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Structuring Leveraged Buyouts: Advanced Planning and Tax Considerations for Debt Financed Acquisitions

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Structuring Leveraged Buyouts: Advanced Planning and Tax Considerations for Debt-Financed Acquisitions

February 7, 2018

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Outline

- Overview of Leveraged Buyouts
- Debt Options for Leverage Buyouts
- Multi-layer Debt and Equity Financing
- Key Considerations for Debt Options for Leverage Buyouts
- Developments in Leveraged Financing
- Key Tax Considerations
  - Tax Treatment of Debt Obligations
  - Impact of Taxes on the Target Company's Cash Flows
  - Tax Attributes as a Value Driver
- Questions

Overview of Leveraged Buyouts

- Became prevalent in the 1980s and continues to be a popular tool for private equity firms.
- By using debt to finance a large portion of the purchase price, acquirors can minimize their equity investment, potentially increasing their rate of return.
- The target's ability to generate cash flow will be key to the success of the acquisition as it is used to make debt payments.
- Prior to Paul and Matt providing a detailed look at the key tax considerations for leveraged acquisitions, we'll give you a general overview of debt options for leveraged buyouts, including using multi-layer debt and equity financing, and key non-tax considerations for determining the right mix of available financing.

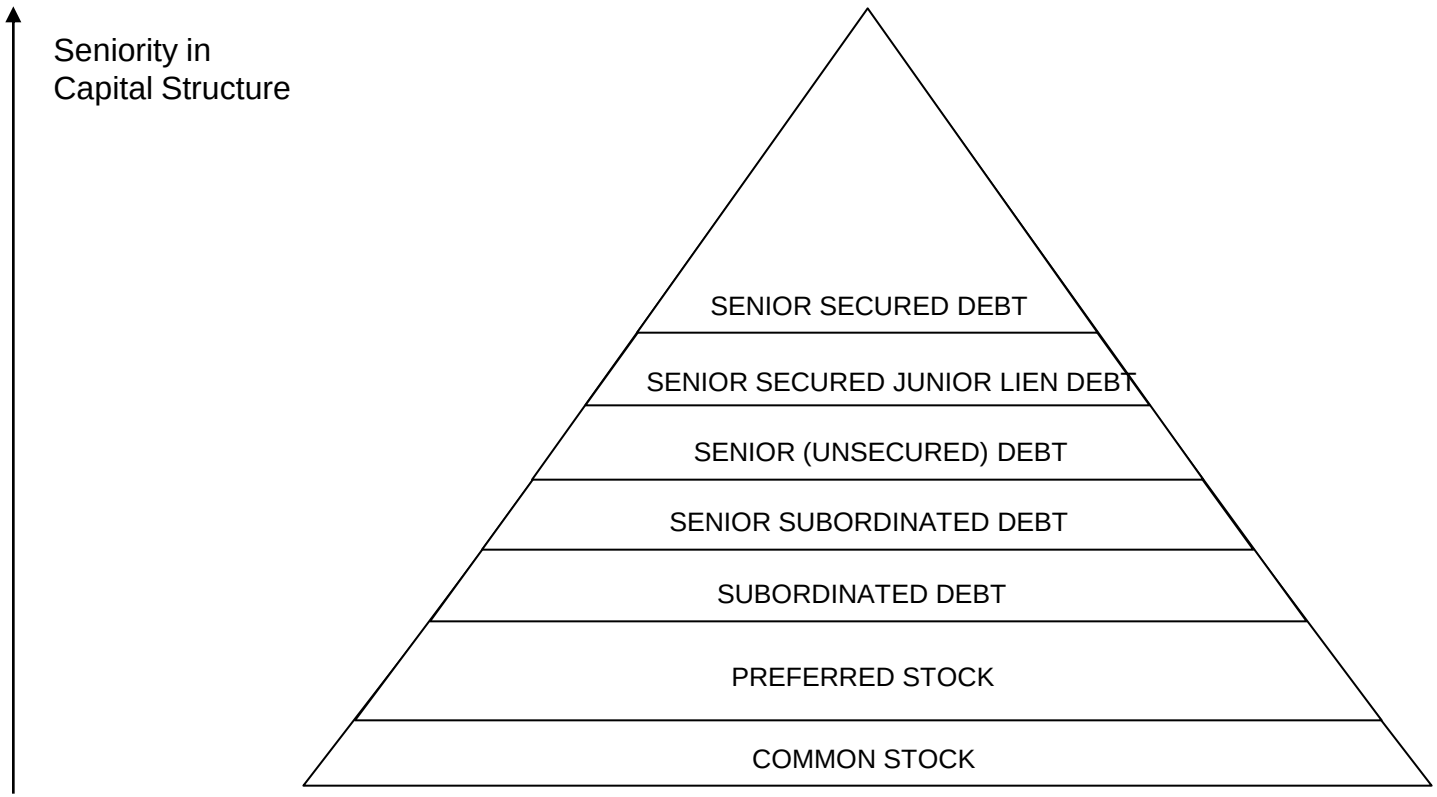
Debt Options for Leverage Buyouts

- Bank Debt:
  - **Term Loan A Facility** – Typically syndicated to the commercial bank market, amortizes at approximately 40-60% over the life of the Facility.
  - **Term Loan B Facility** – Typically syndicated to non-bank institutional investors, with loans that amortize at a rate of 1% per year (or no amortization in the case of a Second Lien Facility).
  - **Revolving Facility –** Typically with commercial banks, with borrower having ability to draw down up to a maximum amount and repay when excess cash is available.
    - **ABL Facility Example** – A common Revolving Facility in which the maximum amount that a Borrower may utilize at a given time is based on the value of certain eligible assets. ABL Lenders will typically have a first priority security interest in certain classes of assets (typically receivables and inventory).
- "High Yield" Notes
  - Typically privately placed, primarily with qualified institutional buyers, potentially with registration rights.
  - Refers to interest rate relative to benchmark securities (e.g., U.S. Treasuries) compared to investment grade debt.
  - Higher interest rate in part a result of placement in capital structure and increased risk.
  - May be Senior or Subordinated (contractually, structurally or effectively).

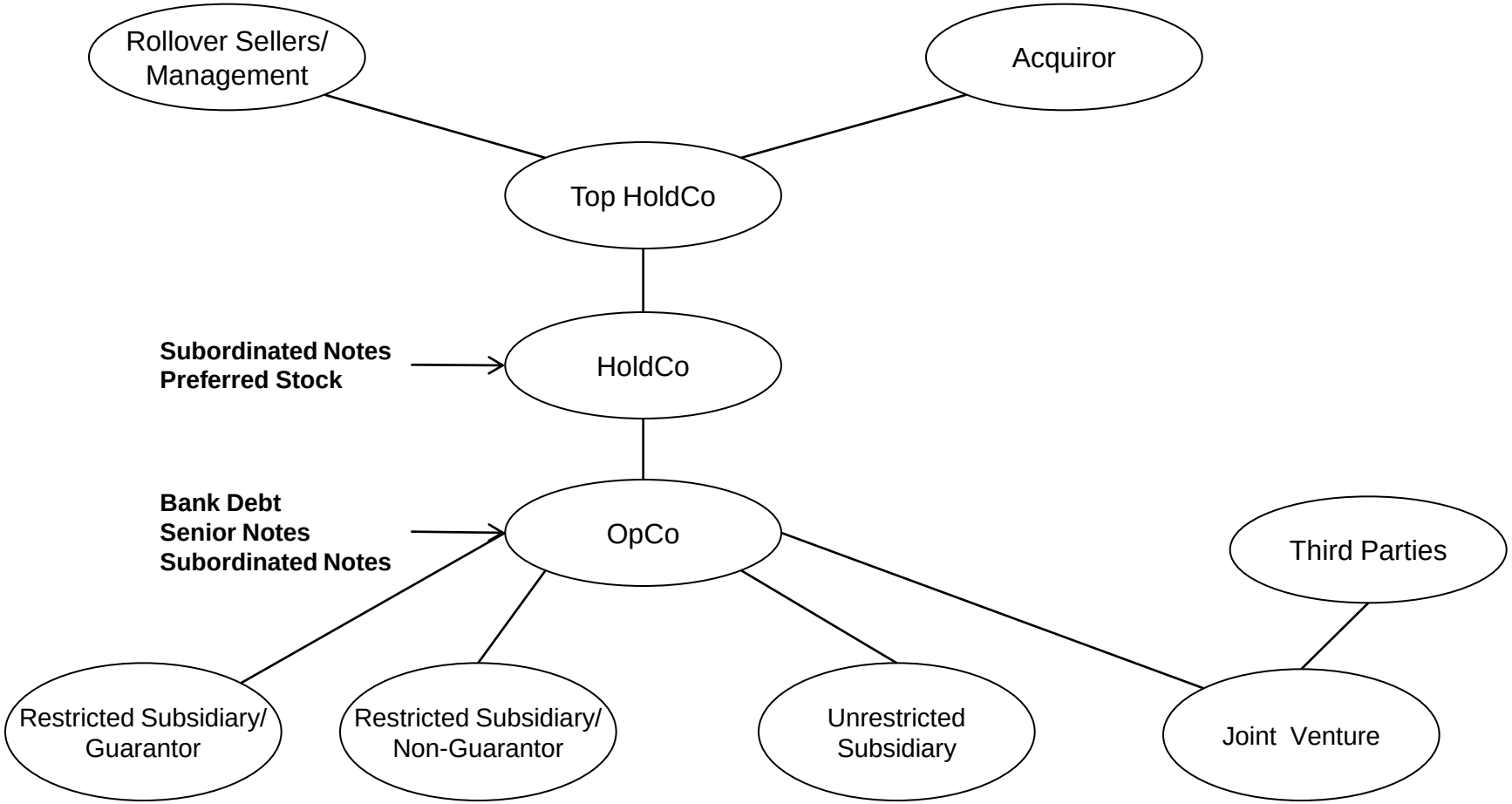
Debt Options for Leverage Buyouts (Cont.)

