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M&A Tax Talk
Cash tax forecasting simplified

Key takeaway
A dynamic tax forecast model allows for scenario analytics and decision-making in a fast-moving transaction process. Such a forecast validates tax elements of the broader deal thesis—positioning the company for a well-informed purchase price and for post-closing enhancement and integration. Preparing such a forecast of a Target's cash income taxes does not need to be a daunting or burdensome task, using the below framework as a guide.

Key tax information related to the Target
You may find that tax is rarely given a "seat at the table" early in the deal process because time is of the essence and tax analysis often carries time-consuming complexity. But ignoring the tax considerations of a deal can lead to overlooking significant value opportunities and risk mitigation strategies. A short bit of time early in the deal process discussing a few targeted questions with the Target company can have a significant impact on driving structure, negotiations, and value. And it equips the rest of the deal team with critical insight to accurately forecast the Target company's cash taxes, to compare alternatives, and to validate courses of action.

While these targeted questions will vary based on Target-specific facts, client-specific facts, industry considerations, etc., we have generally found that some form and combination of the following questions drive the cash tax forecast:

1. **Target's tax legal entity structure**, identifying the tax classification of the entities in the transaction perimeter and the Proposed Transaction structure.
2. Estimate of **EBITDA and cash taxes** by significant jurisdiction.
3. An overview of the Target's tax operating profile, intercompany framework, and **transfer pricing policy**.
4. Target's **US federal income tax returns** for the prior three years.
5. Estimate of **significant tax attributes** that are expected to carryover in, or be generated by, the Proposed Transaction.

Structure of cash tax forecast
The discussion herein focuses on the Target structures depicted in Diagrams 1 and 2. If the Target's structure is different (e.g., is non-US parented), the approach to a simplified cash tax forecast, or "build," may differ.

Diagram 1
Assumes Target is a US corporate entity ("Target Parent") with non-US corporate subsidiaries ("Target Subsidiaries"). Assumes Target Parent has borrowed from third-party lenders. The cash tax build will focus on estimating (1) non-US corporate income taxes and (2) US corporate income taxes.

Diagram 2
Assumes Target is treated as a US partnership ("Target Parent") with limited US and/or non-US corporate subsidiaries ("Target Subsidiaries"). Assumes Target Parent has borrowed from third-party lenders. The cash tax build will focus on estimating (1) US/non-US local corporate income taxes and (2) US tax distributions.

Diagram 1.

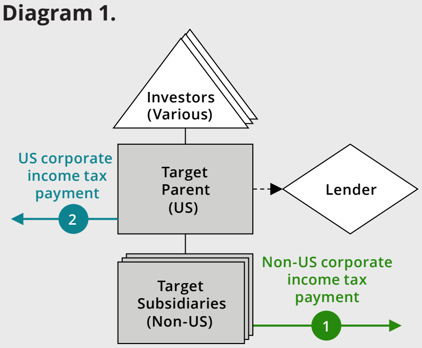
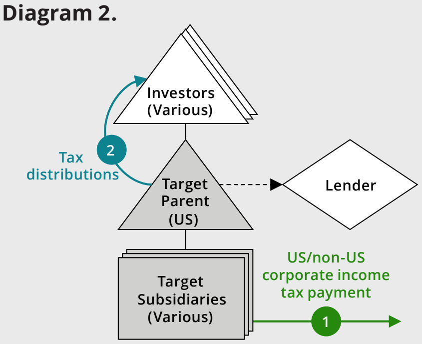


Diagram 2.



Cash tax forecast framework
Table 1 provides a basic framework for a cash tax build, with each component discussed in greater detail below. The discussion herein focuses on tax rules currently effective for tax years beginning on or after January 1, 2022.

Table 1.

EBITDA
(+)(–) Book-to-tax/other adjustments

Adj. Tax EBITDA
(–) Tax D&A – Proposed transaction
(–) Tax D&A – Existing assets
(–) Tax D&A – Capex
(–) Tax D&A – Future M&A spend

Adj. Tax EBIT
(–) Tax deductible interest expense

Taxable income (before NOLs)
(–) NOLs utilized

Taxable income
(x) Income tax rate

Cash income taxes

Unless Target is a single entity and/or has deminimis non-US operations, a consolidating —rather than consolidated—cash tax build is generally needed in order to ensure:

1. Entity level taxes are appropriately reflected in a flow-through structure.
2. The EBIT of Target Subsidiaries is not incorrectly impacting Target Parent's EBIT for purposes of calculating interest expense deductibility.
3. Losses and deductions of one entity/jurisdiction are not incorrectly offsetting income of another entity/jurisdiction.
4. Different statutory income and withholding tax rates are properly applied (i.e., a blended rate may not be appropriate).

