Tax Reform – What Are the Implications on M&A Structuring

Analysis of the TCJA and Tax Planning Under the New Law

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Overview of Today's Discussion

- Key Components of the New Legislation
- Entity Choice Considerations
- Buyer/Seller Considerations
- Buy-side Tax Due Diligence
- Other M&A Tax Planning

Key Components of the New Legislation

The Tax Cuts and Jobs Act of 2017 (TCJA)

Legislative Process

- September 27, 2017 – The Unified Framework released by GOP Leadership
- October – December – Legislative Action by Congress
- December 22, 2017 – Signed into law by President Trump

Many Questions Remain

- Limited legislative history is available
- Additional guidance will be issued to provide additional clarity and address ambiguities
- Technical corrections will likely also be required

Effective Dates

- Most provisions are applicable to tax years beginning after December 31, 2017
- Several provisions apply to tax years ending after December 31, 2017, several have earlier effective dates, and several have delayed effective dates
- Many tax provisions related to individuals expire on December 31, 2025 while most corporate tax provisions are permanent

Decreasing Tax Rates

U.S. federal tax rates	2017	2018
Highest marginal corporate tax rate	35%	21%
Highest marginal individual income tax rate	39.6%	37%
Highest marginal individual long term capital gain rate	20%	20%
Highest marginal individual qualified dividend rate	20%	20%
Net Investment Income Tax	3.8%	3.8%
Pass-through – w/ 20 percent QBID	N/A	29.6%

Notes

- Under prior law, graduated rates applied with a maximum of 35%. Under the new law, the US federal corporate income tax rate is a flat 21% at all levels.
- The decrease in individual tax rates is a temporary provision set to expire beginning in the 2026 tax year.

Corporate Income Tax Changes

Corporate Tax Rate Reduced to 21% flat rate

- No special rate for personal service corporations
- Fiscal year corporations will get a blended tax rate based on the respective number of days in the 35% and 21% portions of the tax year for their first year ending in 2018

Reduced Dividends Received Deduction

- Reduces the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%
- Reduces the corresponding taxable income limitations

Corporate Alternative Minimum Tax Repealed Beginning in 2018

- AMT credits can fully offset regular tax beginning in 2018 and remaining credits become refundable from 2018-2021
- Alleviates need for tracking AMT and ACE depreciation
- Increases availability of credits previously limited by AMT (e.g., research credit)

S corporations Electing to be C Corporations

- Ratio of AAA to E&P applied to characterize distributions from corporations that (i) were S corporation upon enactment of TCJA, (ii) converted to C corporations within two years of that date, and (iii) which have the exact same ownership at the time of enactment and distribution
- Section 481(a) adjustments necessitated by C corporation conversion under rules above spread over 6 years (e.g., change from cash to accrual method)

Net Operating Losses

Corporations

- Corporations will only be able to offset 80% of their taxable income for losses arising in tax years beginning after December 31, 2017 (20% of remaining income is taxed at 21%)
- Corporations will be able to carryforward losses generated in tax years ending after December 31, 2017 indefinitely (previously 20 years)
- Corporations will no longer be able to carryback NOLs generated in tax years ending after December 31, 2017

Limitation on Business Losses

- Net business losses of individuals only able to offset up to $500,000 of non-business income ($250,000 for single filers)
- Excess treated as a NOL carryforward to the next taxable year

Qualified Business Income Deduction

General Rule	• A deduction is allowed for individuals and trusts in an amount equal to 20% of business income
What is Covered?	• Income effectively connected with a trade or businesses in the U.S. (domestic income), qualified REIT dividends, and qualified publicly traded partnership income • Does not apply to wages, guaranteed payments, or capital gains paid by the business to the owner
Initial Limitations	• Limited to the greater of: a) 50% of the taxpayer's allocable share of W-2 wages paid by business; or b) 25% of such W-2 wages, plus 2.5% of the original acquisition cost of depreciable property used in the business
Limitations Exception	• Taxpayers with taxable income below \$415,000 (joint return) or \$207,500 (single) do not apply the above limitations (phase-out begins at \$315,000 and \$157,500 respectively)
Additional Limitation	• Deduction limited to 20% of taxable income
Does Professional Service Income Qualify?	• No for any income above the thresholds noted above; as such, many professional service professionals will not qualify for this deduction
What is a Professional Service?	• The professional service rules apply to 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 any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees

