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US tax reforms to spark global M&A activity

We are just weeks away from knowing more of the details of the much-vaunted United States tax reform package, a central pillar of the Republican Party's legislative program for President Trump's first term in office.

The program is expected be the most comprehensive since President Reagan's 1986 tax reforms were introduced. But the announced details in early September will signal the start, rather than the end of the reform program. The bill's passage into law is likely to be anything but smooth given the political pressure to ensure the changes are "revenue neutral" and other expected turf battles over the repeal of tax benefits sacred to certain sectors.

While the path the legislation takes is uncertain, we do know that the U.S. Congress will advance a tax bill that, if enacted (most probably in late 2017 or early 2018), will have far reaching consequences for multi-national corporations operating in the U.S. And, if the optimists are right, the measures contained in the bill will re-ignite the embers of the U.S. M&A market, the fires of which have died down considerably in 2017, leading to a knock-on effect on global M&A.

Although global deal values in the first half of 2017 were marginally up, the U.S. recorded its lowest level of M&A activity since the first half of 2013 – a fall of 17% on H1 2016 – according to Thomson Reuters.

The months since have seen a dearth of U.S. deal making with an increasing number of CEOs waiting for clarity on any tax reform bill that emerges from Washington in September.

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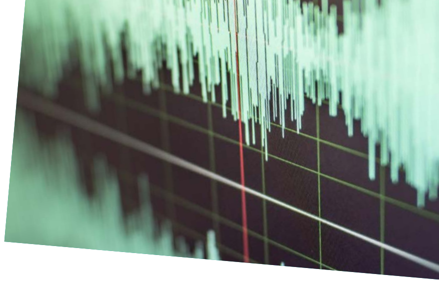

Earlier this month, Ian Read, chief executive of Pfizer, cited uncertainty over tax reform as the reason for the hiatus in takeover activity, remarking: ‘Right now we need to see tax reform or the absence of tax reform to understand what the market values are.’

An ambitious program of tax reform is predicted, led by a headline cut in the corporate income tax rate from 35% to 25%, or less. It is also expected that the extra-territorial tax regime, which imposes U.S. tax on all worldwide income of U.S. based multinationals, will be replaced by a simpler territorial system.

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Part of the move to a territorial tax will likely encompass a one-time repatriation tax, expected to be up to 10%, imposed on undistributed profits of non-U.S. subsidiaries owned by U.S. companies. These profits, as well as future profits, would then not be subject to U.S. taxation when distributed in the U.S.

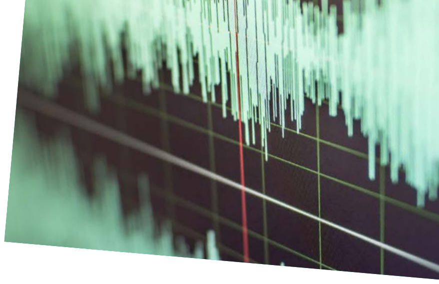
Counterbalancing the shift to a territorial regime are likely to be so-called ‘base erosion provisions’ (new CFC rules), intended to dissuade U.S. companies from locating income-generating assets in low-tax jurisdictions. The current proposal being considered is that income of non-U.S. subsidiaries of U.S. multi-nationals, attributable to foreign-held intangible assets that are subject to a non-U.S. tax rate of less than 15%, would be taxed, whether repatriated or not, at 15-25%.

It is also expected that the reforms will include provisions to enhance deductions for capital investments. This might enable businesses to write off as much as 100% of their costs of capital expenditure in the years they are in service, although an immediate 50% bonus depreciation is more probable.

A limit on the tax deductibility of interest is also being considered, as is the elimination of the preferential capital gains rate for carried interests.

Finally, in keeping with President Trump’s America First agenda, we think that a tax bill may well include incentives for companies to locate income-generating assets in the U.S. The “stick” of the base erosion provisions only goes some of the way to stemming tax incentives to move U.S. generated intangibles offshore. A “carrot” may also be needed. One option is a so-called “patent box” measure, where U.S. businesses developing intellectual property in the U.S., rather than abroad, would enjoy reduced tax rates. A reduced rate for manufacturers is also possible to encourage U.S. manufacturing.

At the company level, the extent to which the tax reform measures add up to an opportunity or threat will vary but we think there will undoubtedly be winners and losers at a sector level.



The potential move to territoriality, as currently envisaged by the Trump administration, presents an opportunity for U.S. businesses to return cash, currently offshore, back to the U.S. at a lower tax rate, which in turn could fuel renewed M&A activity. This, in particular, might be a kicker for activity in the technology and pharmaceutical arenas, both of which have powered global M&A activity in recent years, with many such businesses having significant cash pools offshore. A potential issue for these sectors, however, is the proposed global minimum tax on intangibles income of 15%.

While replenished war chests and eliminating the U.S. tax on repatriated foreign subsidiary income might fuel domestic and outbound U.S. M&A activity, the reforms would mean that some U.S. businesses are made more attractive and ultimately vulnerable to non-U.S. takeover. A lower effective tax rate reduces the cost of locating income generating assets in the U.S. and, all other things being equal, makes U.S. corporations more attractive for acquirers.

A potential loss of interest deductions would likely serve to stymie highly leveraged deals, the takeover weapon of choice for acquisitive private equity and hedge fund groups.

Meanwhile, the financial services industry could lose out on the potential benefits of territoriality, given that so many businesses in the sector operate overseas on a branch basis, while the retail market in the U.S. will be a major beneficiary of the slashing of the corporate income tax rate to 25%, or less.

For the energy sector, the proposed package is likely to offer up a mixed bag. The sector is likely to be hurt by the limit on interest deductibility, with infrastructure projects highly leveraged. But other aspects would be beneficial, albeit large existing tax losses may mean there is less immediate benefit.

The proposed package could also prompt changes to the way businesses structure acquisitions in the future. Territoriality will be a further nail in the coffin of controversial inversion-led deal making. Bonus depreciation or possibly lifetime expensing for capital assets, including intangibles, could incentivize U.S. buyers to acquire these assets directly, rather than through stock deals. Private equity funds would likely change their structures if carried interests lose their capital gains tax preference, as proposed by some.

Given the plethora of potential changes to the U.S. tax regime likely to be tabled in September, it is easy to understand why standing on the sidelines has become the M&A strategy of choice for some CEOs this summer.

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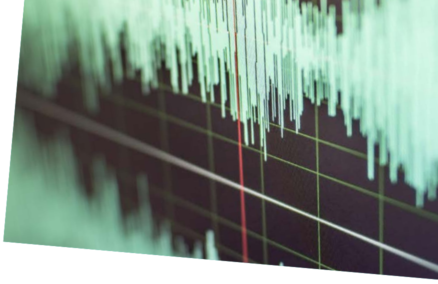

But as CEOs return from their vacations, the scale and ambition of the program the Republicans are expected to put forward is becoming clearer, meaning a holding pattern will soon cease to be the appropriate option.

Understanding the implications of the likely tax reforms will be a key priority for CEOs considering M&A activity in the weeks, months and years ahead.



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