The necessity of one or multiple cash tax builds for Target Subsidiaries will primarily depend on the applicability of factors 3 and 4 above to Target Subsidiaries.

EBITDA

EBITDA will need to be allocated between Target Parent and Target Subsidiaries. The bifurcation of EBITDA between Target Parent and Target Subsidiaries should reflect any significant intercompany transactions and transfer pricing.

Consider whether this allocation percentage remains constant during the holding period or varies (e.g., to reflect growth of non-US operations).

Book-to-tax/other EBITDA adjustments

The components outlined herein are the most common adjustments in walking from EBITDA to taxable income, but consider whether there are additional book-to-tax adjustments or other adjustments to EBITDA that should be incorporated in calculating tax EBITDA.

Adjustments could relate to the treatment of stock options deductions, transaction costs, deferred revenue, US taxation of non-US earnings (discussed further below), etc.

Tax depreciation and amortization (D&A)

If Target is engaged in a “capex-light” business, the cash tax build may be able to assume that tax D&A equals book D&A, but for most manufacturing businesses and software companies, that is not an appropriate assumption.

Proposed transaction step-up

If the acquisition of Target Parent is structured as an asset purchase or deemed asset purchase for tax purposes (e.g., acquisition of partnership interests), a tax basis step-up may be generated relative to the assets or interests acquired.

If the tax basis step-up was generated inside of a corporation (e.g., corporate acquirer of assets, Section 338(h)(10) election, etc.), the tax D&A related to the step-up may be incorporated into the tax build.

If the tax basis step-up was generated from the acquisition of partnership interests, the inclusion of the tax D&A related to the step-up as it relates to tax distributions will often be a matter of negotiation under any applicable credit agreement and/or the partnership agreement.

Existing assets

To the extent Target Parent has significant existing tax basis in depreciable and/or amortizable assets, consider whether to incorporate the runoff of such tax basis in the cash tax build.

It is common to see significant existing tax basis when the target company owns its facilities and/or has completed acquisitions that generated amortizable tax basis.

Capital expenditures (Capex)

The cash tax build will need to reflect tax depreciation related to capex. US tax rules (Section 168(k)) generally provide that, in the case of "qualified property" (generally property with a recovery period of 20 years or less) placed in service before January 1, 2023, a tax deduction (referred to as "bonus depreciation" or "immediate expensing") is available equal to 100% of the cost of such property (the applicable percentage decreases by 20% for property placed in service each year thereafter).

For purposes of the cash tax build, any residual capex spend not eligible for immediate expensing should be depreciated over the remaining useful life, depending on asset class (e.g., generally, a tax life of 7 years is appropriate for machinery and equipment). Note that non-residential real property is not eligible for immediate expensing and generally has a tax life of 39 years.

For companies engaged in R&D and software development, the tax D&A rules operate differently beginning in 2022.

For purposes of the cash tax build, any R&D and software development expenditures included in EBITDA should be added back and aggregated with any such expenditures included in capex. The costs may then be amortized over 5 years (if US-related) or 15 years (if non-US-related). Consider incorporating a blended amortization life, assuming a mix of US and non-US R&D resources.

Future M&A

To the extent the deal model includes spend for future acquisitions, consider whether such M&A spend may generate amortizable tax basis (e.g., an acquisition of assets, an acquisition of partnership interests, etc.) that should be incorporated into the cash tax build.

If there is a specific acquisition in the pipeline, the transaction structure and availability of a tax basis step-up may be known. However, more commonly, deal models contemplate general M&A and therefore assumptions will need to be made about the portion of M&A spend related to (i) US asset/deemed asset acquisitions and (ii) the portion of the spend allocated to (iii) that relates to amortizable basis.

Tax-deductible interest expense Assuming the deal model contemplates financing, it will be key to analyze the tax interest expense deductibility rules in the cash tax build. As indicated above, for purposes of this discussion, it has been assumed that all third-party debt is at the level of Target Parent. Generally, such assumption is reasonable, unless there is existing non-US debt and/or a planned structure to push debt down.

US interest expense (inclusive of OID) is limited to 30% of US tax EBIT (Section 163(j)). Excess interest amounts carry over to future years. Financing fees are generally amortized for tax purposes over the term of the loan.