Business Interest Expense Limitation

General limitation on business interest expense deduction	Deduction limited to: (1) 30% of adjusted taxable income, <u>plus</u> (2) business interest income, <u>plus</u> (3) Motor vehicle floor plan financing interest
What is adjusted taxable income?	• 2018-2021 - Taxable income before interest, depreciation, and amortization (i.e., EBIDA) • After 2021 - Limitation is equal to tax-basis EBI • Net operating losses are always added back
Exceptions	• Businesses with <$25 million of average gross receipts for the 3 prior years (aggregation rules apply) • Certain public utilities and electing farming businesses • Real estate development, construction, rental, management, or brokerage businesses that elect out
Carryforward period	Unlimited; subject to Section 382 limitation if ownership change
Application to partnerships and S corporations	• Limitation applied at entity level and results are flowed-through to the owners; • Excess limitation of a pass-through entity may increase owners limitation for interest directly incurred by the owner • Carryforward applied at owner level but can only be offset by excess limitation from that pass-through entity in future years • Upon sale of partnership interest any unused excess interest increases outside basis of partnership interest (special rule does not apply to S corporations)
Related party debt	Rules remain unchanged → arm's length/FMV

Business Interest Expense Limitation

	At Transaction Date	Break Even	Loss
Taxable Income	$8,000,000	$0	$(15,000,000)
Interest Expense	0	5,000,000	5,000,000
Tax Depreciation Expense	2,000,000	2,000,000	2,000,000
Tax Amortization Expense	0	5,000,000	5,000,000
EBIDA*	10,000,000	12,000,000	(3,000,000)
(1) 30% of EBIDA	8,100,000	3,600,000	0
(2) Business interest income	100,000	100,000	100,000
(3) Floor plan financing interest	0	0	0
Interest Deduction Limitation	8,200,000	3,700,000	100,000
Interest Expense Limited**	0	1,300,000	4,900,000

* Excludes US federal income taxes
**Real estate businesses may elect out of interest expense limitation rules

Depreciation Expense

Section 179 Expensing
• Limitation increased to $1 million of the cost of qualifying property placed in service beginning in 2018; • Phase-out threshold increased to $2.5 million

Bonus Depreciation

Acquired	Placed in Service	Bonus Depreciation %
Before 9/28/2017	9/28/2017 to 12/31/2017	50%
Before 9/28/2017	2018	40%
Before 9/28/2017	2019	30%
After 9/27/2017*	9/28/2017 to 12/31/2022	100%
After 9/27/2017*	2023	80%
After 9/27/2017*	2024	60%
After 9/27/2017*	2025	40%
After 9/27/2017*	2026	20%

- Qualified property includes used property as well as new property
- Currently excludes leasehold improvements

International Tax Considerations

Territorial System

- The U.S. tax code has now switched to a territorial taxing system, instead of a worldwide system

Deemed Repatriation

- There is a one-time tax on deemed repatriation of foreign earnings
  - 15.5% rate on E&P invested in cash or cash equivalents
  - 8% to the extent invested in other assets
- Can election to pay the reparation tax in 8 installments (first five are 8%, sixth is 15%, seventh is 20%, and eighth is 25%)
- Earnings and profit calculation and cumulative tax pools is extremely important to quantify tax costs by original tax return due date
- Consider financial statement implications for C corporations
- Review international structure for tax efficiency/inefficiency going forward

Base Erosion and Profit Shifting - BEAT, FDII, GILTI

- Determine basic application to existing business structure
- Model results under existing business practices if regime applies
- Consider implications of changing if it would provide benefits
- Determine timelines necessary to model and execute planning to determine priorities

Additional Tax Consideration

Entertainment Expenses

- No deduction permitted with respect to any activity generally considered to be:

  (i) Entertainment, amusement, or recreation; or

  (ii) Membership dues with respect to any club organized for business, pleasure, recreation or other social purposes

