



Business Tax Reform 2018

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Agenda

- Selected domestic business tax reforms only*
 - Pass-through and sole proprietorships
 - All businesses
 - Corporations
- Implications for choice of entity
- Implications for M&A

Provisions discussed are effective for tax years beginning after 12/31/17 unless otherwise noted

*For a comprehensive listing of all of the tax provisions of the Tax Cuts and Jobs Act, see <https://www.bna.com/tax-reform-roadmap/>



Pass-Through Entities and Sole Proprietorships

Non-Corporate Tax Rates

- Top rate temporarily reduced to from 39.6% to 37%
- Capital gains rates and breakpoints unchanged
- Surtaxes on high-income taxpayers unchanged
 - 3.8% net investment income tax (“NIIT”)
 - 0.9% additional tax on wages and self-employment earnings (added to 2.9% tax on wages/earnings of all taxpayers)
 - Result: top rate on compensation and on passive income reduced from 43.4% to 40.8%
 - Surtaxes do not apply to non-passive, non-trading profits
- AMT exemption temporarily expanded
 - But not for trusts and estates?

Non-Corporate Tax Rates

2018 (Prior Law With Inflation Adjustments)			
Joint / SS	Single	Trust	Rate
\$ -	\$ -	\$ -	10.0%
\$ 19,050.00	\$ 9,525.00	\$ 2,600.00	15.0%
\$ 77,400.00	\$ 38,700.00	\$ 6,100.00	25.0%
\$ 156,150.00	\$ 93,700.00	\$ 9,300.00	28.0%
\$ 237,950.00	\$ 195,450.00		33.0%
\$ 424,950.00	\$ 424,950.00		35.0%
\$ 480,050.00	\$ 426,700.00	\$ 12,700.00	39.6%
<u>Adjusted Net Capital Gains and Qualified Dividends</u>			
\$ 77,400.00	\$ 38,700.00	\$ 6,100.00	0.0%
\$ 480,050.00	\$ 426,700.00	\$ 12,700.00	15.0%
excess			20.0%
<u>Standard deduction</u>			
\$ 13,000.00	\$ 6,500.00	\$ 6,500.00	
<u>Additional amount for elderly and blind</u>			
\$ 1,300.00	\$ 1,600.00		
<u>Exemption and phase-out range</u>			
\$ 4,150.00	\$ 4,150.00		
\$ 320,000.00	\$ 266,700.00		
\$ 442,500.00	\$ 389,200.00		

2018 Through 2025 (New Law)			
Joint / SS	Single	Trust	Rate
\$ -	\$ -	\$ -	10.0%
\$ 19,050.00	\$ 9,525.00		12.0%
\$ 77,400.00	\$ 38,700.00		22.0%
\$ 165,000.00	\$ 82,500.00	\$ 2,550.00	24.0%
\$ 315,000.00	\$ 157,500.00		32.0%
\$ 400,000.00	\$ 200,000.00	\$ 9,150.00	35.0%
\$ 600,000.00	\$ 500,000.00	\$ 12,500.00	37.0%
<u>Adjusted Net Capital Gains and Qualified Dividends</u>			
\$ 77,200.00	\$ 38,600.00	\$ 2,600.00	0.0%
\$ 479,000.00	\$ 425,800.00	\$ 12,700.00	15.0%
excess			20.0%
<u>Standard deduction</u>			
\$ 24,000.00	\$ 12,000.00	\$ 12,000.00	
<u>Additional amount for elderly and blind</u>			
\$ 1,300.00	\$ 1,600.00		
<u>Exemption and phase-out range</u>			
Repealed			
Reduced inflation rate (C-CPU-U) for indexing brackets.			

Rates for married filing separately and head of household not shown.

