

Impact of Tax Reform on Choice of Entity and M&A Transactions

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Overview of topics

- Key federal income tax rate changes
- Choice of entity considerations
- Converting to a different entity type
- Changes that impact M&A transactions

Background on entity choices

- Three main choices for tax purposes:
 - C corporation, partnership, and S corporation
- C corporation: double layer tax at corporate and shareholder levels
 - Income taxed at corporate level as earned
 - Income taxed at shareholder level when distributed
- Partnership: single layer of tax at partner level, regardless of whether income is distributed
- S corporation: single layer of tax at shareholder level, regardless of whether income is distributed

Key federal tax rate changes

- Federal income tax rates have generally been lowered for
 - Individuals,
 - C corporations, and
 - Income earned through flow-through entities (including partnerships, S corporations, sole proprietorships, and limited liability companies taxed as any of the foregoing)

Rate changes for individuals

- Max income tax rate on ordinary income dropped from 39.6% to 37%

Single individuals (other than surviving spouses and heads of households)

Old tax rates	Old tax bracket	New tax rates	New tax brackets
10%	\$0 to \$9,525	10%	\$0 to \$9,525
15%	\$9,526 to \$38,700	12%	\$9,526 to \$38,700
25%	\$38,701 to \$93,700	22%	\$38,701 to \$82,500
28%	\$93,701 to \$195,450	24%	\$82,501 to \$157,500
33%	\$195,451 to \$424,950	32%	\$157,501 to \$200,000
35%	\$424,951 to \$426,700	35%	\$200,001 to \$500,000
39.6%	\$426,701+	37%	\$500,001+

Married individuals, filing jointly, and surviving spouses

Old tax rates	Old tax bracket	New tax rates	New tax brackets
10%	\$0 to \$19,050	10%	\$0 to \$19,050
15%	\$19,051 to \$77,400	12%	\$19,051 to \$77,400
25%	\$77,401 to \$156,150	22%	\$77,401 to \$165,000
28%	\$156,151 to \$237,950	24%	\$165,001 to \$315,000
33%	\$237,951 to \$424,950	32%	\$315,001 to \$400,000
35%	\$424,951 to \$480,050	35%	\$400,001 to \$600,000
39.6%	\$480,051+	37%	\$600,001+

Taxpayers at almost all income levels receive a cut to their marginal tax rates on ordinary income, except for single individuals earning between \$200k and \$426k and married individuals earning between \$400k and \$480k.

Other changes for individuals

- **Standard deduction increased:** from \$6,350 to \$12,000 for single and \$12,700 to \$24,000 for married filers
- **Personal exemption suspended:** \$4,050 exemption for taxpayer, spouse, & dependents suspended 2018-2025
- **Temporary:** reduced income tax rates for individuals and larger standard deduction expire on Dec. 31, 2025
- **Slower inflation adjustments:** brackets will be adjusted more slowly because “chained,” not regular, CPI will be used
- **No changes to long-term capital gains:** tax rates applicable to long-term capital gains, as well as the 3.8% net investment income tax and Section 1202 exclusion of gain on the sale of certain qualified small business stock have not changed

Deduction limits for individuals

- **State and local taxes:** itemized deduction for state and local income and property taxes is now capped at \$10,000 for 2018-2025, including state income taxes paid by an owner of a flow-through entity
- **Miscellaneous itemized deductions:** individuals may no longer deduct tax preparation fees, attorney and accountant fees, investment management fees, unreimbursed job expenses, and other itemized deductions previously subject to the 2% floor

Rate changes for C corporations

- 2017 maximum federal corporate rate = 35%, with a graduated rate schedule in effect

Taxable Income				
Over	But Not Over	Pay +	% on Excess	Of the Amount Over
\$0	\$50,000	\$0	15%	\$0
\$50,000	\$75,000	\$7,500	25%	\$50,000
\$75,000	\$100,000	\$13,750	34%	\$75,000
\$100,000	\$335,000	\$22,250	39%	\$100,000
\$335,000	\$10,000,000	\$113,900	34%	\$335,000
\$10,000,000	\$15,000,000	\$3,400,000	35%	\$10,000,000
\$15,000,000	\$18,333,333	\$5,150,000	38%	\$15,000,000
\$18,333,333			35%	

- 2018 & beyond, flat corporate tax rate = 21%
- No graduated rate schedule

Rate changes for C corporations

- **Corporate tax cut is permanent:** does not expire on Dec. 31, 2025 like the individual tax cut
- **Dividends-received deduction reduced:** reduction from 80% to 65% (for 20% owned corporations) and from 70% to 50% (for most other dividends received from domestic corporations)

Rate changes for flow-throughs

- Deduction for up to 20% of qualified business income (“**QBI**”) from flow-through entities through 2025
- Various special rules and limitations apply:
 - Not available for capital gains, dividends, and interest (except for interest allocable to a trade or business)
 - Owners of certain service businesses are subject to phase-out rules and the deduction can be limited to a percentage of wages and depreciable property
- When fully available, the deduction can result in an effective federal marginal income tax rate of 29.6% on QBI from flow-through entities (plus the 3.8% net investment income tax, where applicable)

