

# The M&A Growth Bulletin

News and Insights on M&A for the Middle Market



A Capstone Strategic, Inc. Newsletter

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## Tax Reform and M&A What You Need to Know



The new tax law signed on December 22, 2017 is the most significant tax reform package that has been passed since 1986 and has numerous changes that will directly and indirectly impact corporate America and deals. Here we have highlighted key areas buyers and sellers should focus on when it comes to taxes under the new law.

### Corporate Tax Rate Drops to 21%

The biggest change to the tax law is the significant cut in the corporate tax rate from 35% to 21%. This significant rate reduction will have a critical impact on the business landscape. Corporations still have two layers of tax, meaning income is taxed at the corporate level, and then once dividends are distributed to shareholders, it is taxed at the individual level. Even with two levels of tax, the corporation is a much more attractive vehicle than it was under the old law.

### Limitations on Net Operating Losses

Limitation on net operating losses will have a major impact on negotiated items in deals. Under new law, NOLs cannot be carried back, but can be carried forward indefinitely. In the past, shareholders were compensated for the tax benefit acquirers would

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### It's a Big Deal: M&A in the News

**Amazon acquires online pharmacy PillPack for \$1 billion** to expand reach in healthcare. Amazon, Berkshire Hathaway and JPMorgan Chase created a joint venture earlier this year that threatens to disrupt the pharmaceutical industry.

After completing the \$85 billion acquisition of Time Warner, **AT&T acquires cybersecurity firm AlienVault**. The deal adds to AT&T's offerings in cybersecurity market, which is growing rapidly.

**ConAgra buys Pinnacle Foods for \$10.9 billion** to increase market share of fast-growing frozen food and snack segments.



### David Braun's Tip for Growth

#### First Impressions Matter

You only have one chance to contact an owner for the first time so it's important to do it right. Once formed, an opinion – good or bad – can be difficult to change.

Making a good first impression begins before your initial contact. Do your homework ahead of time to show that you are a serious buyer and the prospect is not just one on a list of many. Tailoring the conversation and materials will go a long way to establish trust so you can persuasively illustrate the strategic fit between your companies. In your first interaction, be sure to set the right tone for the buyer-seller relationship moving forward.



#### The latest events from M&A U™

##### Building a Robust Pipeline of Acquisition Prospects

Learn how to identify the best companies for acquisition.

1 PM EDT – July 26

##### Keys to Integration Success

Successfully plan and execute the integration of two companies.

1 PM EDT – August 22

##### The Basics of Valuation for M&A

Understanding core concepts and demystifying key terms of valuation.

1PM EDT – September 20

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receive from NOLs, but under the new law, the benefit may be limited.

## Loss of Deduction for State and Local Taxes

Under new law, the deduction for state and local taxes is limited to \$10,000 per individual. The loss of deduction will impact which entity, corporation or passthrough, is selected.

There are limitations to whether the 199 A deduction applies. The deduction only applies to "qualified business income." For a professional services firm such as law or accounting, except for engineering, which has been excluded, the 199 A deduction can only be applied to the first \$157,500 for an individual or \$315,000 for a married couple. For these types of businesses, this is a pretty low threshold. Once your income exceeds this threshold, you are ineligible for the 199 A deduction. For a traditional manufacturing or operating business (not professional business), there is no cap to how big the deduction can be, but there are other limitations based on wage and property that could sneak up on you.

It's advisable to get your tax professional involved early on to determine if you qualify for the 199 A deduction.

## One-time Repatriation of Foreign Cash

While tax reform will prompt changes in domestic deals, for the most part, deal work will be played in the same ballpark. On the other hand, when it comes to cross-border M&A, there will be a massive shift in the way deals will be executed. The most significant change to be aware of is the one-time repatriation of foreign cash. Under the old law, any cash held overseas was taxed at 35% when brought back to the US. Now, this income will be taxed at a much lower rate of 15.5%. This will drive deals activity as companies become flush with cash.

## Limitation on Debt Financing

New rules significantly limit how much of a deal can be financed, which will impact leverage models, especially for private equity firms. This will likely level the playing field between private equity and strategic buyers, but we need to wait and see how it will affect deal prices.

## Full Expensing

Buyers can now fully expense their purchase in the first year instead of amortizing or depreciating tangible assets over time. This can be valuable, but it is limited to specific situations where the buyer is acquiring significant tangible assets and a large amount of the purchase price is allocated to the tangible assets.

A popular prediction is that full expensing would drive more asset deals, but this may not be the case. In the majority of deals, most of the value is not in the tangible assets, but in

the intangible assets of the company. Even deals where a high amount of the purchase price is allocated to tangible assets may not see a significant shift. The lower corporate tax rate of 21% means tax savings are now less than they were pre-tax reform. Full expensing offsets this lower tax savings so the total savings will be about the same as the savings pre-tax reform.

The takeaway for M&A is to maximize the value of full expensing, allocate as much as you can of the purchase price to tangible assets. Full expensing is helpful, but in the M&A world it will not be as powerful as many had initially assumed.

For companies with any foreign subsidiaries or activities, it is for more beneficial to be a corporation than a partnership. Under new tax law both partnerships and corporations face the same penalties, but only corporations are eligible for many of the protections and benefits.

## The Key Takeaway

Tax considerations should not drive your acquisition rationale, but they are an important component of the deal. The changes listed above may or may not directly impact your specific acquisition, but it is helpful to consider each of them from a high-level to ensure no item is uncovered.

*Do you have questions about M&A? We would love to hear from you. Please contact us at 703-854-1910 or [Growth@CapstoneStrategic.com](mailto:Growth@CapstoneStrategic.com).*

\* This article is based on the webinar "Tax Reform and M&A: What You Need to Know" presented by Tax Attorney Alexander Lee.

## Let's Talk Growth

Are you looking to move your company to the next level?

Capstone has 20 years' experience helping middle market companies grow with M&A.



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