Deloitte.

# M&A Tax Talk
## Power shift, tax shift?

**A change in presidential administrations often signals the possibility of changes in tax policy, and this is certainly true in the case of the current transition. This article provides a high-level overview of President Biden's proposed tax law changes to corporate and individual taxes and the potential impact on M&A transactions if such changes are enacted.**

### Setting the stage

More than two months after the nation went to the polls on Election Day, questions around who will control the levers of power in the White House and on Capitol Hill are now finally settled. Joe Biden became the nation's 46th president at noon on January 20 and will be working with a Democratic Congress.

A change in presidential administrations often signals the possibility of changes in tax policy, and this is certainly true in the case of the current transition. President Biden campaigned on a platform of ensuring that businesses and wealthy individuals pay "their fair share" in taxes. To that end, he has proposed modifying or repealing key provisions of the 2017 tax code overhaul known informally as the Tax Cuts and Jobs Act (TCJA, P.L. 115-97). Among other things, he has called for increasing the top tax rates on corporations and upper-income individuals (generally those with income greater than $400,000) and for phasing out the deduction for certain passthrough business income. If signed into law, these proposed changes may also affect M&A transactions and other deal activity.

This article provides a high-level overview of Biden's proposed tax law changes to corporate and individual taxes and the potential impact on M&A transactions if such changes are enacted. However, some significant caveats are worth keeping in mind.

First, very little detail is currently available on many of the proposals Biden has put forward. Over the course of the campaign, he did not release detailed tax policy documents to the public or deliver a substantial, tax-focused economic address. The proposals discussed herein are gleaned largely from statements on Biden's campaign website, as well as from comments made during Democratic primary debates, rallies, campaign speeches, and briefings to reporters. Additionally, consideration will need to be given to the potential impact on state tax legislation that may ensue following any federal tax policy changes.

Second, it's important to note that tax law originates in Congress, not the White House, so any legislation that is enacted into law inevitably will reflect the priorities of congressional leaders. Democrats hold the majority in the House in the 117th Congress, which officially convened on January 3, and have a narrow majority in the Senate after Sen. Kamala Harris became vice president on January 20. This potentially provides an opportunity to enact some level of tax increases in the coming two years. But the shape, breadth, and timing of any legislative proposals that advance on Capitol Hill are likely to be affected by:

- **Differing priorities:** The Democratic party has historically brought together politicians with widely disparate views on many issues, including tax policy, and finding common ground could prove to be challenging in 2021 and 2022. While Democratic taxwriters are united in their public criticism of the Republicans' 2017 tax overhaul, they have not, for the most part, weighed in on many of the specific proposals Biden laid out during his campaign.
- **Narrow majorities:** House Democrats control 222 seats in the 117th Congress, compared with 211 for Republicans—a significantly smaller majority than over the past two years. Democratic victories in the two Georgia Senate runoff races on January 5 mean that Democrats and the GOP hold 50 seats each in that chamber. Democrats effectively control the Senate since Vice President Harris, in her role as president of the Senate, will cast the tiebreaking vote whenever lawmakers are deadlocked. Democrats' slender majorities in both chambers will leave leaders with little room for error as they navigate the sometimes conflicting priorities of lawmakers in the progressive and moderate wings of the party.

Finally, the full impact of any tax law changes enacted in the early days of the Biden administration will depend on whether those provisions take effect prospectively or are retroactive to January 1, 2021. Retroactive enactment of tax law changes is uncommon and generally is viewed as unlikely. Nonetheless, the potential risk that future tax changes might be retroactive prior to the date of enactment is something that should be kept in mind.

### Higher rates and other tax increases

Biden proposes to increase the corporate tax rate from 21 percent to 28 percent. Further, he has called for a 15 percent minimum tax on book income for companies that report net income of more than $100 million for financial statement purposes but owe no US income tax.