Choice of entity considerations

- Prior to tax reform, partnerships were the most common entity choice for tax purposes
- After tax reform, there is still no single solution for all businesses
- C corporations are now generating more interest and may become a more common choice
- Caution should be exercised as there may be a high tax cost to converting out of a C corporation

Choice of entity considerations

- Consider the tax results:
 - upon formation
 - during operations
 - upon a sale or conversion
- Also consider state law entity type
 - LLCs can be partnerships or C or S corporations
 - State law corporations cannot be partnerships

Factors impacting entity choice

- Makeup of the investor base
- Debt and equity capitalization structure
- Borrowing requirements
- Likelihood of distributing earnings
- State tax rates
- Compensation and benefit considerations
- Participation of owners in the business
- Sale or exit strategies

Impact of distributions

- Consider the distribution requirements of owners
- C corporation dividends are taxed at a 31.45% combined federal and Wisconsin tax rate
- Partnerships and S corporations can generally make tax-free distributions to the extent of basis

Impact of state taxes

- C corporations may still deduct state taxes in full
- Owners of flow-through entities pay state income taxes on their share of flow-through income but cannot deduct state taxes in excess of \$10,000
- This difference is important for businesses that operate in higher taxing states, such as California, New York, or Minnesota
- Wisconsin's corporate tax rate is a flat 7.9%
- Wisconsin's individual rate tops out at 7.65%

C corporation effective tax rates

All net earnings retained

Corporate income	100,000
Wisconsin corporate tax at 7.9%	<u>(7,900)</u>
Federal taxable income	92,100
Federal corporate tax at 21%	<u>(19,341)</u>
After-tax corporate income	72,759
Federal tax on dividend at 20% + 3.8%	-
Wisconsin tax on dividend at 7.65%	-
Net after taxes	<u><u>72,759</u></u>
Total taxes paid	27,241
Effective tax rate	27.2%

C corporation effective tax rates

All net earnings paid as a dividend:

Corporate income	100,000
Wisconsin corporate tax at 7.9%	<u>(7,900)</u>
Federal taxable income	92,100
Federal corporate tax at 21%	<u>(19,341)</u>
After-tax corporate income	72,759
Federal tax on dividend at 20% + 3.8%	(17,317)
Wisconsin tax on dividend at 7.65%	<u>(5,566)</u>
Net after taxes	<u><u>49,876</u></u>
Total taxes paid	50,124
Effective tax rate	50.1%

Flow-through tax rates

Full 20% qualified business income deduction

Income	100,000
20% qualified business income deduction	<u>(20,000)</u>
Federal taxable income	80,000
Federal income tax at 37%	(29,600)
Self-employment tax or net investment income tax at 3.8%	(3,800)
Wisconsin income tax at 7.65%	<u>(7,650)</u>
Net after taxes	<u><u>58,950</u></u>
Total taxes paid	41,050
Effective tax rate	41.1%

Flow-through tax rates

No qualified business income deduction

Income	100,000
20% qualified business income deduction	-
Federal taxable income	<u>100,000</u>
Federal income tax at 37%	(37,000)
Self-employment tax or net investment income tax at 3.8%	(3,800)
Wisconsin income tax at 7.65%	<u>(7,650)</u>
Net after taxes	<u><u>51,550</u></u>
Total taxes paid	48,450
Effective tax rate	48.5%

Impact of Basis Build-Up

- The build-up of basis in flow-through entities remains a valuable feature
 - Owners' basis in a flow-through entity increases as the entity recognizes income
 - Owners' basis in a flow-through entity decreases as losses are realized or as distributions are made
 - This basis build-up decreases gain on an ultimate sale of the flow-through entity
- No similar build-up in stock basis for C corporations

Sale considerations

- Buyers still likely to prefer asset acquisition treatment
 - Buyer obtains a step-up in tax basis of assets
 - Immediate expensing of fixed assets provides immediate value to buyer
 - Buyer can amortize goodwill and intangibles over 15 years
- But with lower tax rates, the step-up in tax basis resulting from asset purchases is now worth less to buyers

Sale considerations

- C corporations
 - Asset sales are still likely undesirable (50% combined tax rate) except if NOLs are present
 - Stock sales are likely preferred (29% combined tax rate), but no build-up in stock basis with C corps
 - Potential exclusion of gain on sale (see next slide)
- Pass-through entities
 - Build-up in tax basis remains advantageous
 - Asset sales and equity sales generally have similar tax consequences (29% combined tax rate)
 - New risk of ordinary income treatment for self-created patents, secret processes, and recipes in asset sales

Gain exclusion for C corporations

- Qualified small business stock (Code § 1202)
- 100% gain exclusion for new issuances of C corporation stock held for more than five years
- Gain exclusion is limited to greater of \$10 million or 10x stock basis
- Corporation must have less than \$50 million of gross assets at time of stock issuance
- 80% of corporation's assets must be used in qualified active businesses
- Professional services, finance, banking, hotels, and restaurants are excluded

