Law Offices of
ROBERT A. BRISKIN
A PROFESSIONAL CORPORATION

WEBSITE: www.rablegal.com
E-MAIL: rbriskin@rablegal.com

Telephone (310) 201-0507 ▪ Facsimile (310) 201-0588

January 2018

BUSINESS ACQUISITIONS AND MERGERS UNDER THE NEW TAX ACT

The new ***Tax Act*** (the *Tax Act* was originally known as the ñ*Tax Cuts and Jobs Act*ò but for technical reasons the new *Tax Act* dropped this name) modifies how business acquisitions and mergers will be structured.

The following summarizes the *Tax Act's* provisions affecting the merger and acquisition of businesses, along with tax planning strategies. In the next year it is anticipated that the IRS and the Treasury Department will issue guidance and that the Joint Committee on Taxation will issue its ñbluebookò to help interpret these new *Tax Act's* provisions.

California is <u>not</u> expected to consider whether or not to conform Californiaôs tax laws to the new federal *Tax Act* until, at the earliest, the end of 2018. Thus, for at least the next year Californiaôs tax rules will be different than the federal tax rules. Californiaôs income tax rates remain for: the highest individual tax bracket at 13.3%, C corporation earnings at 8.84%, and S corporation earnings at 1.5%. California does <u>not</u> have a lower long-term capital gains tax rate. Additionally, Californiaôs tax rules on the carryback and carryforward of net operating losses differ from the federal tax rules. Political commentators feel California is unlikely to follow many of the federal tax law changes since such conformity would reduce Californiaôs tax revenues. These commentators point out that California requires increased tax revenues to fund Californiaôs state programs and state pension obligations.

The discussion below focuses on those *Tax Act's* provisions which effect mergers, sales and acquisitions of businesses.

1. ***Reduction in the C Corporate Tax Rate Will Encourage the Use of C Corporations.***

The C corporation tax rate is reduced from its former maximum 35% rate to a flat 21% tax rate for tax years beginning after December 31, 2017. The corporate alternative minimum tax has been repealed.

This reduction of the C corporation income tax rate to 21% encourages the use of C corporations for business acquisitions. The double taxation of C corporation earnings is now reduced at the corporate level and at the individual shareholder level. Now C corporate earnings are first taxed at the corporationôs 21% rate, and then when distributed to the shareholders at a 20% maximum qualified dividend income tax rate, plus a 3.8% net investment income tax, for an overall tax on C corporation earnings of 39.8%. In addition to this effective 39.8% federal tax on corporate earnings there is an 8.84% California corporate level tax and a maximum 13.13% California individual tax. The corporation (but not the individual) can continue to deduct California state income taxes against their federal income for federal tax purposes.

The lower corporate tax rate will encourage increased capital investment in U.S. businesses (including by foreign investors) and will encourage an increase in business operations. Also, this lower C corporate tax rate will encourage structuring business acquisitions as asset sales.

The favorable ñqualified small business stockò tax benefits of §1202 for C corporations have been left intact by the new *Tax Act*, making sales of C corporation stock (which qualifies as small business stock) more tax advantageous. Use of §1202 can produce a 100% tax exclusion when the business is sold as well as allowing a tax-free reinvestment of the qualified small stock salesô proceeds. The new lower C corporation tax rate will make §1202 small business stock more tax favorable for startup businesses.

The low current C corporation 21% tax rate will encourage the use of a C corporation as the acquiring entity for a target business (rather than using a pass-through entity as the acquirer). Furthermore, the simplicity of using one single C corporation (with a flat 21% tax rate) may replace the former pass-through entity tax structures of using a partnership with blocker C corporations for tax sensitive partners.

The new *Tax Act* contains limits on the use of debt and the deduction of interest (as discussed below) for a C corporation. Additionally, there are new limits on the use of net operating losses for C corporations. However, the new *Tax Act* does contain tax favorable provisions of increased amortization and expense deductions (as discussed below).

Another consequence of the lower C corporation tax rate is that the value of the target corporationôs deferred tax attributes in a business acquisition is now reduced.

Instead of using a C corporation to own a business, a pass-through entity (such as a limited liability company or partnership) could be the acquiring company or the selling target company, in which case the new 20% qualified business income tax deduction of §199A, discussed below, can be utilized. The decision on whether to use a pass-through entity or a C corporation to own the business will depend in part as to whether there will be a distribution of the companyôs earnings to its owners. If an existing partnership or limited liability company finds that being a C corporation (and the 21% C corporate tax rate) is more tax advantageous then a ñcheck-the-boxò election can be made by that pass-through entity in order to be taxed as a C corporation.

2. ***<u>Utilizing a Pass-Through Entity Allows the Use of the New §199A Twenty Percent (20%) Deduction Against Business Income.</u>***

In deciding whether to use a C corporation or a pass-through entity (such as a partnership, limited liability company or S corporation) as the acquiring entity of the target business you need to consider whether earnings are to be accumulated at the entity level or instead is the goal to immediately distribute earnings to the entity owners. Utilizing a pass-through entity such as a partnership, limited liability company or an S corporation will generally produce a lower combined tax rate on the pass-through of the businessôs earnings then would a C corporation, especially where the new §199A 20% deduction is applied.