On the individual side of the tax code, Biden proposes to increase the top rate on ordinary income from 37 percent to its pre-TCJA level of 39.6 percent for those with taxable income greater than $400,000. Long-term capital gains and certain dividends would be taxed at ordinary rates for individuals with income greater than $1 million—an increase from the current top long-term capital gains and dividend tax rate of 20 percent. Income from carried interests would also be taxed at ordinary rates. (Under the TCJA, carried interests are taxed at preferential long-term capital gains rates if held for more than three years.) In addition to raising the top individual rate, Biden proposes to tighten tax benefits currently available to owners of large passthrough entities, who are taxed as individuals, by phasing out the deduction under section 199A for taxpayers with income of more than $400,000.

The current-law 37 percent top rate for individuals and the 20 percent deduction for passthrough business income, both of which were enacted in the TCJA, are currently scheduled to expire after 2025.

**M&A implications**

There has been some acceleration of M&A deal activity in anticipation of these proposed income tax rate increases. Business owners (corporations and individuals) that are contemplating such a transaction may be motivated to close a transaction before the potential increase in tax rates. The following are simplified examples to illustrate the impact of an increase in tax rates and do not contemplate other taxes such as the net investment income tax or state-level taxes. If a corporation sells today and recognizes gain of $100,000, the corporation will have after-tax cash proceeds of $79,000 at current rates. If an individual (with income of greater than $1 million) sells his or her business today for capital gains treatment for $100,000 of gain, he or she would recognize after-tax cash proceeds of $80,000 at current rates. Absent other possible tax changes, if Biden's plan to increase the corporate and individual income tax rates becomes law, the corporation would realize after-tax cash proceeds of $72,000, resulting in $7,000 of additional tax versus current law; and the individual would recognize after-tax cash proceeds of $60,400, resulting in $19,600 of additional tax versus current law. Similarly, if an investment fund treated as a partnership for federal income tax purposes sells its interest in a business today that was held for more than three years, an individual investor (with income of greater than $1 million) in a fund management partnership would generally be taxed at the current capital gains rate of 20 percent versus 39.6 percent on his or her share of the "carried interest" income from the sale.

Additionally, if Biden's 15 percent minimum tax on certain businesses becomes law, a corporation with net operating losses (NOL) and paying no US income tax may not seem as attractive a target for acquisition. Depending on how the 15 percent minimum tax is drafted, the new owner of the corporation could be liable for taxes on the corporation's financial income, even though the company may not have any taxable income due to the NOLs.

On the other hand, a business's NOLs and other tax attributes may become more valuable as tax rates increase, because they can be utilized to offset income that would otherwise be subject to the higher tax rates.

The analysis of different structuring alternatives may also change. If long-term capital gains are taxed at ordinary rates (for certain individuals), sellers may not be as concerned with structuring transactions to achieve capital gains tax treatment. For example, if a buyer or seller is considering an earnout (i.e., generally a contractual commitment to make a future contingent payment if post-closing conditions are met) in a proposed transaction, the earnout could be taxed at ordinary or capital gains tax rates. If the earnout is considered compensation (and, potentially, tax-deductible), generally the earnout payments will be taxed as ordinary income. If the earnout is considered a deferred purchase price (and, potentially, not tax-deductible), generally the earnout payments will be taxed at capital gains tax rates. If the gap between ordinary tax rates and capital gains tax rates shrinks, tax sensitivities with respect to structuring earnouts between buyers and sellers may become less important.

Alternatively, businesses may become more concerned with tax structuring alternatives. For example, a buyer typically favors a structure that is treated as an asset acquisition or deemed asset acquisition because it may deliver a step-up in tax basis. If the rates increase, the tax basis step-up will drive incremental value by providing additional deductions that would offset taxable income subject to higher tax rates.

**Importance of M&A future cash tax analysis**

When planning for an M&A transaction, buyers and sellers should consider evaluating these proposed changes and the potential impact they may have on transactions now. The potential increase in tax rates and value of future tax attributes, such as NOLs and tax basis step-up, should all be considered when projecting future cash tax flows, analyzing potential outcomes, and considering appropriate tax planning alternatives.

