Selected US Tax Developments

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IMPACT OF US TAX REFORM ON CROSS-BORDER M & A

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This article addresses the possible impact that US tax reform may have on cross-border mergers and acquisitions (M & A) affecting Canada. The M & A market in the United States has been driven recently by a combination of strategic buyers and demand from private equity firms, the availability and cost of capital, and potential returns to buyers. Tax reform would alter that calculus.

KEYWORDS: M & A ■ CROSS-BORDER ■ US ■ TAX REFORM ■ MERGERS ■ ACQUISITIONS

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INTRODUCTION

Like it or not, taxes play an important role in the structure and attractiveness of possible acquisitions, affecting bedrock assumptions about the cost and benefit of alternative uses of capital. Tax reform in the United States is likely to free up offshore cash, which will in turn pressure US multinationals to do something with the cash. On September 27, 2017, the "Big Six," consisting of Republican leaders from the House Ways and Means Committee, the Senate Finance Committee, and

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the Trump White House, released a nine-page framework for overhauling the US system of taxation[1] (herein referred to as "the framework"). This article considers possible impacts of the coming changes on cross-border investment opportunities, including mergers and acquisitions (M & A). The framework is broad and lacking in detail, and as a result it is too early to truly specify what tax reform will bring, and the timing of implementation of the new rules (assuming that they come); but it is not too early to consider the potential impact of those changes, their side effects, and their subtle influences.

The framework represents a significant step for the Republican Party in terms of providing guidance on its view of what the US tax system should look like and the types of proposals that will be analyzed and negotiated to implement the party's vision. At this stage in the process (writing in the second half of 2017), however, because the policies set forth in the framework will need to be developed into actual legislation by the US Congress, the specifics of US tax reform are hazy. Nevertheless, this article considers how some of the proposals contained in the framework could affect financial and M & A markets. We have not developed a sophisticated econometric model of the likely impacts of tax reform in the United States, nor is this article based on extensive interviews with industry players. Instead, we pose some of the questions to be asked by readers and their advisers who might be interested in anticipating the likely effect of future US tax reform legislation on cross-border M & A. More specifically, we ask "what if" certain tax reform proposals are enacted in the United States; we note some of the macroeconomic impacts, for which the answers are uncertain; and we address some of the likely answers. We describe some areas of concern for passive foreign investors and for buyers and sellers of businesses, and provide different points of view on the impact of such changes on US and foreign multinationals.

We note that, although uncertainty may lead to inaction, the first half of 2017 has seen strong cross-border M & A activity, possibly in response to the perception of a business-friendly regulatory environment as well as a significant probability of tax reform that might be favourable to the M & A landscape.

The bizarre process of passing federal tax reform legislation in the United States includes a choice of ending deficit-generating provisions in 10 years or subjecting the proposal to block by filibuster in the Senate, absent passage by 60 percent. At the time this article was being written, the Senate was considered likely to approve some $1 trillion in tax deficits as part of its tax reform agenda.

The key areas set forth in the framework that are likely being considered by business owners, managers, and investors in determining whether to move forward with a potential transaction include

1 United States, Department of the Treasury, "Unified Framework for Fixing Our Broken Tax Code," September 27, 2017 (www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf).

1. changes to corporate tax rates,
2. the deductibility of interest expense,
3. the ability to repatriate overseas cash in a tax-efficient manner,
4. the acceleration of cost recovery (for example, through immediate expensing of capital expenditures),
5. a shift to a territorial system, and
6. potential repeal or modification of the US estate tax.

One area that seemed ripe for tax reform and had some initial momentum was a border adjustment tax; however, it seems that a border adjustment tax has little or no chance of being enacted now, and such a measure was not included in the framework.

It may be ironic that the United States is finally motivated to move on tax reform and reduce its historically higher relative corporate tax rate, and possibly adopt a territorial system of taxation, at a time when Canada may be on the threshold of increasing its own tax rates. It will be even more ironic if the United States becomes a tax haven for Canadian investors and those drawn to a second home south of the border.