- Equity
  - Can be combination of new equity and roll-over equity (including from management).
- Mezzanine Financing
  - Placement in capital structure are between equity and traditional bank/high-yield debt.
  - Terms are not as standardized as bank debt or high yield.
  - Typically subordinated, unsecured debt or preferred equity.
  - Mezzanine debt typically includes an equity component.

Debt Options for Leverage Buyouts (Cont.)



Multi-layer Debt and Equity Financing (Cont.)



Key Considerations for Debt Options for Leverage Buyouts

- Closing the Transaction
  - Rating, yield and pricing of debt.
  - Timing and process.
  - Availability of credit and certainty of closing debt.
- Ongoing Business
  - Cash flow to cover debt.
  - Investor base for the issuer.
  - Covenants.
    - Operate and grow the business, plan for the future without needing to seek an amendment.
    - Allow for certain currently contemplated transactions.
    - Refinance and restructure debt.
    - Appropriate covenant package should be based on the debt being offered and its place in the capital structure (i.e., liens, guarantees, etc.).

Key Considerations for Debt Options for Leverage Buyouts (Cont.)

Issuer

Degrees of Separation

(1) Guarantors

(2) Domestic, Wholly Owned Restricted Subsidiaries

(3) Foreign, Wholly Owned Restricted Subsidiaries

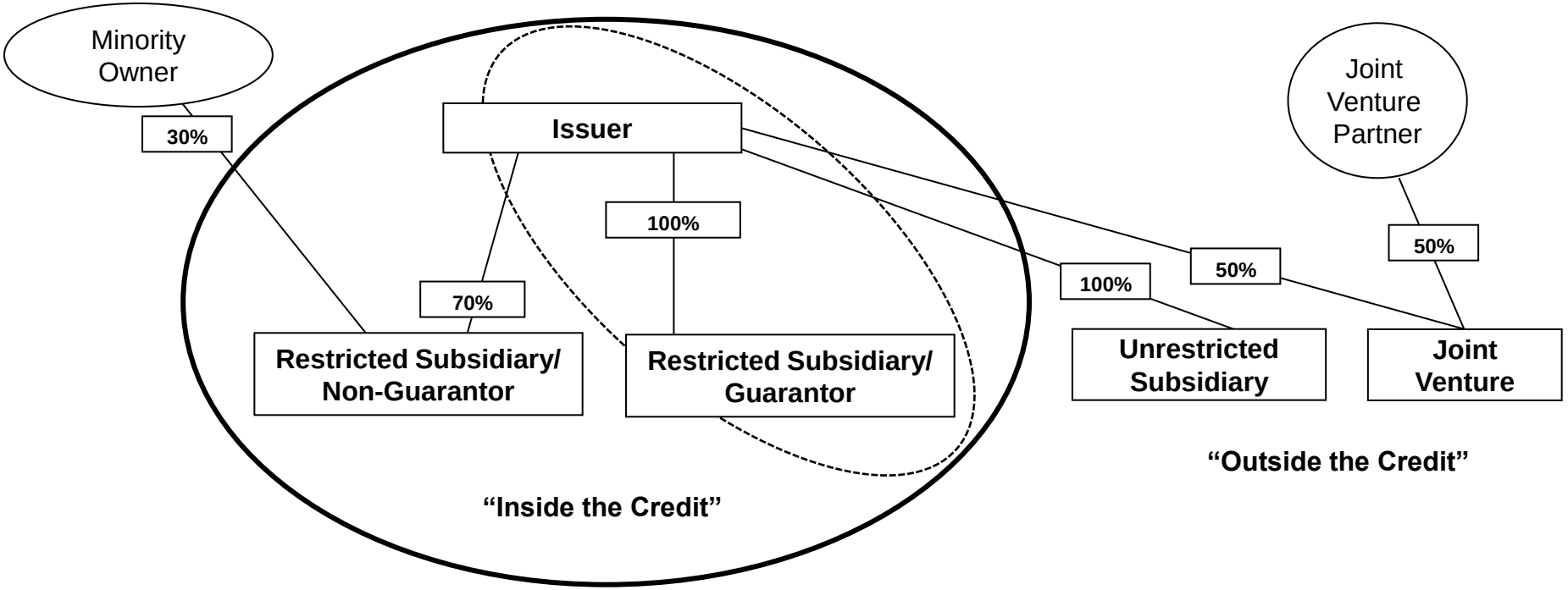
(4) Non-Wholly Owned Restricted Subsidiaries

(5) Unrestricted Subsidiaries

(6) Other Investments (*e.g.*, joint ventures)

Credit Quality

Key Considerations for Debt Options for Leverage Buyouts (Cont.)



Key Considerations for Debt Options for Leverage Buyouts (Cont.)

- Exit Strategy
  - Providing for Acquiror's exit plan.