Non-Corporate Tax Rates

- Non-corporate AMT

<u>Prior Law (2018)</u>	Joint / SS	Single	Trust
Rate breakpoint (26% to 28%)	\$ 191,500.00	\$ 191,500.00	\$ 191,500.00
Exemption amount	\$ 86,200.00	\$ 55,400.00	\$ 24,600.00
Phase out begins	\$ 164,100.00	\$ 123,100.00	\$ 82,050.00
Phase out ends	\$ 508,900.00	\$ 344,700.00	\$ 180,450.00
<u>Current Law (2018 - 2025)</u>			
Rate breakpoint (26% to 28%)	\$ 191,500.00	\$ 191,500.00	\$ 191,500.00
Exemption amount	\$ 109,400.00	\$ 70,300.00	\$ 24,600.00
Phase out begins	\$ 1,000,000.00	\$ 500,000.00	\$ 82,050.00
Phase out ends	\$ 1,437,600.00	\$ 781,200.00	\$ 180,450.00

Sec. 199A: Qualified Business Income

- **⚠️ WARNING**: do not try to deduce any coherent policy principles in Sec. 199A
- New 20% deduction for the sum of:
 - Qualified business income
 - Qualified REIT Dividends
 - Qualified publicly traded partnership income
 - Qualified cooperative dividends
- ***Effective maximum tax rate of 29.6%*** (80% x 37%)
 - 33.4% if 3.8% net investment income tax applies
- Deduction generally cannot exceed 20% of the excess of taxable income over net capital gain ("**TI – NCG**")



Sec. 199A: Qualified Business Income

- **Qualified business income (“QBI”)**
 - QBI is net taxable income from a qualified trade or business (“QTB”) that is effectively connected with a U.S. business
 - Net loss carries over to succeeding year
 - Deduction in succeeding year is calculated by first subjecting QBI in the carryforward year to applicable limitations (discussed below) and is then offset by 20% of the carryforward loss
 - Non-business items excluded
 - Capital gains and losses
 - Dividend and interest income
 - Non-business commodity and foreign currency transaction income
 - Income from notional principal contracts
 - Income from non-business annuities
 - Items of deduction of loss attributable to the foregoing

Sec. 199A: Qualified Business Income


- **Qualified trade or business (“QTB”)**
 - A QTB is any trade or business except:
 - The trade or business of being an employee
 - A specified service trade or business (“SSB”)
 - An SSB is
 - Any trade or business:
 - involving the performance of services in the fields of ***health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services***, or
 - where the ***principal asset is the reputation or skill of 1 or more of its employees or owners***
 - Engineering and architectural services expressly omitted
 - Exceptions for “Not Rich” and “Near Rich” taxpayers (next slides)



Sec. 199A: Qualified Business Income

- Limits based on Threshold and Upper Limit amounts

Taxpayer Type	Threshold	Upper Limit
Joint Return	\$315,000	\$415,000
Other	\$157,500	\$207,500


Not Rich **Near Rich** **Rich**

Sec. 199A: Qualified Business Income

- **Wage/Basis Limit**

- For Rich taxpayers, the deduction for each QTB is limited to the greater of:

- 50% of W-2 Wages, or
- 25% of W-2 Wages plus 2.5% of qualified property unadjusted basis

- Limit is phased in for Near Rich

- **SSB Phase Out**

- For Near Rich, first apply the Wage/Basis Limit, and then phase out the resulting deductible amount