TAX REFORMS ASSUMED

On the basis of the framework, we believe that likely tax reforms, at the time of writing, include the following:

1. *Lower domestic corporate tax rates*, but not necessarily lower rates for passive foreign investors. Lower rates will result in a one-time hit to the balance sheet of corporations with deferred tax assets, and reset the calculation of the cost and benefit of taxable versus tax-deferred acquisitions. The framework envisages a reduction in corporate tax rates from current rates of 35 percent to 20 percent.
2. *Further limits on interest deductibility*, together with lower rates that would reduce the tax benefit of leverage in any event. Although the framework provides for limitations on deductibility of interest paid by corporations, the details for how interest expense deductions will be limited have been left to the US Congress to sort out.
3. *Accelerated cost recovery* that will change the net present value of deploying capital into improvements, noting uncertainties of application to buildings and other structures and intangible assets. Specifically, the framework provides for immediate expensing of the costs of "new" investments for at least five years.
4. *Territorial system of taxation and forced repatriation of offshore earnings* by US multinationals. After a one-time balance sheet hit, US multinationals may be flush with cash, but pressed by shareholders to increase dividends, buy back shares, and defer acquisitions. The framework provides that to transition from

the current worldwide system of taxation to a territorial system of taxation, accumulated earnings held offshore under the old system will be deemed to have been repatriated and will be taxed under a two-tier system.

5. *Reduced incentives for expatriating*, including engaging in inversion transactions, but continued incentives to seek lower foreign taxes, wages, and other costs. For example, the framework's reduction in corporate tax rates, limitations on interest deductibility, and switch to a territorial tax system will reduce some of the key incentives that US-based multinationals are seeking to obtain with an inversion transaction.
6. *Estate tax repeal* (benefiting foreign investors holding US securities and US real estate) but perhaps tied to a carryover basis in decedents' assets. Although the framework calls for an estate tax and generation-skipping tax repeal, no further guidance is provided as to how that would be implemented.

LARGELY UNANSWERABLE QUESTIONS

A number of questions are unanswerable at the time of writing, including the following:

1. the impact of tax reforms on the strength of the US dollar (including not only reduced interest rates, noted below, but also other impacts on economic activity, price levels, etc.);
2. the impact on interest rates (reduced demand for debt);
3. the permanence and timing of transition to a new system, and the impact on pending transactions;
4. the secondary impact of tax reform (for example, if there were a large decrease in revenue, whether the United States would explore a consumption tax);
5. the impact of tax reform on research and development, alternative energy initiatives, and infrastructure;
6. whether capital cost allowance will be permitted in taxable asset acquisitions of existing equipment and fixtures; and
7. the future of US tax treaties (specifically, those that are hung up in the US Senate).

LARGELY ANSWERABLE QUESTIONS

Impact on Passive Foreign Investors

Although reduced corporate tax rates are a key component of the framework and appear to be a cornerstone of any tax reform that we should expect under the current administration, there does not appear to be any support for reducing the US tax rate on US-source income payable to passive foreign investors (such as dividends, interest, and royalties). Generally, such passive income is subject to a 30 percent US withholding tax, unless reduced by an applicable treaty.

The reduction of corporate tax rates coupled with the potential strengthening of the rules preventing base erosion through deductible interest payments to related foreign lenders may reduce the debt appetite of US companies, since the benefit typically attributable to interest payments would be reduced.

As debt instruments become less attractive to US borrowers issuing debt to related foreign lenders, we expect to see an increased desire for structures that permit distributions from a US company to its foreign shareholders without, or with a reduced, US withholding tax on dividends. Specifically, ensuring that foreign passive investors have access to reduced US withholding tax rates under applicable treaties will be of particular importance in structuring any investment of a foreign passive investor into the United States.

In addition, a recent Tax Court case provided some taxpayer-favourable guidance to passive foreign investors in entities treated as partnerships for US tax purposes that earn effectively connected income. In *Grecian Magnesite Mining, Industrial & Shipping Co., SA*,[2] the Tax Court held that gain from a foreign partner's sale of an interest in a US partnership that was engaged in a US trade or business did not give rise to income that was taxable in the United States. Although this was welcome guidance to taxpayers, and was contrary to a 1991 published ruling by the Internal Revenue Service (IRS),[3] the Tax Court's decision could put pressure on Congress to change the law to impose tax on a disposition of interests in flowthrough vehicles generating effectively connected income (such as partnerships and master limited partnerships).