Developments in Leveraged Financing

- Regulatory environment continues to impact regulated lenders.
  - Leverage lending guidelines is impacting banks' ability to finance acquisitions.
  - Impacts not just new financings but refinancing and amendments.
  - As a result, non-regulated financial institutions are filling bigger holes.
- Despite leveraged lending guidelines, leverage ratios have been increasing.
- Private equity to private equity leveraged buyouts are becoming more prevalent.

Key Tax Considerations

Overview of Key Tax Considerations

- Tax is a critical consideration in the structuring of leveraged acquisitions.
- We will discuss:
  - **Tax Treatment of Debt Obligations**: Along with fees and debt service, the cost of leverage is driven largely by the tax treatment of the obligation, which depends on the characteristics of the borrower and the borrowing.
  - **Impact of Taxes on the Target Company's Cash Flows**: Taxes represent a cost that reduces cash flows from an investment and therefore reduces cash available to service financing.
  - **Tax Attributes as a Value Driver**: Tax attributes available to reduce future tax liabilities (e.g., NOL carryovers, basis, credits) represent assets to which parties may assign value upon acquisition and/or at exit Taxes may also factor into the value of a target corporation.

Tax Reform

- The Act commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "TCJA") made changes to the Internal Revenue Code that affect nearly every tax consideration related to leveraged acquisitions.
- Although the full extent of the impact of these changes on transactions remains uncertain, we'll provide insight into how the considerations outlined on the previous slide have been impacted by the TCJA

Tax Treatment of Debt Obligations

Interest Deductibility: In General

- Subject to important limitations, interest paid or accrued on indebtedness is deductible for U.S. federal income tax purposes. IRC § 163(a).
  - Deductibility extends to payments and accruals of amounts that are economically identical to interest, e.g.:
    - Accruals of original issue discount. See IRC §§ 163(e).
    - Repurchase premium. See Treas. Reg. § 1.163-7.
    - Unstated interest on deferred payments of purchase price. See IRC §§ 1274, 483.
- The unlimited deductibility of interest has historically created a powerful tax incentive in favor of debt financing.
  - In contrast to debt, payments with respect to equity (whether dividends or return of capital) are generally not deductible by corporations.
  - This distinction raises a principal question in U.S. federal income tax law – whether an investment represents debt or equity.

Interest Deductibility: Debt vs. Equity

- The critical requirement for the deductibility of payments or accruals of interest is that the interest be on "indebtedness" for tax purposes.
  - Beyond limitations with respect to AHYDO (discussed below), debt/equity considerations have not historically been material to leveraged buyouts.
  - However, in the wake of changes brought about by the TCJA, such considerations may become important to acquisition financing.
- Whether an investment constitutes debt or equity for U.S. federal income tax purposes is generally a factual determination, looking at, among other factors:
  - whether there is a written unconditional promise to pay on demand or on a specified date a sum certain;
  - subordination;
  - ability to exercise traditional creditors' rights;
  - debt-equity ratio; and
  - identity of ownership between equityholders and purported creditors (see IRC § 385).
- Consider also IRC §§ 163(l) (denying deduction where interest payable in equity of issuer or related party); 249 (limiting deduction for repurchase premium on convertible debt); 279 (denying deduction where interest payable on equity-like acquisition indebtedness)

Interest Deductibility: AHYDO

- Although debt/equity determinations are generally factual, a special *per se* rule applies to deny/defer deductibility on OID for "applicable high-yield debt obligations" (AHYDO) that are equity-like in their degree of payment subordination. See IRC § 163(e)(5), (i).
- AHYDO are instruments with the following features at issuance (or deemed issuance):
  - (i) maturity > 5 years;
  - (ii) YTM $\geq$ AFR+500bps; and
  - (iii) at the close of any accrual period ending more than 5 years after issue date: unpaid OID or PIK > [issue price (as computed for U.S. federal income tax purposes) x YTM].
- If debt is AHYDO, a portion of the OID is effectively treated as stock (and therefore any deduction on accrual or payment is denied) and any deduction with respect to the remainder is deferred until payment.
  - The denied portion is the total return on the debt multiplied by the ratio: (YTM – [AFR+600bps])/YTM (but denied portion cannot exceed the total OID)
- AHYDO may be cured with "catch-up" interest payments after year 5.
  - However, such a solution for junior debt may be unacceptable to senior lenders.

Interest Deductibility: New IRC § 163(j)

- The TCJA completely revised IRC § 163(j).
  - Formerly applied only to payments by leveraged corporations to related persons.
- In general, new IRC § 163(j) creates a 30% cap on deductibility of interest.
  - Cap is 30% of (essentially) EBITDA for tax years beginning before 2022; narrows to 30% of (essentially) EBIT thereafter.
  - Without regard to payor's leverage or whether payee is a related person.
  - Unlimited carryover of disallowed interest deductions (discussed below).
  - Existing debt is subject to new IRC § 163(j), i.e., <u>not</u> grandfathered.
- Exceptions to new cap:
  - To offset business interest income
  - For certain interest (i.e., motor vehicle floor plan financing)
  - For certain taxpayers:
    - Certain small businesses
    - Regulated utilities
    - Electing farm businesses
    - Electing real property businesses

Interest Deductibility: Alternatives?

