Selling Your Company After 2017 Tax Reform

On 22 December 2017, United States (US) President Trump signed into law the *Tax Cuts and Jobs Act* (the Act) following passage in the House and Senate earlier that week. The new law and a number of other factors will make 2018 an ideal time to sell a business.

M&A activity continues to be robust spurred on by a record high stock market, continued low interest rates and trillions of dollars in available capital. Additionally, there are now a number of provisions in this tax reform legislation that should enhance the M&A environment including:

- Companies repatriating profits now held overseas are expected to use some of those funds to spur growth through acquisitions.
- Lower corporate tax rates will provide increased capital for acquisitions.
- Lower tax rates provide increased net proceeds from the sale of a business.

General business provisions that may affect M&A

While the effect of the provisions in the Act ought to be analyzed on a company-by-company basis, as well as a sector-by-sector basis, many provisions of the Act have general applicability to many companies considering a merger, sale or acquisition.

<u>Corporate</u>

21% corporate tax rate — The 21% corporate tax rate is effective 1 January 2018.

Repeal corporate alternative minimum tax (AMT) — The corporate AMT is repealed under the Act, and taxpayers with an AMT credit can use the credit to offset regular tax liability. Taxpayers are able to claim a refund of 50% (100% for years beginning in 2021) of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning before 2022. The provision applies to tax years beginning after 2017.

Dividends received deduction — The amount of deduction allowable against the dividends received from a domestic corporation is reduced. Specifically, the deduction for dividends received from other than certain small businesses or those treated as "qualifying dividends" is reduced from 70% to 50%. Dividends received from 20%-owned corporations are reduced from 80% to 65%.

Expensing — Bonus depreciation increases from 50% to 100% for "qualified property" placed in service after 27 September 2017 and before 2023. Under the Act, the original use of the property does not need to commence with the taxpayer. The increased expensing phases down, starting in 2023, by 20% for each of the five following years. Qualified property is defined to exclude — as with the Section 163(j) interest limitation — certain public utility property and floor plan financing property. A transition rule allows for an election to apply 50% expensing for the first tax year ending after 27 September 2017. The Act increases the depreciation limitations for listed property and removes computer or peripheral equipment from the definition of listed property. The changes are effective for property placed in service after 31 December 2017, in tax years ending after that date. Section 179 expensing increases to US$11 million for "qualified property" (i.e., tangible personal property used in a trade or business) placed in service in tax years beginning after 2017, with a phase-out beginning at $2.5 million. Additionally, the term "qualified property" is expanded to include certain depreciable personal property used to furnish lodging, and improvements to nonresidential real property (such as roofs, heating and property protection systems).

Interest limitations — The revised Section 163(j) limitation is on net interest expense that exceeds 30% of adjusted taxable income (ATI). For the first four years, ATI is computed without regard to depreciation, amortization, or depletion. Thereafter (beginning in 2022), ATI is decreased by those items, thus making the computation 30% of net interest expense exceeding EBIT (earnings before interest and taxes). ATI is otherwise defined similar to current Section 163(j). A small business exception is keyed to businesses satisfying a gross receipts test of $25 million. The provision is effective for tax years after 2017.

Net operating losses (NOLs) — For losses arising in tax years beginning after 2017, the NOL deduction is limited to 80% of taxable income. The carryback provisions are repealed, except in certain limited situations but, for many taxpayers, an indefinite carry-forward is allowed.

Like-kind exchanges — The non-recognition of gain in the case of like-kind exchanges is now limited to those involving real property only.