Treatment of Research Expenses

- Research credits are enhanced and less likely to be subject to limitation
- Beginning in 2022, research expenses are required to be capitalized and amortized over 5 years (15 years for foreign research expenses)

Domestic Production Activities Deduction

- Eliminated starting in 2018

Additional Tax Consideration

Small Taxpayers Method Changes

- Taxpayers with less than $25 million in average annual gross receipts over the prior 3 years can utilize the cash method
- Also exempted from long-term contract accounting, inventory accounting, and UNICAP/§263A

State and Local Tax Issues

- Federal changes will impact state and local taxes
- States may either conform with or diverge from the new law
- States may try to circumvent the federal limitation on state tax deductions by enacting new provisions, such as:
  - A credit against property/income taxes for charitable contributions made to the state
  - Conversion of income tax to employer payroll tax
- Be cognizant of potential changes over the coming years as states react

Entity Choice Considerations

Entity Choice – The Analysis

"To C, or not to C, that is the question"

- Under prior law, it was generally more favorable to be in pass-through structure
- Now, many pass-through owners are considering whether to remain in a flow-through structure or convert to a corporation
- The tax rate difference between a C corporation and a pass-through entity qualifying for QBID is now 8.6%

Tax rates	**2017**	**2018**
Pass-through	39.6%	37%
QBID	N/A	80% (20% deduction on qualified earnings)
Pass-through rate	39.6%	29.6%
C corporation rate	35%	21%
Rate differential	4.96%	8.6%

- However, the double tax imposed on C corporations is considerably less than it was under prior law but can still be substantial.

Prior law	50.5%
New law	39.8%

* Calculations exclude state tax considerations

- While a pass-through structure appears to remain more tax efficient in many situations, because of the significant decrease in corporate taxes, analysis and tax modeling should be done to determine the optimal structure

Entity Choice – Key Modeling Considerations

Key Considerations in Entity Choice Analysis

- Holding period, anticipated date of an exit transaction, anticipated future buyer (private equity or strategic)
- Projected income
- Pass-through entity deduction / projected W-2 wages (QBID – Section 199A)
- Projected cash needs of operations
- Projected distributions
- Change in basis of owners of a pass-through entity compared to C corporation based upon distributions and taxable income projections
- Section 1202 stock (potential exclusion of taxable gain on sale if certain requirements are met)
- Active v. passive owners / net investment income tax (3.8%)
- State and local tax considerations
- Current tax attributes (e.g., suspended losses, disallowed interest carryforwards, NOLs, E&P, etc.)

Entity Choice – Implementation and Other Considerations

Implementation and Other Considerations

- Current ownership structure and need for a blocker (institutional investors, private equity, foreign investors, minority C corporation owners)
- Articles of incorporation, operating agreements and by-laws may need to be amended
- Distributions required under the operating agreement
- Future acquisitions, expansion, and financing of such
- Financing considerations (debt, preferred equity, convertible notes)
- International operations
- Tax compliance and resulting complexity of the optimal structure
- Financial reporting considerations and flexibility in freely transferring assets amongst entities
- Valuation needs in legal entity reorganization/restructuring
- Employee / ownership incentive plans (profits interest, stock options/warrants, etc.) should be re-visited to make sure they align with the entity choice

Timeline to Change Entity Type

- Partnerships and S corporations may be able to retroactively convert to a C corporation as late as March 15, 2018
- C corporations may be able to convert to an S corporation as late as March 15, 2018 but generally cannot retroactively covert to a partnership

Corporate vs Pass-Through Tax Rates w/o State Taxes

	Corporate 2017	Corporate 2018	Pass-Through 2017	Pass-Through 2018	PS Pass-Through 2018
Operations Taxable Income	$10,000,000	$10,000,000	$10,000,000	$10,000,000	$10,000,000
Pass-Through Deduction (20%)	$0	$0	$0	$2,000,000	$0
Net Taxable Income	$10,000,000	$10,000,000	$10,000,000	$8,000,000	$10,000,000
Income Tax rate*	35%	21%	39.6%	37%	37%
Resulting Income tax on operations	$3,500,000	$2,100,000	$3,960,000	$2,960,000	$3,700,000
After Tax Income	$6,500,000	$7,900,000	$6,040,000	$7,040,000	$6,300,000
Effective Rate on Distributions	23.8%	23.8%	N/A	N/A	N/A
Tax on Dividend	1,547,000	1,880,200	N/A	N/A	N/A
Cash Received by Owners	4,953,000	6,019,800	$6,040,000	$7,040,000	$6,300,000
Effective Overall Tax Rate on Cash Distributed	**50.5%**	**39.8%**	**39.6%**	**29.6%**	**37%**