- The new 30% cap under IRC § 163(j) creates an incentive in high leverage scenarios for parties to seek out alternative financing that preserves the deductibility of servicing payments.
  - For example, the 30% cap under new IRC § 163(j) does not apply to payments or accruals of rent. See, e.g., IRC § 467.
  - New 30% cap does not apply to preferred equity.
    - If issued by a tax partnership (e.g., LLC or LP), allocations of income to preferred holders may result in reduction of tax for common equityholders similar to interest deductions (see example on following slide).
    - Such arrangements are likely to raise debt-equity tax issues hitherto novel to leveraged acquisitions.
    - Such an alternative may not be attractive to non-U.S. financiers.
  - New 30% cap would not apply to derivatives (to the extent not otherwise treated as indebtedness).
- IRC § 163(j) contains no specific delegation of regulatory authority to redefine what constitutes interest or promulgate anti-abuse rules.

Interest Deductibility: Alternatives? (cont.)

- Example: In TY2018, Corporation (T) borrows $10,000 at **4.0%** interest pursuant to an instrument treated as indebtedness for U.S. federal income tax purposes.
  - T has gross income of $1,000, interest expense of $400, and pre-tax cash of $600.
  - T's IRC § 163(j) cap is $300.
  - T's taxable income is $1000-$300 = $700.
  - T's TY2018 federal tax liability is $700 x 21% = $147.
  - T's after-tax cash flow is $600 - $147= **$453**.
- If, instead of issuing debt, T had offered **4.25%** coupon preferred interests for $10,000 in a partnership that held T's business (and so T has pre-tax cash flow of $575):
  - T's allocable taxable income is $1,000-$425 = $575.
    - The preferred holder is allocated $425 of the partnership's income under the terms of the partnership agreement.
  - T's TY2018 federal tax liability is $575 x 21% = $120.75.
  - T's after-tax cash flow is $575 - $120.75 = **$454.25**.

Security for Debt: The Pre-2018 Traps of IRC § 956

- Historically, borrowers have been careful to structure guarantees from and pledges of foreign subsidiaries to avoid the application of IRC § 956.
  - Under IRC § 956, certain guarantees from and pledges of foreign subsidiaries of U.S. borrowers are effectively treated for U.S. federal income tax purposes as if the amount of the guarantee or pledge were distributed by the foreign subsidiary to the U.S. borrower (and taxable accordingly).
  - As a result, income on which residual U.S. federal tax was otherwise deferred becomes subject to immediate tax.
  - In addition, under the IRS interpretation of IRC § 956, multiple foreign pledges or guarantees in support of the same indebtedness can result in multiple inclusions for security on the same debt amount.
- Regulations generally appear to permit the pledge of 66 2/3 percent of top-tier foreign subsidiary voting stock without an IRC § 956 inclusion.
  - Under market practice, pledges and guarantees of domestic holding companies of foreign subsidiaries are typically limited or prohibited.
  - Collateral adjustment mechanisms also present issues under IRC § 956.

Security for Debt: The Post-2017 Calculus of IRC § 956

- The TCJA changed the U.S. approach to international taxation and, as a result, changed the calculus regarding the application of IRC § 956.
  - Subject to certain exceptions, foreign-source income of foreign subsidiaries is generally exempt from residual U.S. taxation, provided such income is subject to an overall foreign tax rate of at least 13.125%.
  - As a result, U.S. corporate borrowers may be able to more easily access cash held by their foreign subsidiaries to service U.S. indebtedness.
- Application of IRC § 956 may be of <u>no immediate consequence</u> to the extent resulting in an inclusion not in excess of a foreign subsidiary's previously taxed earnings and profits.
- Application of IRC § 956 may be <u>beneficial</u> to the extent a loan of funds from a high-tax foreign subsidiary results in a deemed payment of foreign taxes under IRC § 960 that would not otherwise be deemed to occur were the same earnings actually distributed.
- Application of IRC § 956 may be <u>more harmful than before</u> to the extent a loan from a low-tax foreign subsidiary subjects earnings that would never otherwise be subject to residual U.S. tax (or at only a reduced rate) to full U.S. corporate income tax.

Security for Debt: Post-2017 IRC § 956 Example

- Example: Corporation (T), a domestic corporation, has three wholly-owned foreign subsidiaries: CFC 1, CFC 2 and CFC 3.
  - Each of CFC 1, 2 & 3 has $100 of gross income in TY2018 that is not excepted from "tested income" under IRC § 951A (e.g., subpart F income or ECI).
  - CFC 1 has sufficient asset basis (for U.S. federal income tax purposes) such that none of its income is currently included in T's income and pays local tax of $30.
  - CFC 2 has sufficient asset basis (for U.S. federal income tax purposes) such that none of its income is currently included in T's income and pays local tax of $0.
  - CFC 3 has no asset basis (for U.S. federal income tax purposes) and pays local tax of 26.5%.
- Absent application of IRC § 956, all the income of CFC 1, 2 or 3 could be distributed to T without residual U.S. federal tax liability.
  - Were CFC 1 to guarantee a $100 T borrowing, T has no residual U.S. tax and $9 of excess FTCs.
  - Were CFC 2 to guarantee a $100 T borrowing, T has $21 of immediate residual U.S. tax.
  - Were CFC 3 to guarantee a $100 T borrowing, T has no residual U.S. tax and no FTCs as the inclusion would represent only previously tax earnings.