We do not expect US tax reform to adversely affect foreign passive investors in US real property. Accordingly, we expect that foreign passive investors in US real property will continue to be exempt from US tax on dispositions of US real property interests under the Foreign Investment in Real Property Tax Act (FIRPTA)[4] for (1) dispositions of up to 10 percent interests in publicly listed real estate investment trusts (REITs), (2) gain from the disposition of a domestically controlled REIT, and (3) gain allocable to "qualified foreign pension funds." We believe that the continued availability of these exemptions, along with reduced corporate tax rates and possible repeal of the US estate tax, could create additional attraction for foreign investors in US real estate.

Finally, a reduction in corporate tax rates could create additional opportunities for foreign investors seeking to make equity investments in industries where the gain on exit will not subject a foreign investor to US tax (for example, investments in non-US real estate).

Impact on US Multinationals

US tax reform as outlined in the framework would have a significant impact on US-based multinationals' appetite for cross-border M & A. As mentioned above, and

2 149 TC no. 3 (2017).

3 Rev. rul. 91-32, 1991-1 CB 107.

4 Foreign Investment in Real Property Tax Act of 1980, subtitle C of title XI of the Omnibus Reconciliation Act of 1980, Pub. L. no. 96-499, enacted on December 5, 1980.

outlined in the framework, a switch to a territorial system of taxation (coupled with a one-time forced repatriation) would make it tax-efficient for US-based multinationals to repatriate cash held overseas by their foreign subsidiaries. Currently, the potential US tax cost for these multinationals to repatriate overseas cash has resulted in massive amounts of cash being locked out of the United States. Awash with cash from forced repatriation and a territorial tax system, these US-based multinationals will face pressure from shareholders to disgorge the funds (for example, through dividends, share buybacks, etc.), whereas management may want to deploy at least a portion of the newly repatriated cash to make additional investments and seek M & A opportunities.

While reduced US tax rates may reduce, in part, the need for US-based multinationals to scour the globe for tax-favourable jurisdictions in which to conduct active business operations, tax cost is just one factor that has driven US-based companies to move operations overseas. Reduced cost of labour and fewer regulations may still provide an incentive to companies to conduct more activities abroad.

Typically, private equity funds seeking short-term returns on portfolio investments rely on the benefit of interest deductibility from acquisition leverage to achieve a desired after-tax rate of return on their investments. Lower tax rates along with further interest deductibility limitations will reduce the benefit of such leverage, potentially putting private equity funds at a disadvantage as compared with strategic buyers seeking longer-term acquisitions, and thereby reducing the price of M & A targets.

Despite unprecedented partisan disagreement in Congress today, one area of reform that both sides of the aisle seem to agree on is the need to target inversion transactions and to block, or reduce the number of, US-based multinationals that seek to move their businesses outside the United States to more tax-favourable regimes. Recently, these expatriation transactions have been attacked by legislation or IRS guidance that either makes it more difficult for companies to leave the United States without triggering the anti-inversion rules or reduces the US tax benefits available to these expatriated companies after leaving the United States. However, to the extent that tax reform results in lower US tax rates and a territorial tax system (making the United States a more tax-favourable jurisdiction in which to carry on business), the need for anti-inversion legislation may be reduced.

Finally, to the extent that tax reform lowers tax rates, accelerates cost recovery, and eliminates industry-specific deductions and credits, such tax reform may provide an increased benefit to capital-intensive industries doing business in the United States (such as manufacturing businesses) relative to industries that currently benefit from special tax incentives (such as mining, oil and gas, and renewable energy).

Impact on US Taxable Sellers and Buyers

Tax reform can have a significant impact on the US tax consequences to sellers and buyers in cross-border M & A transactions, which can result in parties to an M & A transaction reconsidering how to structure their acquisitions, often with competing interests. For example, parties that may have considered structuring acquisitions or dispositions to qualify for non-recognition treatment for US tax purposes may be less inclined to meet the sometimes onerous requirements for non-recognition treatment, since the benefit of tax deferral is reduced as tax rates are lowered.

Lower tax rates may motivate business owners and founders, often with low tax basis, to sell their businesses because the tax implications of the disposition will be less costly. Similarly, rate reductions may encourage the structuring of business dispositions as asset sales rather than stock sales. Purchasers, however, may be less inclined to acquire assets since the benefit of the basis step-up from an asset acquisition would have a lower net present value—unless, of course, tax reform would permit accelerated cost recovery for the acquisition of used assets (as opposed to just original-use assets).