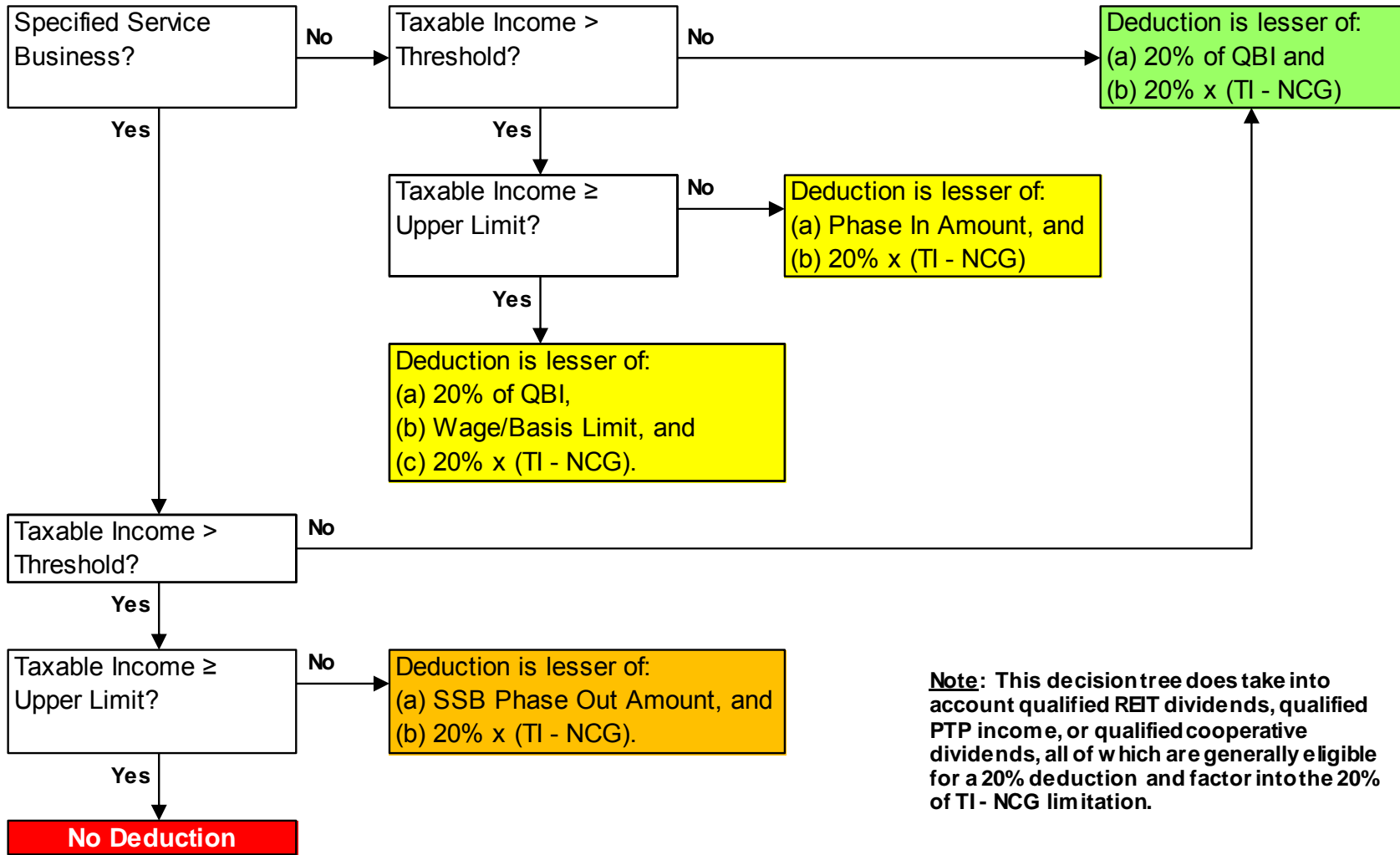
Sec. 199A: Qualified Business Income



Business Type	Not Rich	Near Rich	Rich
Specified Service Business	Full Deduction	Phase In Wage/Basis Limit and apply SSB Phase Out	No Deduction
Other Qualified Business	Full Deduction	Phase In Wage/Basis Limit	Apply Wage/Basis Limit

Limits: QBI deduction + 20% of qualified REIT dividends + 20% of qualified publicly traded partnership income cannot exceed 20% of TI - NCG - qualified cooperative dividends. 20% of qualified cooperative dividends cannot exceed TI - NCG.

Sec. 199A: Qualified Business Income



Note: This decision tree does take into account qualified REIT dividends, qualified PTP income, or qualified cooperative dividends, all of which are generally eligible for a 20% deduction and factor into the 20% of TI - NCG limitation.

