EVERSHEDS SUTHERLAND

Risky Business: Impact of reforms on commercial transaction

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Agenda

– M&A 1,000 Foot Trends and how U.S. Tax Reform has Affected the M&A Market
– Financial Accounting Changes Affecting Commercial Activity
– How Privacy Concerns may Drive Negotiations in Commercial Contracts

M&A 1,000 Foot Trends and how U.S. Tax Reform has Affected the M&A Market

Promise of Tax Reform and Hoped-for Results

- According to the U.S. Senate Committee on Finance, the TCJA "overhauls America's tax code to deliver historic tax relief for workers, families and job creators, and revitalize our nation's economy. By lowering taxes across the board and eliminating costly special-interest tax breaks, the TCJA will help create more jobs, increase paychecks, and make the tax code simpler and fairer for Americans of all walks of life".
- Many have predicted that the TCJA would enhance global as well as U.S. M&A activity.
- "Many companies have additional cash reserves in their arsenal if they want to buy and many companies are now worth more if they want to sell" . . . . "It is a positive mix for the M&A market."

Certain TCJA Provisions Were Expected to Lead to Enhanced US M&A Activity

- Reduction in Corporate Tax Rate from 35% to 21% makes the U.S. attractive for enhanced M&A.
- Repeal of corporate Alternative Minimum Taxes (AMT) reduces complexity inherent in U.S. corporate taxation.
- TCJA allows companies to take advantage of immediate 100% deductions for tangible personal property and land improvements, which applies to both new and used property, meaning that asset sales (or stock sales subject to a Section 338(h)(10) election) may be more attractive.
- Although the rules for net operating losses (NOLs) have changed and NOLs may only be offset up to 80% of taxable income, these losses may now be carried forward indefinitely making loss companies more attractive.

Diligence Considerations in US Transactions

- How to account for transaction costs? What are trends and IRS exposure?
- How to Evaluate the effects of bonus depreciation?
- What to do about transactions that involve Qualified Improvement Property?
- Should an election out of bonus depreciation be considered? Should the 50% bonus depreciation election be made?
- How to address situations when the Target has failed to fully comply with revenue recognition requirements of Section 451(b)/(c)?
- How to address section 163(j) limitations?
- How to compensate for NOL carryback of transaction costs that may no longer be available?

Industries Predicted to Experience Increased US M&A Activity

- **Pharmaceuticals**: Pharmaceuticals hold significant cash off shore. Because the TCJA makes it cheaper for multinationals to repatriate foreign cash, this sector may use that cash to fund US transactions.
- **Manufacturing**: As a capital intensive industry, bonus depreciation is being used widely, enhancing corporate value, and offering a significant benefit in asset-based transactions.
- **Banks**: M&A is one way in which banks and financial institutions may reinvest. Also, the reduced corporate tax rate is helping US lenders compete more effectively with their lower-taxed international rivals.
- **Retail**: Retailers pay some of the highest tax rates and generate the majority of their income in the U.S. The TCJA sought to assist this industry with the changes to qualified improvement property, bonus depreciation, and other provisions.

Has the Tax Cuts and Jobs Act (TCJA) met expectations with M&A Activity?

- What were the results in 2018 and 2019?
- What are expectations for 2020?
- How do US expectations and experience differ from the global market?

Current State of the Global Market*

- 2018 saw a strong year for M&A (especially in the first half); in 2019 M&A volumes have stabilized:
  - Q1-Q3 2019 aggregate global deal values down 11.4% from 2018 and deal volume down 21.2% from 2018.
  - Third quarter activity particularly subdued with $622.2bn worth of deals struck globally, down 21.2% from 2018.
  - Through Q3 2019 31 "mega deals" took place; only the second time since 2008 that more than 30 such deals were recorded in the first 9 months of the year.
  - Valuations and deal sizes are increasing in part led by PE's continued buyout activity.
  - After a quiet first half of 2019, European activity rebounded in 3Q only off 2.3% from 2018. Overall M&A activity 1Q-3Q19 down in Europe 29.4%.
  - No one industry sector globally has dominated 2019, but pharmaceuticals, medical and biotech as well as industrials and chemicals have been strong.

*Mergermarket Global & Regional M&A Report Q1-Q3 2019

Current State of the US Market

- US “megadeals” (greater than $10bn in size) continue to be a significant driver of activity in 2019 – the average deal size among disclosed deals increased 39% in the US compared to 2018, despite a decrease in volume (down approx. 15%). Through 3Q19, the average deal size of disclosed deals in the US was $831m, compared to $531m through 3Q18.
- 3Q activity declined in both count and value with small and mid-market deals most affected by the decline with over 75% of activity by value in 3Q worth at least $1bn.
- Pharmaceutical, medical and biotech sectors led activity by value with a combined $229bn through 3Q. Activity led by Bristol-Myers Squibb’s announced merger with Celgene Corporation and Pfizer’s Upjohn unit to merger with Mylan.
- The media sector has also been active with CBS and Viacom announcing a recombination in August.
- M&A activity faces uncertainty from global currency values and trade policies, as well as a general concern about a slow down.