## International tax proposals

Biden's proposed increase in the corporate tax rate would also have an impact on global intangible low-tax income (GILTI) and foreign derived intangible income (FDII). Biden proposes to increase the tax rate on GILTI to 21 percent from 10.5 percent and eliminate the exemption of a 10 percent return on the average adjusted basis of foreign tangible property from GILTI.

Biden would encourage domestic manufacturing—and discourage offshoring of US jobs and production activity—through a combination of tax penalties and incentives. He has proposed an offshoring tax penalty of 10 percent, on top of the 28 percent corporate tax rate, on the profits of foreign production (of either goods or services) that are intended for sale in the United States. Further, he would eliminate US deductions associated with moving these operations offshore. Additionally, Biden

has proposed an advanceable "Made in America" credit of 10 percent that could be applied to several categories of qualifying expenses, including those related to returning production to the United States, as well as revitalizing existing closed or closing manufacturing facilities, incrementally increasing wages paid to US manufacturing workers, and retooling facilities to advance manufacturing competitiveness and employment.

**M&A implications**
With these proposed changes to international tax, business owners may continue to be motivated or incentivized to retain earnings and growth in the United States. When contemplating a strategic M&A transaction, US companies may look to acquire domestic companies or move a business's operations back to the United States, though the complexity of international tax implications merit careful consideration as deals are considered and structured.

## Tax credits and initiatives

Biden proposes to expand the new markets tax credit and work opportunity tax credit, create a new manufacturing communities' credit, and retain and reform the Opportunity Zone program.

**M&A implications**
These tax credits and initiatives may provide additional tax benefits to business owners who grow their business and enter new markets. Under the Opportunity Zone program, corporations and individuals may invest previously earned capital gains into certain communities and temporarily defer paying taxes on those capital gains. Further, the taxpayer may also benefit from a basis step-up or permanent exclusion of capital gains, depending on how long the investment is held for. As such, business owners may be incentivized to expand and invest through the Opportunity Zone program if they are able to defer their capital gains, especially if those capital gains would otherwise be taxed at ordinary tax rates (as discussed above).

## Conclusion

Despite the present uncertainty over how much of President Biden's tax policy agenda can advance through a closely divided Congress and get enacted into law, significant tax law changes over the next few years remain a possibility. Biden's tax proposals may affect M&A activity and transactions, including the timing and structure of transactions, as well as the level of activity and value of transactions. When planning for an M&A transaction or integrating a recently closed acquisition, it is important to start evaluating the tax proposals the Biden White House puts forward, modeling potential outcomes, and considering the appropriate actions to take if and when these proposals go from high-level plans and talking points to fully framed legislation with substance and effective dates.

**Want to learn more?**

Reach out to our contacts below:

