under reform is that the original use of the assets acquired need not commence with the acquiror. As such, there should be an increased desire to structure deals as actual or deemed asset acquisitions (use of section 338 elections for example) to not only achieve asset tax basis step-up or goodwill amortization, but now 100% expensing of certain tangible assets acquired. The capex expensing provisions generally phase down beginning in 2023 before ultimately expiring for tax years after 2026.

Note that this 100% immediate depreciation deduction turns into a net operating loss (NOL) if it cannot be used to offset taxable income immediately and carries forward indefinitely, although the use of NOLs generated after 2017 is generally limited to 80% of taxable income for the year, as described below. Taxpayers who do not wish avail themselves of this provision may elect out of its application.

NOLs

NOLs can no longer be carried back, but may now be carried forward indefinitely. However, the trade-off is that they may generally only offset 80% of taxable income going forward. Note that NOLs arising in tax years beginning before 2018 should be subject to the old rules (two year carryback, 20 year carryforward, and no taxable income use limitation). These new rules may affect how acquisitive taxpayers value NOL tax attributes to the extent that they cannot structure asset deals.

BEAT

Reform essentially introduced a new minimum tax for US companies with foreign related party payments that drive down their US taxable income. US companies that have $500 million or more of average annual gross receipts and 3% or more of deductible payments owed to foreign related parties (“base erosion payments”) will have to pay the greater of regular tax or the BEAT (5% for 2018, 10% thereafter, and 12.5% beginning in 2026). In general, the BEAT is applied to taxable income plus base erosion payments. Note that services at cost and cost of goods sold are not subject to these provisions.

Careful consideration of transfer pricing policies will be necessary to understand the potential impact of the BEAT and whether any changes or modifications to US company functions and operations may be warranted.

US companies with foreign operations

Generally, US companies that own at least 10% of a foreign corporation will enjoy a 100% dividends received deduction (DRD) on foreign sourced dividends. In addition, US corporate taxpayers with income derived from servicing foreign markets may be eligible for a foreign derived intangible income (FDII) deduction which would reduce their overall effective tax rate (ETR). Note that intangible income is a misnomer, as the type of income eligible is much broader provided it is income from servicing non-US jurisdictions. Although the DRD will facilitate more

efficient repatriations, allowing for better flow of capital from US company-owned foreign corporations, and the FDII may spur US companies to expand sales and services to non-US markets, it does not come free as noted below.

There is an immediate toll tax on untaxed foreign earnings and profits (15.5% for cash and cash equivalents and 8% for all other assets). In addition, reform did not extend an often used subpart F income exclusion for certain controlled foreign corporation (CFC) to CFC payments (royalties, dividends, and interest for example) and it essentially created a new category of subpart F when it introduced the global intangible low taxed income (GILTI) rules. Similar to FDII, intangible is a misnomer, given that if income earned is in excess of a prescribed return, GILTI would result in an immediate income inclusion for the US company where none may have otherwise existed under the former rules.

Not only will acquisitive taxpayers be required to evaluate the above in the context of future tax due diligence processes, consideration of how to operate foreign businesses of US company targets will require study and possibly reorganization.

Carried interest

Reform expanded the holding period required to access the individual long term capital gains preferential tax rate as applied to typical carried interest scenarios. The holding period moved from greater than one year to greater than three years. This will have a significant impact on fund sponsors that employ a short term asset holding strategy, as the tax rate differential is 17% (20% versus 37%). As such, thought may be given to ensuring the three year threshold is met before divesting assets if this does not impede the fund's overall internal rate of return (IRR) and is commercially feasible. Even if this is not practicable, how this provision applies to certain situations remains to be seen – partnership interest sales for example.

Foreign person partnership interest sales

Gains or losses from the disposition of a partnership interest are considered US trade or business effectively connected income (ECI) to the extent that the transferor would have had ECI had the partnership sold all of its assets at fair market value as of the date of the partnership interest sale or exchange. This rule is not new per se, as it was espoused in Internal Revenue Service Revenue Ruling 91-32. As such, the rule codifies the same, but removes the debate of whether to follow the Revenue Ruling or take the position that absent the partnership holding US real property interests, the gain may generally be capital in nature and sourced to the residence of the partner.

Next steps

President Trump declared US tax reform as one of the great holiday gifts of 2017. His reference was in the context of tax breaks for the middle class, but it is evident that it can and will apply to taxpayers looking at US targets. Like with all gifts, however, watch out for defects. Engage your local tax service provider to carefully contemplate US tax reform's impact on your US business and future US target acquisitions to avoid traps for the unwary. What used to make sense may not anymore and the fact that many areas of reform are awaiting further technical explanation makes the new rules more complex. Don't embark on the journey alone - Deloitte can help you navigate this new US tax landscape.

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