FT Series **M&A outlook**

Opinion **Inside Business**

Disney-Fox deal heralds a new dawn in tax-related M&A

Cut to US corporate tax levy expected to clear path for more dealmaking

SUJEET INDAP

Disney's deal was announced just before the US Congress enacted sweeping changes to the tax code © Bloomberg

Sujeet Indap JANUARY 15, 2018

Walt Disney's blockbuster deal with 21st Century Fox was heralded as the onset of a new era in media. Its complex terms may similarly portend a new age in deal structuring.

Disney's acquisition was announced in December, just before the US Congress enacted sweeping changes to the tax code, slashing the corporate rate from 35 to 21 per cent. Expectations that this shift was coming almost certainly affected the outcome of the negotiations.

Under the old 35 per cent rate, companies and dealmakers often went to great lengths to design deal structures that avoided triggering corporate taxes, including spin-offs, split-offs and other more exotic contortions. Now that the rate is lower, companies suddenly have more flexibility.

Dealmakers insist that mergers and acquisitions are dictated first and foremost by business imperatives. But a more benign tax regime will make it easier for Corporate America to realise its strategic dreams.

Whether due to the controlling Murdoch family's interests or because of Disney's preferences, Disney bought only part of the business: the Fox film and television studios and its stake in the European broadcaster Sky. Fox kept its Fox broadcast television network, the Fox News cable channel, its local affiliates across the US and some other television assets together worth more than $20bn.

This decision to split up the company is a painful one from a tax perspective. If a company is sold whole, no corporate tax liability is incurred; the target company ceases to exist so there is no entity to pay it. The only tax owed is by shareholders on whatever gains they realise on their stock. But when a portion of a company is divested at a profit, the seller pays tax on that capital gain.

Asset sales are often used to cast off old, legacy operations. This presents two related problems. First, the cash proceeds are often small, and their age means that their tax basis is low, so a large share of those proceeds is eaten up by tax.

The corporate tax that Fox owes in connection with the Disney transaction is a whopping $8.5bn. Disney is the ultimate payer of that tax as it will technically spin off the new smaller Fox, but the Murdochs have agreed to send $8.5bn to Disney to cover that tax.

That $8.5bn figure is a pure transfer from the pockets of Fox shareholders to the US Treasury and represents more than a tenth of the value of the pre-deal larger Fox. But, the tax rules are never totally straightforward, and Fox will eventually get some of that money back. That is because the transaction means Fox can revalue the assets it is keeping, creating a separate tax benefit that is worth $4.5bn, analysts have estimated. Still, a net tax hit of $4bn is substantial.

All of those sums assumed the 35 per cent corporate tax rate, but the agreement called for the terms to be adjusted if the tax law passed, which it did just days after the deal was agreed. Now Fox's net tax hit falls from $4bn to about $2.5bn.

Most companies have gone to great lengths to avoid tax bills of the size Fox was facing, including listing the discarded unit on a stock exchange. Although such spin-offs are tax-free, they have shortcomings. The spun-off company has to be compelling enough to attract its own investor base. The parent company also cannot realise much in cash proceeds, and the various rules required to keep the taxman at bay can be onerous to follow.

But now with a lower tax rate, such gymnastics can be avoided. Companies can simply sell a unit for cash and pay a more modest tax. That is good news for buyers who previously would have trouble prying out the narrow piece of business they wanted. Activist investors will have taken note, too. They often press companies to drop lower-performing units. Companies until now have been able to resist by claiming that such asset sales would not be tax efficient.

The corporate tax is now lower, however, not eliminated, and so asset sales are not perfectly clean. But dealmakers are excited about a marketplace that has become more streamlined. “One of the hardest parts of getting a deal done for buyers and sellers is finding a deal value that works for both of them. The higher tax rate historically made this more difficult. The lower rate now mitigates one of the biggest issues in many potential deals,” says Joe Todd, an M&A banker at Goldman Sachs.

sujeet.indap@ft.com