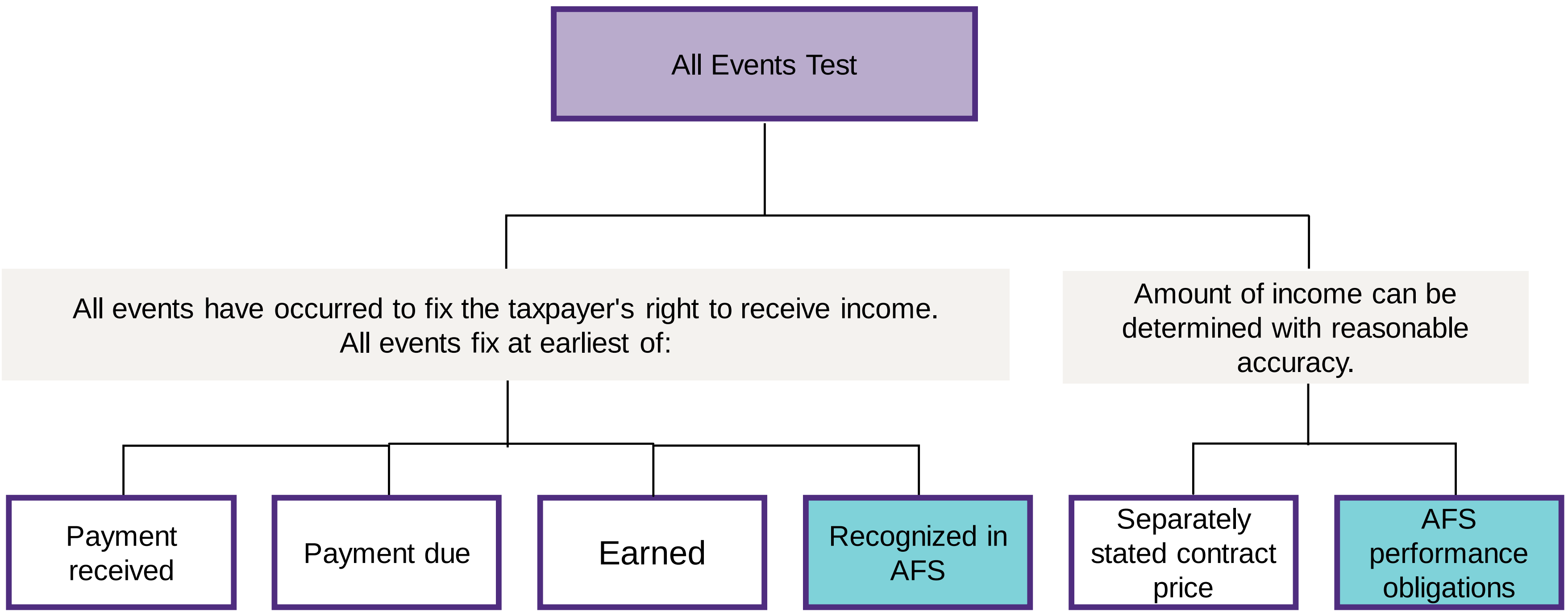
How have changes in Financial Accounting Standards Affected Commercial Activity?

Recent Change to Financial Accounting Standards -- Accounting Standard Codification 606 (ASC 606)

- Companies must recognize revenue when goods and services are transferred to the customer, in an amount that is proportionate to what has been delivered at that point.
- As a result of the change, companies are re-evaluating when and how they account for revenue; public (2018), private 2019.
- Many companies are finding that implementation results in acceleration of revenue into earlier years:
  - Verint Software recognized additional revenues of $48 million (4% of total revenue and 50% of revenue growth).
  - Under previous guidelines, revenue from software licensing agreements where payment for the license is paid in installments over more than 12 months could only be recognized when the customer was billed for each payment.
  - Under ASC 606, contracted revenue can be recognized upon transfer of control of the software license.
- Companies are also finding that it has the potential to impact sales, go-to market strategies, compensation plans, product roadmaps, sales commissions, etc.

First there was a Financial Accounting change for revenue recognition; then there was a tax change to revenue recognition as part of TCJA.

Section 451(b) was modified and accrual taxpayers are now required to recognize income no later than the tax year in which it is taken into account in a taxpayer's "applicable financial statements.“



Revenue Recognition (cont'd)

- Section 451(c) codifies one-year deferral of advance payments previously allowed in Rev. Proc. 2004-34.
- Revokes deferral method provided by Treas. Reg. Sec. 1.451-5 for advance payment received for goods, including the multi-year deferral for inventoriable goods.
- Interaction of section 451 (b)/(c) with ASC 606:
  - ASC 606 changes revenue recognition and generally accelerates income to an earlier period reflecting when goods and services are transferred to a customer.
  - New Section 451 accelerates income recognition by tying recognition to no later than when it is recognized for financial accounting purposes.
  - New Section 451 also requires a taxpayer to allocate a contract's transaction price among performance obligations equal to the allocation in taxpayer's financial statements.
  - Taxpayers are subject to the new Section 451 for 2018, but if they don't implement ASC 606 until 2019, may have to make another change in 2019.