Converting existing entities

- Existing businesses may want to reconsider entity choice for tax purposes
- A state law entity conversion may or may not be required to change tax treatment of entity
- Some conversions for tax purposes may be done solely by filing tax elections
- Conversions may or may not have tax consequences

Partnership → C or S corporation

- Partnership to C or S corporation is generally tax-free
- Some tax may be triggered if the partnership has liabilities in excess of basis at the time of conversion
- Conversion can be done any time during the tax year
- If converting to a C corporation, potential to qualify for Section 1202 gain exclusion
- A state law LLC can elect to be a corporation for tax purposes and remain an LLC under state law
- Or, a state law LLC can convert into a state law corporation

S corporation → C corporation

- S corporation to C corporation conversion is generally tax-free
- Conversion may be done during the taxable year by intentionally terminating S election
- Otherwise, conversion must coincide with beginning of tax year
- Five-year waiting period before reelecting S corporation status
- No state law entity conversion required

C corporation → S corporation

- C corporation to S corporation generally does not trigger an immediate tax liability
- LIFO inventory may be taxed over four years
- A built-in gain tax applies for 5 years after conversion
 - Built-in gain must be measured at conversion
 - Corporate-level tax if gain is recognized within 5 years
- Corporation must be eligible to elect S corporation status (single class of stock, eligible shareholders)
- Conversion must coincide with beginning of tax year
- No state law entity conversion required

C corporation → partnership

- C corporation to partnership is generally taxable
- Conversion is treated as a taxable liquidation of the corporation
- Taxed at both the corporate and shareholder levels (50% effective tax rate)
- With reduced corporate tax rates, these conversions may now be more feasible
- Corporate NOLs may offset some of the gain on conversion

Changes that may impact M&A

- Important changes that may affect M&A transactions:
 - Interest deduction limitations
 - Corporate AMT repeal and NOL limitations
 - Full and immediate expensing of certain property

Interest deduction limitations

- **Limit:** the deduction for business interest expense is limited to 30% of “adjusted taxable income” (“ATI”), plus business interest income.
- **Exception:** the limitation does not apply in certain cases, including taxpayers whose average annual gross receipts for the three-year period ending with the last taxable year do not exceed \$25 million
- **Flow-throughs:** for flow-through entities, the interest limitation is computed at the entity level, with rules that limit carryovers to offsetting only the income of that entity
- **Debt vs. equity:** the lower corporate tax rate (reducing the value of interest deductions) and limitation of interest deductions is intended to tip the scales more in favor of equity than debt and may lead to less leverage in certain businesses.

Interest deduction limitations

- **What is ATI:** Initially, ATI is related to EBITDA, but post-2022 ATI more closely resembles EBIT
- **Calculation:** ATI = a taxpayer's taxable income, calculated without counting any non-trade or business income and without regard to:
 - Any business interest expense or interest income,
 - The amount of any net operating loss deduction,
 - The 20% QBI deduction on flow-through income, and
 - For taxable years before Jan. 1, 2022, any deduction allowable for depreciation, amortization or depletion

Corp. AMT repeal & NOL limits

- **AMT Repeal:** Corporate alternative minimum tax (“AMT”) is repealed for tax years starting in 2018
- **NOL Limitations:** NOL carrybacks are eliminated but indefinite NOL carryforwards are permitted. NOL deductions may only offset 80% of income.
- **Impact:** NOL limitation offsets AMT repeal benefit
 - For 2018 and beyond, the corporate tax rate for taxpayers generating NOLs is 4.2%
 - Formerly, under the AMT, NOLs could offset 90% of taxable income, resulting in a minimum tax rate of 2%

Corp. AMT repeal & NOL limits

- Impact on transactions:
 - **No Carryback** – inability to carryback NOLs means that NOLs arising from a deal, such as extraordinary compensation payments or other deal-related items cannot be carried back to produce a seller tax-benefit
 - **Indemnities** – inability to carry back a loss of a target company to offset pre-closing tax liabilities may change the structure of certain tax-indemnities

Full expensing of certain property

- Temporary 100% expensing deduction is allowed for the full cost of certain property placed in service before 2023
- The deduction applies for not only new personal property, but also used property and computer software. After 2023, the percentage is phased down over 5 years:

Property Placed in Service Between	Bonus Depreciation/Immediate Expensing
Sept. 1, 2017 and Jan. 1, 2023	100%
Dec. 31, 2022 and Jan. 1, 2024	80%
Dec. 31, 2023 and Jan. 1, 2025	60%
Dec. 31, 2024 and Jan. 1, 2026	40%
Dec. 31, 2025, and Jan. 1, 2027	20%

- **Transactional impact:** buyers in asset sales for tax purposes (whether direct, forward merger, or 338 election) may purchase property at its tax basis and immediately expense the cost, rather than step into the shoes of the seller, inheriting the depreciation deductions that would otherwise have been spread over multiple years

Questions?

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