Sec. 199A: Qualified Business Income

- **Understatement penalty effects**
 - Taxpayers claiming a Sec. 199A deduction have a 5% of tax penalty cushion under Section 6662 (versus a 10% cushion)
 - May increase utility of tax opinions for aggressive reporting positions

Sec. 199A: Qualified Business Income

- **Guidance priorities**

- Definition of SSBs
- Business versus investment (e.g., real estate)
- Grouping of trades or businesses (Sec. 169 activities?)
- Calculations for net loss carryovers
- Expenses allocable to QBI
- Wages paid through an employee leasing company
- Qualified property
- Sales to cooperatives versus independents
- De minimis rule for non-qualified income
- Eligibility of Electing Small Business Trusts (“ESBTs”)

Sec. 199A: Qualified Business Income



- **Planning?**

- Separate SSBs into service and non-service elements
- Convert a portion of owner profit share to wages
 - 28.57% sweet spot (wages relative to profit before wages)
- Convert contractors to employees?
- Purchase rather than lease property?
- Convert employees to profit share partners or consultants?
 - Not practical in most cases
- Convert partner guaranteed payments to profit share?
 - For SSB, no advantage for Rich partners, and only partial advantage for Near Rich partners

Sec. 461(l): Excess Business Losses

- No deduction for “excess business loss” of non-corporate taxpayers
- Disallowed loss = NOL carryover to following year
 - Subject to new limitations on NOLs (discussed later)
- Excess business loss = excess of
 - (i) aggregate trade or business deductions, over
 - (ii) aggregate income from such trades or businesses plus **\$250,000 (\$500,000 if joint return)***
- Applied at the partner/S corporation shareholder level after passive activity loss limit

*Amounts are indexed for inflation after 2018.

Sec. 1061: Carried Interests

- **General Rule:** Net LTCG with respect to “applicable partnership interests” held \leq 3 years is STCG
- **Applicable partnership interest (“API”):**
 - Any partnership interest directly or indirectly transferred to (or held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business (“ATB”)
 - Excludes
 - An interest held by a corporation [other than an S corporation?]
 - A “capital interest” (to be explained in regulations)
 - An interest held by a person employed by another entity conducting a non-ATB business and only providing services to such other entity

Sec. 1061: Carried Interests

- **Applicable trade or business (“ATB”)** = regular, continuous, and substantial activity consisting of:
 - Raising or returning capital, and
 - Investing in, disposing of, or developing specified assets (or identifying specified assets for investing or disposition)
- **Specified Assets**
 - Securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing
 - Note: oil, gas, and other mineral interests = real estate
 - A partnership interest to the extent of the partnership’s proportionate interest in any of the foregoing

Sec. 1061: Carried Interests

- **Transfer to a related person**

- If taxpayer transfers any API, directly or indirectly, to a related person, taxpayer has STCG = any excess of:

- So much of the taxpayer's LTCG with respect to such API for such taxable year attributable to the sale or exchange of any asset held for \leq 3 years as is allocable to such interest, over
- Any amount treated as STCG under the general rule with respect to the transfer of such API

- Related person is a family member, or a person who provided services to any ATB of the taxpayer during the current or 3 preceding tax years

- Prevents a sale of an API held $>$ 3 years to related person who then sells the underlying assets held $<$ 3 years



Selected Provisions Applicable to All Businesses

Sec. 163(j): Business Interest Expense

- Business interest deduction for a year is limited to:
 - Business interest income, plus
 - 30% of adjusted taxable income, plus
 - Floor plan financing interest*
- Disallowed deduction carries forward and is added to business interest in following year
- Note: disallowed interest expense carry forward is not subject to Sec. 382 limits on NOL carry forwards

*Interest paid or accrued on debt to finance motor vehicle inventory.