ASC 606 and Sec. 451 Example 1

Fact

Company operates a delivery service. Delivering construction equipment from Pittsburgh, PA to San Diego, CA.

Company has the right to bill once delivery is complete.

Book

Pre 606 – Company recognized revenue ratably as services were provided. Under ASC 606 – Company makes no changes.

Tax

Pre 451(b)– Company recognizes tax revenues as billed (earned).

Under new 451(b) – Company accelerates tax revenues for Sec. 451(b).

Example 1

	Year 1	Year 2	Year 3	Year 4
Old Book	$300	$200	-	-
New Book	$300	$200	-	-
Old Tax	-	$500	-	-
New Tax	$300	$200	-	-

- Book – Revenues are recognized over time as services are provided.
- Tax – Old Tax no income is recognized until delivery is complete. Now, revenues are accelerated as a result of changes to all events test under Sec. 451(b), which requires revenue recognition no later than when it is recognized for financial accounting purposes.

ASC 606 and Sec. 451 Example 2

Fact

Company sells computer software licenses for $1,200.

Each software license comes with a 3-year update, maintenance and service agreement.

Book

Pre 606 – Company recognized revenue ratably over the 3-year period.

Under ASC 606 – Company allocates $900 to the software license and $300 to the maintenance.

Tax

Pre 451(b) – Company follows Rev. Proc. 2004-34.

Under new 451(b) – Company continues to defer portion of income for 1 year.

Example 2

	Year 1	Year 2	Year 3	Year 4
Old Book	$400	$400	$400	-
New Book	$1,000	$100	$100	-
Old Tax	$400	$800	-	-
New Tax	$1,000	$200	-	-

- Book – Recognize license at a point in time; recognize maintenance over time.
- Tax – Defer advance payment, 1 year only, but additional revenue is recognized in Year 1 due to changes in ASC 606 recognition.

ASC 606 and Sec. 451 Example 3

Fact

Company manufactures and sells cars to dealers.

Each car includes the vehicle, free scheduled maintenance, roadside assistance and satellite radio (collectively "services") for 4 years.

Book

Pre 606 – Company recognized revenue upon sale of the car.

Under ASC 606 – Company allocates value between the vehicle and the services.

Tax

Pre 451(b) – Company recognizes income as earned.

Under new 451(b) – Company will have values assigned to each performance obligation.

Example 3

	Year 1	Year 2	Year 3	Year 4
Old Book	$20,000	-	-	-
New Book	$18,500	$500	$500	$500
Old Tax	$20,000	-	-	-
New Tax	$18,500	$1,500	-	-

- Book – Sale of vehicle recognized point in time; services recognized over time
- Tax – Defer advance payment, 1 year only

ASC 606: Contract Considerations

- Service relationships may change significantly over time.
  - With digital companies, subscriptions may change frequently. Whether a customer upgrades or downgrades a plan, contract changes are the norm. These changes can make compliance obligation - - that is, identifying a contract -unclear.
  - In some circumstances, contract changes are handled as a modification to the existing contract, while in other situations, a separate contract is created.
  - The handling of common subscription characteristics—e.g., evergreen subscriptions, nonrefundable upfront fees—become tricky when companies have to decide whether to recognize revenue immediately or defer it.
- Termination provisions
  - What payments (and refunds) are made at termination?

ASC 606: Contract Considerations

- Payments
  - Minimum payments / minimum orders
  - Upfront payments for services
  - Delay fees / penalties
  - Rebates / Service credits
  - Volume discounts
- Do you have “pass through costs”?
- Do you have a master contract?

How have Privacy Concerns Affected Commercial Activity?

Data Security and Confidentiality in Commercial Contracts

Data security and confidentiality continue to drive discussions and negotiations

– What's happening in customer contracts?
  - Security obligations and use of data
  - Security incidents
  - Confidentiality
  - Indemnification and limitation of liability
  - Insurance

Data Security Obligations and Security Incidents

Key considerations

- Types of Security Obligations
- What Types of Information
- Levels of Protections
- Use Limitations
- Security Programs
- Compliance with Laws
- Business Continuity and Force Majeure
- Notification obligations
- Risk Shifting (who bears the cost?)

Confidentiality, Indemnification and Limitation of Liability

Key Considerations

- Confidentiality
  - Scope of confidential information
  - Syncing with data security provisions
  - Disclosure permissions
- Indemnification
  - Breaches of security obligations v. data breaches
  - Breaches of confidentiality obligations
  - Compliance with laws
  - No duplication of claims
- Limitation of Liability
  - Caps and secondary caps
  - Carve-outs to damages
  - Insurance coverages (cyber, business insurance, E&O)
- A Note on Insurance

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