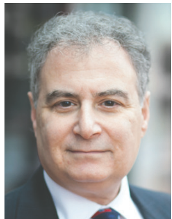
PORTLAND
BUSINESS JOURNAL

EXPERTS' VIEW

FIVE WAYS TRUMP TAX PLAN WILL UPEND M&A

These elements of tax reform will either drive, hinder or alter deals this year, write **Larry J. Brant and Steven D. Nofziger of Garvey Schubert Barer**



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The Tax Cuts and Jobs Act enacted late last year significantly impacts mergers and acquisitions in several ways. Broadly speaking, it will affect transaction structuring, pricing, financing, negotiations and due diligence, and it could ultimately lead to fewer highly-leveraged M&A deals.

Below we outline five key things to watch for in 2018 and in future years. These are just five of the Tax Cuts and Jobs Act's many provisions that will impact M&A. As has always been the case, any M&A transaction should be thoroughly analyzed by qualified tax professionals before it is structured and carried out. This is even more important with the enactment of this act.

1 Reduced tax rates and 100 percent expensing

The act reduces the corporate tax rate from 35 percent to 21 percent and repeals the corporate alternative minimum tax. It also reduces individual tax rates and retains the 20 percent capital gains tax rate, thus maintaining a tax preference for individuals selling stock, real estate or other capital assets.

Also, through 2022, it allows buyers of assets acquired in M&A the potential to immediately expense 100 percent of the cost of depreciable tangible assets (e.g., equipment).

These two changes clearly impact M&A structures. Lower tax rates mean potential sellers may be more willing to sell assets as they may end up with more money in their pockets than they would have in past years. Likewise, buyers will likely favor asset purchases as they can immediately deduct the cost of equipment and other depreciable assets. Additionally, even in a stock purchase, buyers will be more motivated to negotiate the making of a Code Section 338(h)(10) election, allowing the parties to treat a stock sale as an asset sale for tax purposes.

Finally, lower tax rates mean sellers have less desire to structure a transaction as a "tax-free" reorganization.

2 Pass-through deduction

Under the Tax Cuts and Jobs Act, non-corporate taxpayers may deduct up to 20 percent of "qualified business income" received from a "pass-through" trade or business, such as an S corporation, partnership, LLC or sole proprietorship. This change places most owners of pass-through business entities on par with owners of C corporations who now have the benefit of the 21 percent top rate. Consequently, buyers may now be motivated to structure transactions so that they end up with a pass-through entity.

3 Section 1031 exchanges now limited to real estate

The act also limits Code Section 1031 to exchanges of real property, meaning that personal property is no longer eligible for tax deferral. Taxpayers wanting to exchange real property that also includes personal property need to be keenly aware of this change to the tax code. Consider a taxpayer selling a 300-unit apartment complex and buying a 450-unit apartment complex in a 1031 exchange. Under the Tax Cuts and Jobs Act, all of the attendant personal property (e.g., washers, dryers, dishwashers, stoves, drapes, tools, landscaping equipment, office equipment and furniture, recreation and pool equipment) is now taxable "boot" in the exchange. The taxpayer must allocate part of the transaction proceeds to the personal property and report income accordingly. This change will significantly impact many transactions.

4 Interest deduction limitation

The Tax Cuts and Jobs Act effectively limits business interest deductions to 30 percent of EBITDA (earnings before interest, taxes, depreciation and amortization), changing to EBIT (earnings before interest and taxes) in 2022. Disallowed amounts can be carried forward. This change will affect many debt-financed transactions and could ultimately lead to fewer highly-leveraged M&A deals.

5 Net operating losses

Using net operating losses arising after 2017 to offset income has been limited by the Tax Cuts and Jobs Act. Net operating losses arising prior to 2018, however, are grandfathered in and may be used to offset income in the manner provided under old law. Thus, the existence of pre-2018 NOLs may enhance the value of an M&A target to buyers, resulting in higher pricing and more significant due diligence to ensure the existence of the NOLs.

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