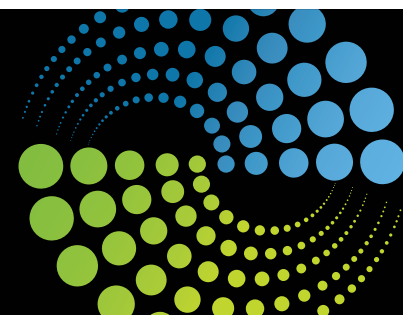


## M&A Tax Talk

### Post-tax reform contracting considerations



**With the passage of the Tax Cuts and Jobs Acts of 2017 (TCJA), US taxpayers engaging in acquisitions and dispositions should evaluate additional contracting considerations for proposed transactions.**

**This is evident when drafting language in letters of intent (LOI) or purchase agreements regarding tax matters including the benefits of immediate expensing of acquired property, inheritance of transition tax liabilities, and how to treat net operating losses (NOLs) in the pre-closing period.**

#### Immediate expensing

Prior to the passage of the TCJA, taxpayers could generally expense 50 percent of qualified property, if that taxpayer originally placed that property into service. Post TCJA, buyers can now immediately expense 100 percent of the cost value of certain acquired qualified property placed in service through 2022.

Because buyers can now deduct 100 percent of the fair market value of acquired qualified property in the year of an acquisition, we are seeing an increased demand by buyers for asset sales over stock sales. Further, while the value allocated to such qualified property must reflect fair market value, buyers generally have a desire to allocate a greater portion of the purchase price to qualified property to the extent the valuation can be supported.

On the other hand, generally sellers may find asset sales less desirable compared to a stock sale because they could owe incremental taxes (e.g., due to a change in tax character to ordinary income related to depreciation recapture). Further, if an asset sale is contemplated, sellers would generally prefer to allocate value (i.e., purchase price) to capital assets taxed at a lower rate (e.g., goodwill) or assets with a high tax basis to reduce their tax liability.

As there can be contention between the parties on the tax structure of an

acquisition, the tax structure should be addressed as early in the deal process as possible, even during the LOI process. Further, the parties should agree on a purchase price allocation methodology that is consistent with the fair market value of the assets prior to closing and through the contracting process.

#### Transition tax

The TCJA imposed a one-time tax on previously untaxed deferred foreign income of non-US subsidiaries owned by US shareholders during its 2017 tax year that could be paid as a lump sum, or over an eight-year period if an election was made to do so. The transition tax treats post-1986 earnings and profits (E&P) of non-US subsidiaries (that are owned by US shareholders owning at least 10 percent of the vote) as subpart F income. Untaxed deferred foreign income was taxed at one of two rates: 15.5 percent on the cash or cash equivalents balance and 8 percent for all other E&P. Taxpayers could pay the transition tax in installments over eight years.

Considering that buyers may inherit a significant tax liability if sellers elected to pay the transition tax over eight years, buyers should assess transfer-tax calculations during due diligence, consider whether any remaining transition tax liability should be an adjustment to purchase price, and which party is economically responsible for such liability through the purchase agreement.