Notes

- Under prior law, graduated rates applied with a maximum of 35%. Under the new law, the US federal corporate income tax rate is a flat 21% at all levels.
- Assuming highest individual tax bracket and not subject to NIIT.
- The 20% deduction is not permitted for professional service income above certain thresholds.
- The marginal tax rates for individuals will be higher than what is reflected because of the new limitation on state and local tax deductions.

Polling Question

Are you considering a change to your entity tax structure as a result of tax reform?

- Yes
- No
- Maybe

Buyer / Seller Considerations

Buyer and Seller Considerations

Buyer

- A buyer generally prefers an asset (or deemed asset) purchase
  - Asset purchase – The buyer will generally want to allocate as much value to the fixed assets because of the immediate expensing of fixed assets acquired
  - Stock purchase – In a stock purchase, greater attention must be given to accounting methods as well as projected tax deductions and amortization because such attributes will carryover

Seller

- A seller generally prefers a sale of equity and desires capital gain treatment on proceeds received
  - Asset sale – The seller may request a gross-up payment to compensate the seller for any incremental cost, including from ordinary income recognized as a result of the sale (e.g., recapture of depreciation); will want to assign less purchase price to fixed assets to avoid recapture
  - Stock sale – Sellers generally prefer to sell the stock of a C corporation instead of the assets to avoid double tax; if a partnership or an S corporation, the additional tax when compared to stock sale is often limited to the additional tax imposed on ordinary income items as long as the entity is not subject to the built-in gains tax.

Reconsider Allocations of Purchase Price

Purchase Price Considerations

- The buyer and seller should agree to a purchase price methodology in the transaction documents to avoid any disputes
- While the cash tax value of the tax basis step-up has decreased because of the lower tax rates have declined
- The value of the tax basis step-up generally may have increased because of the immediate expensing of fixed assets, and potentially smaller gross-up payments paid to sellers
    - C corporation 21% (versus 35%)
    - Pass-through – w/ QBID 29.6% (versus 39.6%)
    - Pass through – w/out QBID 37% (versus 39.6%)
- Sales tax – by allocating additional value to fixed assets (e.g., vehicles), additional sales/bulk-sales tax may be triggered because of such allocations

Certain Intangible Assets

- Under new laws, the sale of self-created intangibles, including patents, inventions, models, designs, and secret formulas or processes, will be taxed as ordinary income
    - Consideration should to this new law when allocating purchase price

Gross-up Calculations - S Corp Acquisitions

Gross-up payment to make sellers indifferent

- A buyer may agree to reimburse the seller (S corporation) for its incremental cost resulting from an asset purchase when compared a stock purchase
- The tax cost often varied based on the degree of ordinary income recognized by the seller since gain on the sale of stock would be recognized as capital gain income
- The rate differential has historically been 19.6% (39.6% less 20% capital gain rate)
- For income included in QBID it is now closer to 9.6% (29.6% (QBID) less 20% capital gains)
- The incremental tax costs resulting from the pick-up of ordinary gain from a deemed asset purchase from an S corporation has decreased considerably
- Modeling is generally needed to determine whether this is beneficial; state taxes should be considered

Seller - Stock v. Asset Sale – Pass Through

S - Corp seller	Book basis balance sheet	Tax basis balance sheet	Purchase price allocation	Gain
Fixed assets (Machinery)	$40,000,000	$20,000,000	$40,000,000	$20,000,000
Intangibles	-	-	15,000,000	15,000,000
Total	$40,000,000	$20,000,000	$55,000,000	$35,000,000
	New law	***Old Law***		
Seller costs	**S - Corp (QBID)**	**S - Corp**		
Ordinary income	$20,000,000	$20,000,000		
Ordinary rate	29.6%	39.6%		
Capital gain rate	20.0%	20.0%		
Rate differential	9.6%	19.6%		
Incremental taxes	$1,920,000	$3,920,000		
Gross-up needed	$2,400,000	$4,900,000		

