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Tax Changes Are More Than Meet the Eye

The Tax Cuts and Jobs Act (the Act) signed into law on December 22, 2017 makes key changes that impact important business decisions made by company owners.

- The federal corporate tax rate is cut from 35% to 21%.
- The top federal tax rate for pass-through entities (S-Corps, LLCs and sole proprietorships) is cut from 39.6% to 37%.
- Pass-through entities are allowed a deduction equal to 20% of qualified business income subject to certain limits.
- Capital expenditures are now 100% expensed against taxes in the year they are incurred.
- Interest is deductible up to 30% of operating income plus depreciation and amortization.

Most of the news is good for companies that are engaged in production activities and we offer the following additional points to consider as part of your business planning for 2018 and beyond.

Corporate Tax Cuts Are What They Appear To Be

The federal corporate tax rate reduction from 35% to 21% is permanent. The central intent of the tax law changes was to make U.S. corporations more competitive on a world stage and to encourage more domestic production activity. The Act accomplishes this by putting U.S. corporate tax rates at levels competitive with those of other countries. The 21% tax rate is permanent absent new legislation.

Pass-Through Cuts May Not Be What They Seem

First, the top federal individual rate cut from 39.6% to 37% is *temporary* and expires December 31, 2025. The 20% deduction for qualified business income, that may not be ***fully available*** in some situations, reduces the 37% tax rate to 29.6%, and is also *temporary*. It expires in 2025. For the reduction to be available beyond 2025, Congress must pass and the President must sign (vetoes are rarely overridden) an extension. We simply do not know what the economic or political conditions will be when changes are considered. Without an extension, in 2026 the maximum individual rate will revert back to 39.6%, and the 20% qualified business income deduction goes away.

In addition, the 20% qualified business income deduction is means-tested. If a taxpayer is married and has a taxable income under $315,000 (indexed for inflation) then the 20% deduction (driven solely from qualified business income) is intact. If one's income is higher than $315,000 but less than $415,000 the deduction can be reduced or disappear entirely based upon the level of the company's total W-2 wages and depreciable assets. In each case, the higher the better. If one's income is greater than $415,000 then the deduction cannot exceed the greater of: (i) 50% of total company wages; or (ii) 25% of total company wages *plus* 2.5% of the original cost of tangible property owned by the taxpayer. Obviously, there is some complexity in calculating the amount of the deduction and without it, the tax rate could be as high as 37%. In a business sale, the chances are higher that the wage and asset tests will significantly limit the deduction subjecting the seller to the higher tax rates for ordinary income portions of sale proceeds not taxed as capital gains.

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In any case, the benefits of the 20% business income deduction for sole proprietorships and pass-throughs are not as clear cut as the permanent corporate tax rate reduction.

Now is a Good Time to be Expanding Your Business

Much of the tax changes are pro-growth measures targeting manufacturers and producers. The law specifically rewards companies that engage in expansion by permitting a 100% write-off of capital expenditures in the year of purchase.

The 100% of capital expenditures write-off applies to tangible property with a recovery period of 20 years or less, software (if not acquired in a business purchase transaction), and non-residential leasehold improvements.

By deducting 100% of the cost of capital expenditures in the year incurred from 2018 through 2022, the U.S. government is encouraging businesses to *invest now*. You may want to get your orders in soon as suppliers and construction firms may struggle to handle the anticipated influx of new spending encouraged by the tax changes.

Now is A Good Time to be a Business Buyer

As a buyer, there are several incentives for you to act quickly with your acquisition efforts.

1) 100% of all capital expenditures can be written off in the year they are incurred through 2022. The write-off steps down by 20% per year thereafter. For many buyers, the effect of this rule is that ***no income taxes*** will be paid for several years after the purchase. Whether your business is a corporation or pass-through, you benefit from reduced taxes and can use the increased cash flow to pay more for the acquired business, make additional capital expenditures or return money to your shareholders.

2) Interest deductibility is more favorable until January 1, 2022 because a buyer can deduct interest expense up to 30% of operating income ***plus*** depreciation and amortization (EBITDA). In 2022 and beyond, the deduction is reduced to 30% of operating income ***after*** deducting depreciation and amortization (EBIT). Given the enhanced depreciation rules, interest deductibility will be significantly reduced for many businesses after 2021. Interest deductions not available due to the 30% limitation may be carried forward to future years when they may not be deductible.

3) Lower tax rates enable buyers to have more annual cash flow from the companies they buy.

Now is A Good Time to be a Business Seller

1) Buyers will have more after tax cash flow in 2018 and beyond than in previous years. This is especially true for the next four years as the 30% interest deduction limitation is not effective until 2022. This means that purchase prices offered by buyers will increase noticeably, especially in the next few years.

2) Business confidence is high, credit conditions are favorable and private equity and mezzanine debt funds have a lot of "dry powder" they need to deploy. With more buyers taking advantage of the new tax rules, it is a seller's market more than ever.

3) As a seller, you will most likely be able to keep more sale proceeds than you would if you sold in 2017.

4) Businesses are currently being sold at multiples that are high by historic measures. One of the reasons for this is that interest rates are at historic lows. When rates increase, and they will, valuation multiples will soften and fall from current levels. For sellers, there is a window of opportunity now: low interest rates + lower taxes = higher prices.

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Consider Being a C Corporation if you Plan to Own the Business for 10 Years or More

We see a renaissance for the C corporation form of business ownership. In most cases, there is still "double" taxation applicable to business' income taxed at the corporate level and then passed to shareholders. On its surface, this seems more onerous than the single level tax applicable to pass-through companies. This "double tax" result may be superior to the single level tax result applicable to pass-through in many situations. This is especially true for those owners that plan to keep their companies for a long time. Here are some things to consider:

1) There is more certainty with the lower C corporation tax rate given that it's a permanent cut from 35% to 21% versus the temporary reduction in personal rates (until 2026) and the 20% qualified business income deduction available to pass-through entities. It is often asserted that the 20% business income deduction results in a 29.6% rate to pass-through entities. This is a result of reducing the highest individual rate by 20% (37% x 20% = 7.4%; 37% - 7.4% = 29.6%). While the math is correct, the assumption that all pass-through business will get a flat 20% deduction from their taxable income is wrong in many situations. First, the 20% deduction does not apply to interest or investment income. More important is that a sale of a business in an asset sale will not benefit from the 20% deduction for any capital gain, nor will it benefit when income from the sale of other assets exceeds the wage/property limitations that apply to the 20% deduction.

2) With a C corporation, cash accumulates at a faster rate (79% of pre-tax cash flow) than for a pass-through business where a maximum of 70.4% of pre-tax cash flow remains after taxes are paid. These accumulation differences can be significant, particularly if the 20% deduction is limited for pass-throughs.

3) C corporations allow state taxes to be deducted when calculating federal taxes. With pass-throughs this is no longer the case. This means C corporation's effectively pay less state tax than pass-throughs.

4) For C corporation Qualified Small Businesses per IRS code 1202 (generally businesses with less than $50 million of assets at the time of stock issuance) 100% of capital gains from stock held more than five years by an individual are excluded from federal taxes up to a limit of $10 million or ten times the original investment.

In conclusion, the Act represents a significant improvement to the business tax outlook for C corporations and pass-through entities alike. It is an impact that will stimulate business activity in 2018 and beyond. The next three years may also be the best time to buy or sell a business.

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