Security for Debt: New Post-2017 IRC § 956 Trap

- The TCJA also changed the attribution rules for determining CFC status in manner that expands the scope of IRC § 956 when a foreign-parented corporation has a domestic subsidiary.
- Pre-TCJA, foreign parent corporations generally did not worry about IRC § 956 because a rule in IRC § 958 generally prevented a U.S. subsidiary from being attributed ownership of its sibling foreign subsidiaries for CFC purposes.
  - As a result, sibling foreign subsidiaries were free to guarantee or pledge assets in support of the U.S. subsidiary's debt without U.S. tax issues.
- However, the TCJA repealed former IRC § 958(b)(4), with the effect of generally making wholly-owned foreign sibling subsidiaries of a domestic subsidiary into CFCs (including for IRC § 956 purposes).
  - As a result, if the foreign parent has a 10% U.S. shareholder, such U.S. shareholder would now have IRC § 956 inclusions with respect to any borrowing of the U.S. subsidiary guaranteed by its sibling subsidiaries.
  - Legislative history states the foregoing result was not intended.

Impact of Taxes on the Target Company's Cash Flows

Depreciation & Amortization Deductions

- Given the TCJA's 30% cap on interest deductions, depreciation and amortization deductions may become of greater importance in leveraged acquisitions.
  - Under IRC § 168, the basis of tangible property is generally depreciable according to the asset's applicable class life, method and convention.
  - Under IRC § 197, the basis of certain acquired intangible property is generally amortizable over 15 years.
- The TCJA expanded and extended so-called "bonus" depreciation (or 100% expensing) under IRC § 168(k) to include used tangible property placed in service through 2022.
  - Stepped down by 20% points each year of the next five years thereafter.
  - Expansion of "bonus" depreciation offers partial explanation for the policy of capping interest deductibility at 30%.

100% Expensing: Amended IRC § 168(k)

- In relevant part, 100% expensing applies to tangible property:
  - with a recovery period of 20 years or less (as well as other specified property), but only if
  - either (i) the original use of the property begins with the taxpayer or (ii) the acquisition of the property meets certain requirements, specifically:
    - the property was not used by the taxpayer at any time prior to such acquisition, and
    - the acquisition of the property is not from a related person (generally, a 50% threshold) and the acquisition was not a carryover basis transaction (nor is substitute basis eligible) (i.e., the acquisition transaction was taxable).

Basis Step-Up Transactions

- Limitations on interest deductibility and availability of 100% expensing under IRC § 168(k) for used property may incentivize leveraged acquisitions to be structured as asset acquisitions for U.S. federal income tax purposes.
  - Such structures would include actual asset acquisitions as well as acquisitions of subsidiaries that either are flow-through or with respect to which an election under IRC § 338(h)(10) or § 336(e) is made.
  - Step-up via an IRC § 338(h)(10) election also available where the target is properly taxable as a subchapter S corporation.
- IRC § 338(h)(10) election is available if the buyer is a corporation and the acquisition constitutes a "qualified stock purchase" (i.e., any transaction or series of transactions in which 80% of the stock, by vote & value, of a target corporation is acquired by purchase during the 12-month acquisition period).
- IRC § 336(e) election is similar in function & effect to an IRC § 338(h)(10) election, except (in relevant part) (i) buyer need not be a corporation and (ii) the election is made by seller & target, not seller & buyer.

Impact of Purchase Price Allocation

- Under IRC § 1060, the parties to a transaction treated as an "applicable asset acquisition" for U.S. federal income tax purposes are generally required to report their allocation of the purchase price to the IRS.
  - Includes consideration treated as purchase price for U.S. federal tax purposes (e.g., assumed debt).
  - Asset acquisitions typically require the parties agree on such allocation.
  - Similar rules apply for acquisitions in which IRC §§ 338(h)(10) or 336(e) elections are made.
- 100% expensing unavailable for intangible property, including goodwill and going concern value (which remains amortizable over 15 years).
  - Under Treas. Reg. § 1.338-6, purchase price in excess of fair market value of tangible assets is generally allocable to intangible property, including goodwill and going concern value.
  - As a result, taxpayers in asset acquisitions would be expected to see emphasis on allocations to tangible property to the extent permitted.
- However, as discussed below, limitations on the utilization of NOL carryovers may reduce some of the benefit of 100% expensing.