- State and local tax considerations excluded

Buyer - Stock v. Asset Sale – Pass Through

S - Corp seller	Book basis balance sheet	Tax basis balance sheet	Purchase price allocation	Gain
Fixed assets (Machinery)	$40,000,000	$20,000,000	$40,000,000	$20,000,000
Intangibles	0	0	15,000,000	15,000,000
Total	$40,000,000	$20,000,000	$55,000,000	$35,000,000
Tax Benefit for Buyer	**C corp buyer**	**Pass-through buyer w/ QBID**	**Pass-through buyer w/ no QBID**	
Basis step-up	$35,000,000	$35,000,000	$35,000,000	
Tax rate	21.0%	29.6%	37.0%	
Tax benefit	7,350,000	10,360,000	12,950,000	
First year tax deductions				
Fixed assets	$40,000,000	$40,000,000	$40,000,000	
Intangibles	$1,000,000	$1,000,000	$1,000,000	

- The above chart excludes the gross-up payment costs
- State and local tax considerations excluded
- The additional purchase price is assumed to be equity and not financed by debt
- The new business interest expense limitation could potentially make the accelerated tax deprecation from an asset purchase less beneficial

Gross-up calculations - C corp acquisitions

Gross-up Payment to Make Sellers Indifferent

- Historically, a buyer would not be willing to pay the incremental tax resulting from the purchase of assets from a C corporation
- Now, it may be beneficial to pay the seller additional consideration because of the immediate tax benefits
- Will generally be applicable to corporations with similar inside tax basis and purchase price (“minimal gain”)
- Modeling is generally needed to determine whether this is beneficial; state taxes should be considered

Section 338(g) Election Instead of a Pure-asset Purchase

- An eligible buyer (must be a corporation) can unilaterally treat the purchase of C corporation as an asset purchase by making a Section 338(g) election
- Historically, this was not done unless the target corporation had a considerable tax shield (e.g., NOLs) to offset the up-front tax costs
- If the buyer is a corporation, a Section 338(g) election may be more attractive than a pure-asset deal with a gross-up payment
- Modeling is generally needed to determine whether this is beneficial; state taxes should be considered

Buy-side Tax Due Diligence

Buy-side Tax Due Diligence

Tax Due Diligence

- It is generally recommended that the buyer perform tax due diligence in connection with a contemplated acquisition
- Because of the decreasing U.S. federal corporate income tax rates, U.S. federal tax exposures will generally decrease
- Due diligence should take into account the structure of the acquisition (asset purchase, deemed asset purchase, stock purchase, stock purchase with a Section 338(g) election)

C Corporation Due Diligence

- It is anticipated that more closely held businesses will choose to be taxed as a C corporation because of the decrease in corporate tax rates and simplicity when compared to the pass-through tax structure
- Buyers should consider materiality threshold – while the cash tax exposure may remain the same, the adjustments necessary to get to that cash tax adjustment will be significantly higher under the decreased corporate tax rates
- Deferred tax asset / tax provisions may become more critical for financial reporting

Buy-side Tax Due Diligence (continued)

S Corporation / Partnership Due Diligence

- While it is anticipated that more companies will choose to be taxable C corporations, pass-through entities will still likely be the dominant entity chose going forward
- Standard S corporation / partnership due diligence will still be recommended
- Pass-through entities will have less incentive to classify employees as independent contractors; however, the tax benefit from QBID may be less than the tax costs of employment taxes depending on facts and circumstances
- The "F" reorganization followed by the conversion to a single member LLC will still be a common acquisition structure of a deemed asset purchase involving an S corporation

U.S. Federal International Tax Due Diligence

- Under the new tax laws, the U.S. tax system is moving from a world-wide taxing system, to a territorial taxing system; because of the switch, there will be a one-time up-front repatriation tax on cash (15.5%) and illiquid assets (8%) held in controlled foreign corporations
- A taxpayer may elect to pay the repatriation tax in 2018, or over an 8 year period
- Because the repatriation may be very significant for certain tax payers, additional tax due diligence will generally be recommended to confirm that the target properly calculated the repatriation tax
- Because the repatriation tax may be paid over the course of 8 years, tax may be owed through the 2025 tax year; this results in the statute of limitations not expiring for the 2018 repatriation tax calculations until 2029 in most cases