**Jonathan Traub**
Washington National Tax
Tax Principal
Deloitte Tax LLP
jtraub@deloitte.com

**Lindsay Wietfeld**
Mergers & Acquisitions
Tax Partner
Deloitte Tax LLP
lwietfeld@deloitte.com

**Jess Williams**
Mergers & Acquisitions
Tax Senior Manager
Deloitte Tax LLP
jrwilliams@deloitte.com

**Megan Sullivan**
Mergers & Acquisitions
Tax Senior
Deloitte Tax LLP
megansullivan@deloitte.com

**Appendix: Summary of current and proposed tax law**

| Corporate and business tax proposals | | |
|---|---|---|
| **Issue** | **Current** | **Proposed** |
| Corporate tax rate | 21% | Increase to 28%<br><br>15% minimum tax on book income of companies reporting US net income >$100 million but owe no US income tax |
| Foreign-source income of US multinationals | Global intangible low-taxed income (GILTI) earned by US-based multinationals subject to a 50% deduction (effective rate of 10.5%) through 2025 and a 37.5% deduction (effective tax rate of 13.125%) thereafter<br><br>Exemption from GILTI applies for a 10% return on average adjusted basis of foreign tangible property | Increase GILTI effective rate to 21%; potentially eliminate exemption for 10% return on average adjusted basis of foreign tangible property; and calculate GILTI on a country-by-country basis |
| Offshoring and redomestication of US jobs | No direct incentives or disincentives | Impose 10% “offshoring tax penalty” on profits of foreign production (including call centers and services) intended for sale back into the United States; penalty would apply on top of proposed 28% corporate tax rate for a combined tax rate of 30.8% on any such profits<br><br>Deny deductions associated with moving jobs and production offshore and implement “strong anti-inversion regulations and penalties”<br><br>Create advanceable “Made in America” credit of 10% applicable to qualifying expenses such as those related to returning production to the United States, revitalizing existing closed or closing manufacturing facilities, incrementally increasing wages paid to US manufacturing workers, and retooling facilities to “advance manufacturing competitiveness and employment”<br><br>Establish a “claw-back” provision requiring a company to return public investments and tax benefits when they shed United States jobs and send them overseas<br><br>Eliminate incentives for pharmaceutical and other companies to move production overseas |
| Tax havens, base erosion generally | Base erosion and anti-abuse tax (BEAT) limits the ability of large multinationals to shift profits from the United States by making deductible payments to their affiliates in low-tax countries | Reduce incentives for “tax havens, evasion, and outsourcing” |

| Corporate and business tax proposals | | |
|---|---|---|
| Depreciation | 100% immediate expensing for qualified property through 2022, then phased down each year through 2026 to 20% (expires after 2026); special rules for longer-production-period property and certain aircraft | No specific proposal; may be affected by proposed minimum tax (see above) |
| **Community and workforce development incentives** | | |
| Opportunity Zones (OZ) | Allow tax-free capital gains for investments held at least 10 years, basis increase for investments held at least five years, and temporary deferral of capital gains on existing assets placed in OZ funds; final OZ designations were certified in June 2018; election to invest capital gains in an OZ expires Dec. 31, 2026 | Reform OZ program by (1) requiring Treasury Department review of OZ projects to ensure incentives are only directed to projects providing "clear economic, social, and environmental benefits to a community," (2) requiring recipients of OZ tax benefits to publicly disclose their investments and the impact on local residents, and (3) providing incentives for Opportunity Funds to partner with nonprofit or community-oriented organizations and jointly produce a community-benefit plan for each investment |
| New markets tax credit | Available for up to 39% of a project's cost for investors in low-income community businesses, through 2020 | Expand and make permanent |
| Incentives for domestic manufacturing | No provision | Establish a manufacturing communities tax credit for five years to incentivize qualified investment in communities affected by mass job losses |
| Work opportunity tax credit (WOTC) | Available to employers for hiring individuals from certain targeted groups who have consistently faced significant barriers to employment (scheduled to expire after 2020) | Expand WOTC target hiring groups to include military spouses |

| Individual income- and asset-based tax proposals | | |
|---|---|---|
| **Issue** | **Current** | **Proposed** |
| Ordinary income tax rates | Top rate of 37% through 2025<br><br>Additional 0.9% Medicare income tax applies to earned income >$250,000 for joint filers and $200,000 for single taxpayers | Restore top rate to 39.6% |
| Capital gains, dividends | 20% tax rate applies to long-term capital gains and qualified dividends<br><br>Additional 3.8% net investment income tax applies to individuals with income >$200,000 and joint filers with income >$250,000<br><br>Exclusion from capital gains tax for up to $250,000 single filers/$500,000 joint filers on qualifying home sales | Tax long-term capital gains and dividends at ordinary income rates for those with taxable income >$1 million |
| Carried interests | Treated as long-term capital gains if held for more than three years | Tax at ordinary rates |
| Passthrough income | Generally taxed at owner's individual rate with a 20% deduction under section 199A for domestic business profits; deduction expires after Dec. 31, 2025 | Phase out section 199A deduction for filers with income >$400,000 |

This communication contains general information only and Deloitte is not, by means of this article, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This article is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this article.

As used in this document, "Deloitte" means Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2021 Deloitte Development LLC. All rights reserved.