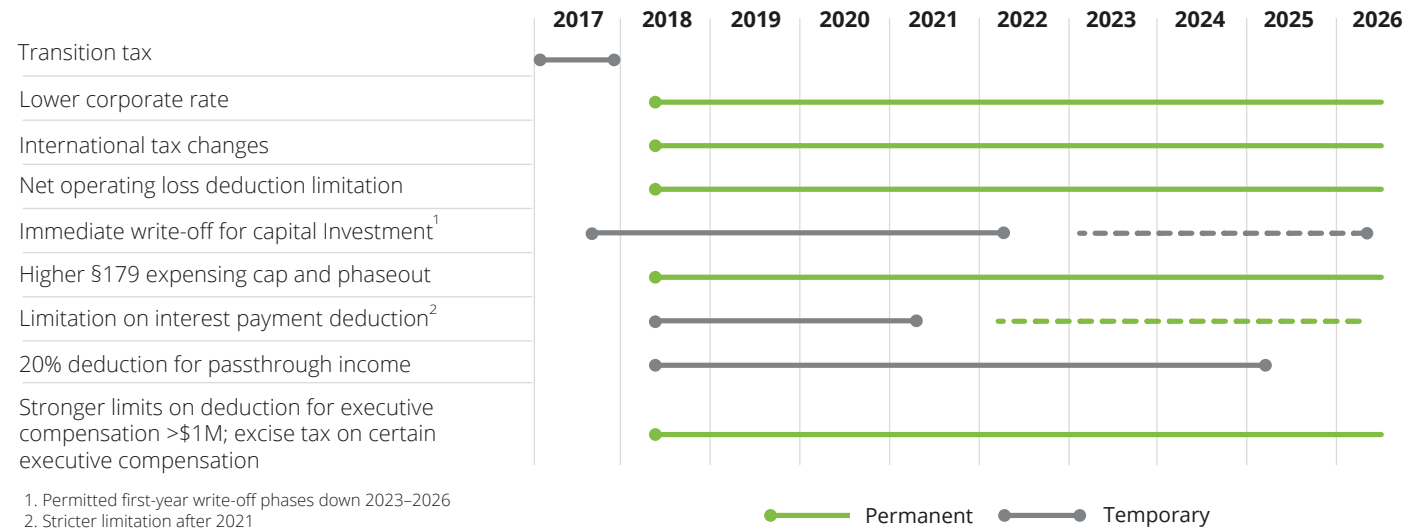
Further, the transition tax liability may be accelerated in certain cases, including when the taxpayer disposes of substantially all of its assets during the eight-year period. Regulations have been issued that allow for the buyer and seller to enter into an agreement and can avoid acceleration of the tax. Accordingly, the parties should consider entering into an agreement within 30 days of closing, whereby the buyer agrees to assume the liability for unpaid installments left from the eight-year election. Similarly, if a buyer agrees to assume the remaining liability through a transfer agreement, the buyer should consider negotiating a purchase price reduction. Buyers should be aware of the liability, and the potential acceleration of the liability in a situation where they will effectively inherit the full liability in the tax year the transaction is consummated. Often, parties can require that the transfer agreement execution be a condition to closing in the purchase agreement.

#### Net operating losses

Federal NOLs generated prior to December 31, 2017, may be carried forward 20 years, carried back 2 years, and could potentially offset 100 percent of federal taxable income. However, under the TCJA, federal NOLs generated after December 31, 2017, may be carried forward indefinitely but may only offset up to 80 percent of US taxable income, and cannot be carried back.

## 2017 Tax Reconciliation Bill

Business taxation-effective dates



Sellers will often take a large deduction for transaction-related expenses, which may create NOLs in the pre-closing tax period (immediately prior to the transaction date). Under prior rules, sellers had the ability to carryback the NOLs, leading to a refund in the hands of the seller. However, post TCJA, buyers will inherit this NOL, which can lead to a negotiating point about which party should receive the economic benefit.

As such, it is increasingly important for the parties to address the economic benefit of transaction-related deductions via other mechanisms in a purchase agreement (especially without any immediate refund opportunity). The parties should clearly define how pre-closing period NOLs will be handled economically as part of purchase price negotiations (as early as the LOI stage) and document it within the purchase agreement.

### Conclusion

The above are a few examples of how the TCJA has changed how buyers and sellers may approach transactions and deal negotiations related to tax matters. Oftentimes, it is best for buyers and sellers to clearly define their intent (as early as during the LOI stage) on how certain items should be treated (e.g., desire to enter into a stock or asset sale and receive a stepped-up basis in assets, transition tax liabilities, treatment pre-closing period NOLs, etc.) in order to expedite the process for both parties to meet their deal objectives.

### Want to learn more?

Reach out to our contacts below:

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