Buy-side Tax Due Diligence (continued)

State and Local Tax Due Diligence

- State conformity – accelerated depreciation methods
- Sales tax considerations
- Successor liability issues

Other M&A Tax Planning

Other M&A Tax Planning Considerations

Other Planning Considerations

- Tax Rate Arbitrage for 2017 Returns Not Yet Filed
- Potential Cash Build-up at "Blocker" Corporations
- Maximizing W-2 Wages for Pass-through Deduction (QBID) in Exit Year
- Planning for Business Interest Limitation
- Section 382 Considerations
- Value of Transaction Cost Deductions and Tax Attributes
- Repeal of Partnership Technical Terminations
- Hold Carried Interests for 3 years when possible

Tax Rate Arbitrage for 2017 Returns Not Yet Filed

Tax Rate Arbitrage - Timing of Income and Deductions

- Business deductions are generally more valuable in 2017 than in 2018
- Strategies are available to shift income and deductions even after year-end including tax accounting method changes or other planning for:
  - Overall methods of accounting, advance payments, compensation accruals, personal and real property taxes, payroll taxes, research expenses, lower of cost or market and subnormal inventory deductions, bad debts, revenue recognition
  - Pension payments made after yearend can be associated with 2017 plan year and potentially deductible in 2017
  - Ensuring maximum depreciation on all existing assets through cost segregations and closer review of prior methods

Potential Cash Build-up at "Blocker" Corporations

Partnership Operating Agreements / Required Distributions

- Many operating agreements state that tax distributions will be paid at the highest marginal tax rate or will choose a distribution rate intended to be reflective of the highest marginal rate.
- These provisions should be examined and adjusted (if necessary) to take into account the lower marginal tax rates
- It also might be possible to convert blocker's excess cash into preferred equity to pay down debt / reduce interest expense/limitation on interest expense

Taxable income	5,000,000		
	Blocker	Pass-through	
Ownership percentage	80%	20%	
Taxable income	4,000,000	1,000,000	
Highest marginal tax rate	21%	29.60%	
Taxes owed	840,000	296,000	
Required distribution rate	45%	45%	
Actual distribution	1,800,000	450,000	
			Total
Excess distribution per year	960,000	154,000	1,114,000
Holding period	5 years	5 years	
Total excess distributions	4,800,000	770,000	5,570,000

Maximizing W-2 Wages for Pass-through Deduction (QBID) in Exit Year

Ordinary income generated on the sale of a business will likely be included in QBI

QBI may not include certain investment income

- Capital gains resulting from the sale of a business might not be included in the QBID calculation

W-2 wage considerations

- Depending on the type of business and the time of the year in which it is sold, there may not be sufficient W-2 wages to support a full QBID on the ordinary income generated on the sale
- Stuffing W-2 wages as well as change-in-control payments/bonuses into the final year may be necessary (as well as beneficial) to support the full deduction
- Further IRS guidance is required to determine how W-2 wages and the 2.5% property base will be calculated in short tax years.

Planning for Business Interest Limitation

Disallowed Interest Expense Limitation Carryforwards

- If sale of C corporation stock, the carryforward remains an attribute of the company when the stock is transferred to the buyer. It will be treated much like a net operating loss. The seller will need to negotiate additional purchase price for the tax attribute from the buyer to realize the tax benefits from the deduction.
- If sale of assets, the gain from the asset sale might be included in the calculation of EBIDA for the year of sale. Substantial gains may allow the ability to use carryforwards in the year of sale. This benefit would be derived at ordinary income rates.
- If sale of an interest in a pass-through entity, the disallowed interest expense increases the basis in the entity. This basis increase will essentially allow the costs to be deducted at sale. However, the benefit might be derived at capital gain rates.