Tax net operating losses (NOLs)

Quantity

If the Target company has existing NOLs and/or an NOL will be generated in connection with the Proposed Transaction (e.g., as a result of tax-deductible transaction costs), consider incorporating the NOL carryforward into the cash tax build.

Note that sellers often seek to negotiate for payment for any pre-transaction NOLs (or other tax attributes) that are utilized post-transaction. Therefore, consider toggling on/off the impact of such a payment (e.g., up-front adjustment to purchase price or payment on an as-realized basis) on cash flow related to tax.

Usability

US tax rules (Section 382) generally limit the usability of NOLs following a change in control (generally defined as a cumulative 50% ownership change over a rolling 3-year period). The annual Section 382 limitation is generally equal to the fair market value of a corporation’s equity immediately prior to the ownership change (with certain adjustments for debt financed acquisitions) multiplied by the applicable long-term tax-exempt rate as published by the IRS. Under current tax rules, that limitation may be increased over the first five years after an ownership change if there is a net unrealized built-in gain in the company’s assets at the time of change. Refer to the Section 382 Tax Talk for more information.

To the extent the Section 382 limitation is expected to significantly limit the usability of NOLs in a given year, it will be important to incorporate such limitation into the cash tax build. Further, to the extent the Target is subject to a prior Section 382 limitation that is more restrictive than the Proposed Transaction’s limitation, such restriction should be reflected.

Subject to the Section 382 limitation described above, (i) US federal NOLs generated prior to 2018 may be carried forward 20 years and offset 100% of US federal taxable income in a given year and (ii) US federal NOLs generated in 2018 or subsequent years may be carried forward indefinitely and offset 80% of US federal taxable income in a given year (Section 172).

To the extent the Target company has significant pre-2018 US federal NOLs, consider whether to bifurcate the NOL utilization in the cash tax build in order to differentiate between the rules described above.

Income tax rate

US corporate income tax rate

Typically a statutory 25%–28% US federal/state blended income tax rate can be applied to US corporate taxable income. The state component of the rate should, however, be refined as more is learned about Target's state income tax profile through diligence.

US flow-through income tax rate

Generally, the highest applicable US federal and state income tax rate will be used for tax distributions, but such rate is a matter of negotiation and is often outlined in the partnership agreement.

Non-US corporate income tax rate

Non-US corporate income tax rates vary by country. To the extent the Target Subsidiaries operate in multiple jurisdictions, use caution when using a blended rate—such rate should accurately reflect the relevant jurisdiction's share of tax EBT and applicable statutory tax rate.

Other factors to consider

US taxation of non-US earnings

To the extent the non-US Target Subsidiaries are disregarded entities for US income tax purposes, the income of such entities generally should be included in the US taxable income calculation of Target Parent.

To the extent the non-US Target Subsidiaries are corporations for US income tax purposes, the income of such entities may need to be included in the US taxable income calculation of Target Parent. US tax rules have various "anti-deferral" provisions, including, in particular, the "GILTI" rules that seek to tax such income. For purposes of the cash tax build, a simplified approach to estimating the GILTI inclusion for Target Parent may be to include the net income of non-US Target Subsidiaries in Target Parent's tax EBITDA. To the extent Target Parent has positive taxable income, it may be able to avail itself of a deduction equal to 50% (37.5% for tax years beginning after December 31, 2025) of such GILTI inclusion (Section 250).

Repatriation of cash in a global structure

To the extent the free cash flow at the level of non-US Target Subsidiaries needs to be repatriated to Target Parent to facilitate financing payments, dividends, or other costs, consider whether there is withholding tax or other tax costs related to such repatriation.

Impact of M&A

In addition to the impact of M&A on the tax D&A build (as described above), consider whether there are other significant implications as a result of future M&A (e.g., impact to the blended tax rate, etc.).

Scenario planning

Similar to the toggles and variables that are incorporated into the deal model's income statement and cash flow forecasts, the key tax inputs and assumptions in the cash tax build should also be toggled (e.g., the allocation of EBITDA between Target Parent and Target Subsidiaries, the tax rate, the NOL carryforward balance, etc.).

Build your tax forecast early and consult it often. Do not think of it as a static outcome. Rather a forecast should be a dynamic tool—flexible for new inputs learned during the deal process and leveraged often to aid in decisions related to structure, value, and negotiations in a fluid process.

Our approach

The material presented in this article is intended to be an overview—cash tax forecasting can be nuanced and complex depending on the specific facts as relevant to the tax profile and industry of your company and the Target. Deloitte can help you apply this general framework to your specific situation.

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