Sec. 163(j): Business Interest Expense

- Adjusted taxable income (“ATI”) = taxable income
 - without non-business items, business interest expense or income, NOLs, Sec. 199A deduction, *and (for years before 2022) before depreciation, depletion, and amortization*
 - with other adjustments provided by Treasury

Sec. 163(j): Business Interest Expense

- **Small business exception**

- Limit does not apply if the taxpayer's 3-year average annual **gross receipts ≤ \$25,000,000**

- **“Tax shelters” are not eligible** for the exception

- Non C corporation equity private placements
- > 35% of losses allocable to limited partners or limited entrepreneurs
- Principal purpose to avoid or evade income tax

Sec. 163(j): Business Interest Expense

- **Excepted businesses**

- Employee
- Electing real property trade or business*
- Electing farming business*
- Furnishing or sale at regulated rates of
 - Electrical energy, water, or sewage disposal services
 - Gas or steam through a local distribution system
 - Transportation of gas or steam by pipeline
- Motor vehicle dealers (unlimited exception for floor plan financing interest)

*Must use alternative depreciation system

Sec. 163(j): Business Interest Expense

- Partnerships and S corporations
 - Limit is applied at the entity level
 - Partner's ATI excludes partnership tax items, but includes distributive share of partnership's "excess taxable income"
 - Excess taxable income is partnership ATI not used to absorb partnership business interest (accounting for the 30% allowance)
 - Similar rules to be applied to S corporation shareholders
 - Carryforwards flow through
 - Disallowed partnership business interest ("excess business interest") is allocated to the partners, reduces basis, and can offset future excess taxable income from the partnership
 - Partner's basis is increased by any unused excess business interest upon disposition of the partnership interest
 - No similar rules for S corporation shareholders (?)

Sec. 163(j): Business Interest Expense

- Guidance issues
 - How will the limit apply to consolidated groups?
 - Does a partnership level real property business election apply to interest on debt incurred by partners?
 - Application to S corporation shareholders
- State tax conformity
- Planning
 - Reallocation of debt among commonly controlled “taxpayers”
 - Debt alternatives (leases, derivatives, preferred equity)

Sec. 179 Expensing

Prior Law	New Law
<ul style="list-style-type: none">• In 2018, taxpayers can elect to expense up to <u>\$520,000</u> of §179 property placed in service during the tax year, subject to reduction by the amount by which the cost of such property exceeded <u>\$2,070,000</u>.• Both amounts are indexed for inflation.• Qualified real property<ul style="list-style-type: none">– Qualified leasehold improvement property– Qualified restaurant property– Qualified retain improvement property	<ul style="list-style-type: none">• For 2018, taxpayers can elect to expense up to <u>\$1,000,000</u> of §179 property placed in service during the tax year, subject to reduction by the amount by which the cost of such property exceeded <u>\$2,500,000</u>.• Both amounts are indexed for inflation.• Qualified real property<ul style="list-style-type: none">– Qualified improvement property– Certain improvements to nonresidential real property (roof, HVAC, fire protection and alarm systems, security systems)

Sec. 168(k): Temporary Expensing

- 100% bonus depreciation for tangible “qualified property” acquired and placed in service after 9/27/2017 and before 2023
- Includes used property (subject to anti-abuse limits)
- Phase out in years after 2022

Year Placed in Service	Bonus Depreciation Percentage	
	Qualified Property	Longer Production Period Property
2023	80%	100%
2024	60%	80%
2025	40%	60%
2026	20%	40%
2027	0%	20%

Sec. 168: Qualified Improvement Property

- Qualified improvement property replaces
 - Qualified leasehold improvement property,
 - Qualified restaurant property, and
 - Qualified retail improvement property
- Congress intended to provide for a 15-year MACRS period, and a 20-year ADS period, for qualified improvement property, but due to a drafting error did not do so
- Knock on effect: no bonus depreciation for qualified improvement property placed in service after 2017
- Possible technical correction?

Sec. 172: Net Operating Loss Deduction

- NOL deduction limited to 80% of taxable income
- No NOL carryback deduction
- Unlimited NOL carry forward
- Effective date:
 - 80% limitation effective for tax years *beginning* after 2017
 - Carryback and carryover changes effective for tax years *ending* after 2017

Sec. 1221: Self-Created Patents, etc.