<u>Pass-through Entities</u>

Pass-through income: special 20% deduction — Under the Act, individuals generally receive a 20% deduction on certain pass-through income. Special limitations apply to "specified service businesses" based on the income of their owners. As a general rule, an individual taxpayer is able to deduct 20% of domestic "qualified business income" (QBI) from a partnership, S corporation, or sole proprietorship (qualified businesses), subject to certain limitations and thresholds. At the top tax rate of 37%, provided in the Act, if a taxpayer's sole income source is domestic QBI and the application of the deduction is not limited, then the effective tax rate on the domestic QBI is 29.6%. The deduction is not allowed against adjusted gross income, but rather a deduction to reduce taxable income. Trusts and estates are eligible for the deduction. Generally, the provisions are effective for tax years beginning after 31 December 2017, and before 1 January 2026.

Repeal of partnership technical terminations — Under Section 708(b)(1)(B) of current law, a sale or exchange of 50% or more of interests in partnership capital and profits within a 12-month period causes a "technical termination" of the partnership. The Act repeals Section 708(b)(1)(B) for partnership tax years beginning after 31 December 2017.

Sale of partnership interests by foreign partners —The Act establishes by statute, a provision to treat gain or loss from the sale of a partnership interest by a foreign partner income that is taxable in the United States if the gain or loss from the sale of the underlying assets held by the partnership would be treated as effectively connected income (ECI). In addition, the Act requires the purchaser of a partnership interest from a partner to withhold 10% of the amount realized on the sale or exchange of the partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or a foreign corporation. The provision regarding the treatment of gain or loss from the sale of a partnership interest by a foreign partner as ECI is effective for sales or exchanges occurring on or after 27 November 2017, while the required withholding on sales of partnership interests applies to sales or exchanges occurring after 31 December 2017.

Carried interest — For certain partnership interests held in connection with the performance of certain services, the Act imposes a three-year holding period to treat capital gain as long-term capital gain. The provision is effective for tax years beginning after 31 December 2017.

<u>Business Asset Sale Comparison</u>

The table below compares the tax effects of an asset sale of business by C-Corporation versus a pass-through entity such as S-Corporation, Partnership or LLC under the old tax law in 2017 and the new *Tax*

Cuts and Jobs Act in 2018 for both the business, and their owners. The example assumes a sale of all assets of the company for $10 million all taxed at ordinary rates. C Corporations do not have a capital gains tax; but, owners of pass-through entities pay capital gains tax at 20%. For simplicity this example assumes that all assets sold were subject to tax at ordinary income rates as will be the case with receivables, inventories and recapture of fully depreciated assets.

Owners of pass-through entities now benefit from a 20% deduction against pass-through income to a maximum tax rate of 29.6%

Tax Cut Comparison from 2017 to 2018 for C Corporations and Pass-Through Entities						
	C Corporation			S Corp, LLC or Partnership		
	2017	2018	Difference	2017	2018	Difference
Selling price	10,000,000	10,000,000	-	10,000,000	10,000,000	-
Corporate tax rate	35.0%	21.0%	-14.0%	0.0%	0.0%	0.0%
Corporate tax	3,500,000	2,100,000	(1,400,000)	-	-	-
Distributable proceeds	6,500,000	7,900,000	1,400,000	10,000,000	10,000,000	-
Shareholder tax rate	39.6%	37.0%	-2.6%	39.6%	29.6%	-10.0%
Shareholder tax	2,574,000	2,923,000	349,000	3,960,000	2,960,000	(1,000,000)
Net to shareholder	3,926,000	4,977,000	1,051,000	6,040,000	7,040,000	1,000,000
Effective tax rate	60.7%	50.2%	-10.5%	39.6%	29.6%	-10.0%

Stock Sale

Consequences of a stock sale are realized at closing by the owners of the business. Sellers will recognize a gain to the extent the sales price is higher than their cost basis of the stock. Any gain will be taxed at the 20% capital gains rates according to the seller's holding period. Consideration should also be given for any effect of the Net Investment Income Tax to a seller holding a business interest as an individual or through an estate or trust. This tax could add an additional 3.8 percent tax on top of the otherwise applicable amount.

Capital gains tax rates remain unchanged under the *Tax Cuts and Jobs Act.*