Net Operating Losses: Background

- Historically, the application of the net operating loss ("NOL") rules has been another critical feature to structuring leveraged acquisitions.
- Tax deductions resulting from transaction expenses (discussed below), interest expense, and depreciation and amortization may give rise to excess tax losses during the financing term.
  - In addition, if the target was a corporation, the target could have pre-existing net operating losses, although the ability to use those losses to offset post-acquisition income would be limited by application of IRC § 382 (discussed below).
- Prior to the TCJA, NOLs could be carried back two years and carried forward 20 years.
  - In certain circumstances, application of the two-year carryback rule could give rise to an immediate refund of a target corporation's pre-acquisition taxes paid.

Net Operating Losses: Revised IRC § 172

- The TCJA revised the net operating loss rules as follows:
  - Eliminated the two-year carryback.
    - Exception for certain farming losses and losses of non-life insurance companies.
  - Made carryovers indefinite (i.e., no 20-year limit)
  - Capped availability of carryover to 80% of taxable income (computed before allowance for the NOL deduction).
    - Cap applies to losses arising in taxable years beginning after December 31, 2017.
    - Therefore, NOLs arising in taxable years beginning on or before December 31, 2017 are not subject to 80% limitation.
    - Ordering rule of IRC § 172(b)(2) generally requires full use of pre-2018 "unlimited" NOLs to offset income prior to use of any "limited" post-2017 NOLs.
- Effective date for elimination of carryback was subject of drafting error.
  - Fiscal-year taxpayers seeking technical correction.

Net Operating Losses & BEAT

- The TCJA eliminated the former corporate alternative minimum tax but replaced it with a new minimum tax referred to commonly as the BEAT (base erosion and anti-abuse tax).
- BEAT is a 10% minimum tax (5% for 2018) measured by the excess of 10% of a corporation's "modified taxable income" (as reduced by applicable credits) over the corporation's regular tax liability (as reduced by all credits).
  - "Modified taxable income" is taxable income plus certain deductions or reductions in gross income attributable to payments to foreign affiliates and a percentage of NOL carryovers determined by reference to the proportionate amount of such payments.
    - Such payments to foreign affiliates need not actually "erode" the U.S. tax base (e.g., such payments may be fully taxable in the U.S. as subpart F income, GILTI or ECI).
  - Applicable credits are the R&D credit and 80% of the low-income housing and renewable energy credits.
- To be subject to BEAT, a taxpayer must be (i) a C corporation (other than a RIC or REIT) with average annual gross receipts (over the preceding 3 taxable years) of at least $500,000,000, and (ii) have base erosion tax benefits equal to 3% (2% for banks and securities dealers) of all deductible payments by the corporation (including any amounts treated as base erosion tax benefits).

Application of Carryover Limitations

- Example: In TY2018, Corporation (T) has $100 of disallowed interest deductions and $100 of NOLs, both of which are carried over to TY2019.
- In TY2019, T has $1,000 of gross income, as well as:
  - $300 of operating expenses;
  - $100 of current interest expenses and
  - $300 of depreciation deductions.
- In TY2019, T is able to fully utilize its disallowed interest and NOL carryovers
  - T's 30% disallowed interest cap is $210 (($1,000-$300)*30%), and current interest expense is only $100, so T can use its entire $100 disallowed interest carryover.
    - If the example were in 2022, T's 30% disallowed interest cap would be only $120 ($1,000-$600)*30%), preventing full use of its disallowed interest carryover
  - T's 80% cap on its NOL carryovers is $240 (($1,000-$700)*80%).
- If T's current interest expense exceeded $110, use of its disallowed interest carryovers would be limited.
- If, for example, T's opex exceeded $475, use of its NOL carryovers would be limited.

GILTI & Leveraged Domestic Parent Corporations

- Under a new provision introduced by the TCJA, 10% or greater U.S. shareholders of foreign corporations generally include in income amounts in excess of normal return (generally computed as 10% of the foreign corporation's asset basis) (i.e., GILTI income).
  - Principal feature: Corporations are eligible for 50% deduction and 80% foreign tax credit under IRC § 960.
    - If the 50% deduction is fully utilized, the foreign effective tax rate exceeds 13.125%, and foreign tax credits are able to be used in full, there is no residual U.S. tax.
- Under IRC § 904(a), a corporation's ability to use foreign tax credits is limited to the same proportion of its U.S. federal income liability tax as its foreign-source taxable income bears to its entire taxable income.
  - Limitation applies separately to four separate sub-categories (or baskets) (including GILTI).
  - Under IRC § 861 regulations, in computing foreign-source taxable income, a corporation generally must apportion its interest expense among its assets.
- If a domestic corporation with foreign subsidiaries takes on debt, to the extent interest expense is apportioned to its GILTI income "basket," the corporation's ability to use foreign tax credits to eliminate the tax resulting from its GILTI inclusion may be impeded.
- In addition, if the U.S. corporate parent's business is conducted predominantly through foreign subsidiaries, the U.S. corporate parent's foreign tax credits may trigger BEAT liability in the U.S.