- Capital asset excludes a patent, invention, model or design (whether or not patented), a secret formula or process held by a taxpayer whose personal efforts created the property, or in whose hands the basis of the property is determined by reference to such taxpayer
- NB: Congress failed to repeal Sec. 1235, which treats most transfers of self-created patents as LTCG or LTCL
 - Result: character of gain from a self-created patent unclear
 - Scope of “patent” in Sec. 1235 versus list of excluded items in Sec. 1221 (above) unclear



C Corporations

Corporate Tax Rates

- Maximum rate decreased from 35% to **21%**
- Maximum rate on fully distributed income reduced from 49.7% to **39.8%** ($21\% + (100 - 21) \times 23.8\%$)

2017	
Income	Rate
\$ -	15.0%
\$ 50,000.00	25.0%
\$ 75,000.00	34.0%
\$ 100,000.00	39.0%
\$ 335,000.00	34.0%
\$ 10,000,000.00	35.0%
\$ 15,000,000.00	38.0%
\$ 18,333,333.00	35.0%

2018	
Income	Rate
\$ -	21.0%

Corporate AMT

- Repealed effective 1/1/18
- AMT credits carry forward
 - Refundable in 2018 through 2021 in an amount equal to 50% (100% for 2021) of the excess of the minimum tax credit for the year allowable over the minimum tax credit allowable against regular income for the year.

Corporate DRD

- Corporate dividends received deduction (“DRD”) is reduced to reflect lower corporate tax rates

Prior Law		Current Law	
Ownership	DRD	Ownership	DRD
≥80%	100%	≥80%	100%
≥20% and < 80%	80%	≥20% and < 80%	65%
<20%	70%	<20%	50%

Ownership is measured by vote and value.

C Corporations

- No change to:
 - Section 1202 (partial exclusion of gain from qualified small business stock)
 - Section 1244 (ordinary loss on stock of a domestic small business corporation)



Business Tax Reform 2018 - Implications for Choice of Entity

Choice of Entity

- *Should I convert my LLC (classified as a partnership) or partnership to a C corporation?*
- Answer: it depends. (But probably no.)

After tax reform, an LLC (classified as a partnership) is still the default choice of entity for business activities, but the alternatives merit more careful consideration.

Choice of Entity

Entity Type	Maximum Income Tax Rate (Active Individual)			
	Operating Income		Gain on Sale	
	Distributed Earnings	Retained Earnings	Retained Earnings	Unrealized Gain
LLC*	29.6% ¹	29.6% ¹	0% ²	20.0% ³
C Corporation	39.8%	21.0% ⁴	18.8% ⁵	~31.4% ⁶
LLC B(W)	10.2%	(8.6%)	18.8%	~11.4%

* Classified as a partnership for tax purposes.

¹ Assumes 20% Section 199A deduction applies. If passive owner, add 3.8%.

² Basis adjustment to LLC equity eliminates gain.

³ Assumes no “hot assets.” Hot assets tax = 29.6%. If passive owner, add 3.8%

⁴ 23.8% dividend tax deferred, but not avoided.

⁵ Effective rate = 23.8% x (1 – 21%).

⁶ Assumes 10% purchase price discount due to lack of a stepped-up tax basis in assets.