Business Interest Limitation – EBIDA Multiples

	5X Multiple	12X Multiple
EBIDA	10,000,000	10,000,000
Multiple	5.0	12.0
Purchase price	50,000,000	120,000,000
Interest rate	8%	8%
Financed	80%	80%
Equity	20%	20%
Debt	40,000,000	96,000,000
Interest expense	3,200,000	7,680,000
EBIDA	10,000,000	10,000,000
30% of EBIDA	30%	30%
Limitation	3,000,000	3,000,000
Excess interest expense	200,000	4,680,000

Section 382 (change-in-control)

Section 382 Overview

- Section 382 imposes limitations on a "loss" corporation's ability to utilize its NOL carryforwards if the corporation experiences an "ownership" change
- An ownership change is defined as a cumulative greater than 50.0% change in the equity ownership of the corporation over a three-year rolling period
- While the tax law changes do not directly change the mechanics of Section 382, the changes will impact certain considerations

NOLs under the New Tax Law

- C corporations will not be able to carryback any NOLs generated in tax years beginning after 12/31/2017
- NOLS generated in tax years ending after 12/31/2017 can only offset 80% of taxable income.
- NOLs generated in tax years ending after 12/31/2017 will not expire (previously NOLs could only be carried forward 20 tax years)

Section 382 (change-in-control) (continued)

Section 382 under the New Tax Law

- Transactions costs commonly create large NOL that were carried back to pre-close period; because NOLs can no longer be carried back, the buyer will receive the tax benefit of the NOLs subject to Section 382 limitations
  - Transaction documents should address such
- Because the 20 tax year carryover period is now indefinite, the base Section 382 limitation imposed on NOLs may carry hundreds of years into the future!
  - Example: A taxpayer with $1M of NOLs and a $1K base limitation would effectively be able to utilize $1K of NOLs for the next 1000 years
- Because NOLs generated after 12/31/2017 will not expire, loss waiver elections to waive the NOL carryforwards acquired and unusable due to Section 382 limitations may no longer be advisable

Conversion of Credits to NOLs

- Section 382 requires tax credits to be converted to the NOL equivalent.
- Because of the decrease in corporate tax rates, credits are now equal to more NOLs!
- Prior Section 382 limitations should be revisited to determine whether the conversion of the credits into a greater amount of NOLs results in any of the credits from being useable under the prior calculations.
  - Example: $350K of credits were previously equal to $1M NOL equivalents; now $350K of credits are equal to $1.667M NOL equivalents

Value of Transaction Cost Deductions and Tax Attributes

- Changed value of transaction related deductions and other tax attributes (e.g., NOL carryforwards, credit carryforwards, etc.)
  - Repeal of NOL carrybacks
  - Limitation on NOL carryforwards generated after 2017 to offset only 80% of taxable income, and
  - the $500,000 limit on the deduction of net business losses for individual taxpayers
- NOL carryforwards – adjusted value to buyers – limitation on utilization and carryforward never expires
  - leading to potential adjustments in purchase price
- Trouble in obtaining cash tax benefits for sellers
  - Corporations: reduced benefits - repeal of NOL carrybacks – must negotiate alternative monetization strategies with a buyer
  - Pass-throughs: reduced benefits - if transaction related deductions result in net business losses in excess of $500,000 which could adversely impact the economics of a transaction

Repeal of Partnership Technical Terminations

- Under prior law, a sale of 50% or more of partnership interest within a 12-month period, resulted in a technical termination of Partnership
- These rules caused the partnership's tax year to formally close, resulting in pre- sale and post-sale reporting periods
- Prevents unintended terminations and depreciation restarts but also prevents planning to restart accounting method and to "cleanly" cut-off tax years when new investors join the partnership
- These rules are fully repealed
- Be aware that books will not formally close in these situations. If a formal closing of the books is desired, a revision to the structure should be considered. The parties might need to more carefully negotiate what happens with respect to the pre and post periods.

Hold Carried Interests for 3 years when possible

Carried Interest

- Imposes a three-year holding period to obtain long-term capital gain with respect to partnership interests received in connection with services performed for a business that consists of
  - (1) raising or returning capital,
  - (2) investing in specified assets or identifying specified assets to invest in, or
  - (3) developing specified assets

Polling Question

Would you like Plante Moran to contact you to?

- Yes
- No

Questions

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