Tax Attributes as a Value Driver

Tax Rates & Tax Attributes

- In any acquisition or sale, any value assigned to tax attributes of a target entity is generally a function of the amount and timing of the taxes such attributes are able to reduce.
- In the case of attributes that reduce taxable income (e.g., NOL carryovers, depreciable/amortizable asset basis), the amount of tax reduced by such attributes is a function of the tax rate.
  - Hence, a reduction in the tax rate reduces the value of such attributes.
  - E.g., $1 of NOL carryover is worth (no more than) $0.35 if the rate of tax is 35%.
  - The TCJA reduced the corporate tax rate to 21%; therefore, the value of a $1 NOL carryover falls to (no more than) $0.21.
- By contrast, attributes that reduce tax liability directly (e.g., credits) are not directly sensitive to rate changes.
  - However, the time value of such attributes may be reduced to the extent the rate change results in less tax liability against which to apply such credits.

Interest, Basis, NOLs and Transaction Expenses

- At a high-level, the most valuable (and plentiful) tax attributes in the context of a leveraged acquisition usually are:
  - Interest expense and original issue discount (OID) (IRC § 163(a), (e))
    - Noted amendments in the TCJA: New IRC § 163(j) (discussed above)
  - Basis, to the extent depreciable or amortizable (IRC §§ 167, 168 & 197)
    - Noted amendments in the TCJA: New IRC § 168(k) (discussed above)
  - Net operating losses
    - Noted amendments in the TCJA: Revised IRC § 172 (discussed above)
  - Deductions for certain expenses (IRC §§ 162(a); 263A)
    - See Treas. Reg. § 1.263(a)-5 (discussed below)

Disallowed Interest Carryovers

- As noted above, under new IRC § 163(j), disallowed interest deductions are carried forward indefinitely.
  - Disallowed interest carryovers are treated akin to NOL carryovers.
  - Apply before application of NOL carryovers.
- These disallowed interest carryforwards may represent a substantial tax asset of leveraged targets.
  - As a result, sellers of leveraged targets may seek value for disallowed interest carryforwards that are available to a buyer.
  - How disallowed interest or NOL carryovers are valued (based on time-value for anticipated use) is a function of EBIT or EBITDA (as applicable), anticipated current interest expense and overall taxable income (before the NOL deduction).
  - Note that disallowed interest carryovers are subject to IRC § 382 (discussed below) as if such carryovers constituted "pre-change loss" under those rules.

IRC § 382: Overview

- The availability of tax attributes after a stock acquisition may be limited under IRC §§ 382 and 383.
  - Net operating losses, net operating loss carryovers and disallowed interest deductions are subject to limitation under IRC § 382.
  - Business credits, minimum tax credits, net capital losses and foreign tax credits are subject to limitation under IRC § 383.
- The TCJA did not generally alter the application of IRC § 382.

IRC § 382: Overview (cont.)

- The limitation under IRC § 382 arises routinely when buyers are valuing a target's tax attributes.
- As a general matter, the IRC § 382 limitation is applied to limit the amount of the target's NOLs and disallowed interest deductions that may be used to offset income after an ownership change.
- The IRC § 382 limitation is generally computed as the equity value of the target immediately prior to the ownership change multiplied by the long-term tax-exempt rate (which is reset monthly by the IRS; currently at 1.97% for February 2018).
  - Subject to important complex exceptions intended to allow a target's pre-change losses to offset its pre-change income.

IRC § 382: Overview (cont.)

- The detailed rules of IRC § 382 are among the most complex under subchapter C and are beyond the scope of this presentation; however, consider the following:
  - The application of the limitation under IRC § 382 can severely limit the value of a target's tax attributes.
  - Confirmation of the proper application of IRC § 382 can be a time-consuming & expensive process for a potential acquirer.
  - Performing due diligence to determine whether a target's claimed NOLs, disallowed interest deductions and other attributes were properly taken can be very difficult and subject to significant uncertainty.
- From a seller's perspective, buyer's failure to properly compensate seller for tax attributes can amount to a windfall.

Transaction Expenses

- Complex rules govern the deductibility of transaction expenses (e.g., fees paid to banks, lawyers and other advisors in connection with a transaction).
- Under Treas. Reg. § 1.263(a)-5, such expenses must be capitalized into basis in a leveraged buyout to the extent paid or incurred to "facilitate" the transaction.
  - Under these rules, an amount is paid to facilitate a transaction if, based on all of the facts and circumstances, the amount is paid in the process of investigating or otherwise pursuing the transaction.
  - Borrowing costs generally not covered by these rules.
  - Employee compensation and overhead generally excluded from these rules.
- A cut-off date (the earlier of LOI/exclusivity or board approval) determines whether costs are "facilitative".
  - However, certain costs are "inherently facilitative" (i.e., whenever performed).
- Success-based fees permitted a 70% safe harbor.
- The TCJA generally did not change the transaction expense capitalization rules.
- Under IRC § 162(k), certain deductions for transaction expenses (generally excluding borrowing costs) are disallowed to the extent incurred in connection with the reacquisition of a corporation's stock.
  - Leveraged acquisition are sometimes structured, in part, as redemptions for U.S. federal tax purposes and therefore IRC § 162(k) is often implicated.

Questions?