Choice of Entity

- *Should I convert my S corporation to a C corporation?*
- Answer: probably no
 - Generally same calculus as for a partnership

Choice of Entity

- **S corporation versus LLC/partnership**
 - S corporation wages paid to owners might favorably impact Sec. 199A deduction calculation
 - S corporation often promoted as preferred over LLC/partnership based on employment tax savings, but this advantage is generally illusory
 - S corporation status has many downsides relative to an LLC and *S corporation status should be avoided whenever possible*

Choice of Entity

- **Many variables to consider**

- Eligibility for Sec. 199A deduction
- Active versus passive owner (3.8% NIIT)
- Non-deductible interest versus deductible preferred return
- State income taxes
 - State income tax deduction
 - State income tax filing obligations for owners
- Conversion costs
 - Suspended losses eliminated
 - Negative capital account recaptured
- Costs to unwind
- Contributions of appreciated property
- Asset basis step up on sale and at death
- Foreign and tax exempt investors
- Flow-through of tax losses
- No corporate AMT
- Ownership of foreign corporations
- Simplicity (Form 1099-DIV versus Schedule K-1)
- Eligibility for Section 1202 benefits

Choice of Entity



- **Section 1202 Stock**

- Non-corporate shareholder can exclude up to lesser of \$10 million or 10x stock basis of *qualified small business stock* held > 5 years

- Basis calculated using lesser of basis or FMV of contributed property
- No tacking of holding period for contributed property

- Requirements

- Domestic C corporation
- Stock acquired at original issuance
- Active business requirement
 - Extensive list of excluded businesses
 - 10% limit on non-business real estate (includes rental property)
- Aggregate gross assets immediately after stock acquired \leq \$50 million
- Other

Choice of Entity

- **Section 1202 Stock**

- Tax savings (cost) relative to pass-through entity varies

- Retained earnings:

- 21% tax on corporate taxable income (retained earnings), versus

- 20% to 40.8% maximum tax on pass-through taxable income

- Sale price discount:

- Buyer will generally discount the stock purchase price to account for the present value tax cost of no step up in the basis of corporate assets

- Tax on excess gain:

- Gain in excess of Sec. 1202 eligible gain incurs a 10% sale price discount plus

- 23.8% maximum tax on stock sale gain (31.42% combined cost), versus a

- 20% or 23.8% maximum tax rate on pass-through equity sale gain

- No flow-through of net operating losses

Choice of Entity



- Sec. 1202 Stock Benefit (Cost)*

	Eligible Gain [^]		Excess Gain
	Retained Earnings	Appreciation	
Material participation investor Sec. 199A eligible	8.60% OI/STCG -1.00% LTCG	10.00%	-11.42%
Material participation investor Not Sec. 199A eligible	16.00% OI/STCG -1.00% LTCG	10.00%	-11.42%
Passive investor Sec. 199A eligible	12.40% OI/STCG 2.80% LTCG	13.80%	-7.62%
Passive investor Not Sec. 199A eligible	19.80% OI/STCG 2.80% LTCG	13.80%	-7.62%

* Assumes a 10% discount on stock sale price to account for no basis step up.

[^] Greater of \$10,000,000 or 10x stock basis (using greater of basis or FMV of contributed property).



Business Tax Reform 2018 - Implications for Mergers & Acquisitions

Implications for M&A

- Interest expense limit and no NOL carryback may reduce highly leveraged acquisitions
- Diligence item: NOL carryforward attributable to disallowed interest expense not subject to Sec. 382
- Preference for debt alternatives (leases, derivatives, partnership preferred equity, and straight equity)
- Bonus depreciation favors asset acquisitions
 - Note: Partnership Sec. 754 election not sufficient
- Purchase price allocations more important
 - Depreciable property eligible for bonus depreciation
 - Self-created patents, etc. not eligible for capital gain?

Implications for M&A

- **Sec. 965 transition tax**

- U.S. owners of $\geq 10\%$ of a foreign corporation's stock are taxed on previously untaxed earnings (at 15.5% on cash and 8% on other) at end of last tax year beginning before 1/1/18
- Deferral election
 - General: U.S. shareholder can elect to pay tax over 8 years
 - S corporation shareholders: can elect to defer tax until a triggering event; S corporation has joint and several liability for the tax
- If target corporation owns $\geq 10\%$ of stock in a foreign corporation **be certain agreement covers any deferred transition tax** (incl. S corp. liability for shareholder's tax)
- Same for foreign corporation target having a non-12/31 year end acquired in 2018

Questions