Although, as discussed, lower tax rates may motivate sellers to dispose of existing businesses, the potential reduction of tax benefits from borrowing (for example, through strengthened interest deductibility limitations) may discourage private equity funds from entering into M & A transactions, resulting in fewer deals.

Impact on Foreign Multinationals

Foreign-based multinationals, like US-based multinationals, will need to analyze the proposals set forth in the framework along with any US tax reform in order to evaluate the impact that such reform may have on their willingness to engage in cross-border M & A transactions. For instance, to the extent that US-based multinationals find themselves with access to significant amounts of cash resulting from forced repatriation and a switch to a territorial system of taxation, foreign-based multinationals may find themselves facing increased competition, particularly for US target companies, since the US-based multinationals may be looking to deploy some of those funds in acquisitive transactions. On the flip side, if additional restrictions are placed on a US company's ability to deduct interest expense, foreign-based multinationals financing acquisitions with debt may find themselves at a competitive advantage as compared with their US counterparts, to the extent that the local jurisdiction of the foreign-based multinational permits such interest deductions.

As noted above, because there is no indication in the framework that tax reform will reduce US tax rates on income from foreign passive investments (dividends, interest, royalties, etc.), foreign-based multinationals will want to remain vigilant in structuring their US investments in such a manner as to ensure access to US tax treaties. Many US tax treaties contain limitation-on-benefits provisions that are intended to prevent or reduce treaty shopping. The United States and some of its treaty counterparts have agreed to modifications to their tax treaties with certain jurisdictions through which treaty shopping may currently be available, but those treaty modifications have stalled and are awaiting ratification by the US Senate. In light of the global push to prevent treaty shopping and base erosion,[5] multinationals

5 For example, see Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), as well as recent changes reflected in the United States Model Income Tax Convention of February 17, 2016.

and their tax advisers will be keeping an eye on any indication that the US Senate will ratify these stalled tax treaties (or otherwise take additional steps to prevent base erosion).

Interestingly, to the extent that tax reform gives rise to lower tax rates and switches the United States to a territorial tax system, we may see the United States becoming, in effect, a tax haven for foreign investors located in higher-tax jurisdictions. In fact, a territorial tax system will make US targets with foreign subsidiaries more attractive to foreign acquirors and more profitable on an after-tax basis. If the US tax landscape becomes more favourable, we may even see US companies migrating out of the United States under a new foreign parent company, in transactions that intentionally trigger the US anti-inversion rules and result in the treatment of the new foreign parent company as a US corporation for US tax purposes. This would permit the US company to leave the United States for regulatory or other non-tax business purposes while retaining access to the new lower US corporate tax rates and territorial tax system.

CONCLUSIONS

The Trump administration has faced challenges thus far in achieving any significant legislative changes; however, one area that may be ripe for a legislative victory is tax reform. There are certain tax reform measures set forth in the recently released framework that have wide appeal to the president and congressional Republicans alike—reduced business tax rates, forced repatriation of offshore profits, and a move from a worldwide system of taxation to a territorial system, to name a few—each of which can have a material impact on cross-border M & A.

Until recently, there was a degree of skepticism on the ability of Congress to pass tax reform, since it was understood that any tax reform plan would be based on a principle of revenue neutrality on a "static" modelling basis (determined without regard to projected economic growth resulting from such tax reform). Some Republican senators have now changed their tune and are willing to consider a tax reform proposal that would add up to $1 trillion to the deficit on a static basis, provided that the tax cuts pay for themselves through economic growth as determined by valid economic modelling. Accordingly, although it is still too early to be certain of the outcome, there is an improved prospect that the Trump administration will be able to pass tax reform, perhaps as soon as early 2018.

Although there is no crystal ball telling us exactly how tax reform will affect cross-border M & A, we believe that it is safe to say that the goal of tax reform will be to make the US tax system more competitive on a global basis and particularly as compared with Canada, which may now be moving in the opposite direction. This increased competitiveness, through reduced tax rates and a territorial tax system, coupled with forced repatriation, can result in lots of cash finding its way into the United States, making US companies that seek to expand more competitive and US targets, particularly those with foreign subsidiaries, more attractive. This tax reform, however, likely will not come without cost. As the world moves to prevent companies from being able to erode the taxable base of jurisdictions to which those companies' earnings are properly attributable, US companies may find new challenges in trying to finance acquisitions with leverage giving rise to deductible interest and in using other common structures to manage the US tax base through currently deductible payments made to foreign related parties.