Pass-through entities can now obtain a 20% deduction against their qualified business income under new §199A. The result of the new §199A 20% deduction is to reduce the effective federal income tax rate on pass-through entities to 29.6% for individuals in the highest tax bracket. The 29.6% effective tax rate for pass-through entities (such as partnerships, limited liability companies or S corporations) is lower than the 39.8% combined tax (plus Californiaôs tax effect) on earnings of a C corporation at the corporate and shareholder level, when those earnings are distributed to the shareholders in the form of dividends. Thus, a pass-through entityôs effective tax rate of 29.6% is in most cases lower than the combined corporate level tax and shareholder level tax rate on the distributed earnings of a C corporation.

Certain service related businesses may not use this new §199A deduction such as those businesses in the fields of health, law, consulting, brokerage services, athletics, and the performing arts.

This new §199A 20% deduction is only available for trade or business income and is <u>not</u> available for income which is compensation, short-term capital gains, dividends, interest income and other items that might be passive income.

If a pass-through entity is used as the acquirer in a business acquisition then ñblocker entitiesò formed as C corporations can still be the investors in that pass-through entity for tax sensitive partners such as foreign partners or tax-exempt entities.

The new §199A 20% deduction cannot exceed (the **"Threshold Test"**) an amount which is fifty percent (50%) of the partnersô share of the W-2 wages paid to employees by the business. However, there is an alternative Threshold Test (favorable to capital intensive businesses) of using 25% of the partnersô share of wages, <u>plus</u> 2.5% of the ñunadjusted basisò of the entityôs <u>depreciable</u> property (which generally is that propertyôs original purchase price) with certain limitations on when that property was acquired. Only depreciable property is included in this 2.5% calculation, and thus, the tax basis of non-depreciable land is excluded from this calculation. If this Threshold Test amount is equal to or greater than the flat 20% deduction then the pass-through entity gets to use the full 20% deduction. If not, then this 20% deduction is reduced to the Threshold Test limitation. This alternative Threshold Test allows entities owning significant capital assets (such as commercial real estate partnerships) but having few employees to be able to utilize this new 20% pass-through entity deduction.

This §199A deduction is only available until December 31, 2025, at which time this deduction is scheduled to expire unless extended by Congress.

3. ***Reduction in Dividend Received Deduction for C Corporations.***

The new *Tax Act* reduces the dividend received deduction (which is a deduction by a C corporation against dividends that the C corporation receives from another corporation) to a sixty-five percent (65%) deduction on the dividends that the corporation receives from a subsidiary corporation that it owns at least eighty percent (80%) of the stock. If the corporation receiving the dividend owns more than twenty percent (20%) of the subsidiaryôs shares but less than eighty percent (80%) of such subsidiaryôs shares, then this dividend received deduction is reduced to fifty percent (50%). Thus, this reduction in the corporate dividends received deduction creates a higher tax for corporations that want to make distributions to their corporate shareholders.

4. ***New Limitations on the Deductibility of Net Business Interest.***

The *Tax Act* imposes a new limitation on the deductibility of interest. One result of this new interest deduction limitation is that it discourages highly leveraged business acquisitions. Thus, in certain cases the acquiring entity will want to raise capital not by debt, but instead through equity, leases or derivatives.

Even debt incurred prior to January 1, 2018 is covered by this new interest limitation rule, and such pre-2018 debt is not grandfathered. These new interest limitation rules do not apply to taxpayers with average annual gross receipts for the three (3) taxable year period ending with the prior taxable year, of less than $25 million (with rules applied to aggregate the gross receipts of related entities). Interest deductions which are disallowed under these new rules can be carried forward to future taxable years (for which these interest limitation rules will continue to apply).

This interest deduction limitation applies as follows. For tax years beginning after December 31, 2017, the *Tax Act* limits a businessôs net interest expense deduction to thirty percent (30%) of the taxpayerôs ñadjusted taxable incomeò. For taxable years beginning after December 31, 2017 and ending January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for interest, taxes, depreciation, amortization and depletion (known as **"EBITDA"**). Beginning in 2022, depreciation, amortization and depletion are not added back in the computation of adjusted taxable income (known as **"EBIT"**), thus making the 30% interest deduction limitation even stricter. Generally, this limitation on the deductibility of interest is determined at the entity level.

There is a ñreal estate interest exceptionò to this new interest deduction limitation. If a taxpayer (who owns real property) elects to use this real estate interest exception then that taxpayer is limited in its use of more favorable cost recovery rules and will have to amortize their real estate over longer recovery periods.

5. ***New Restrictions on the Use of Net Operating Losses.***

The new *Tax Act* limits the deductibility of net operating losses to eighty percent (80%) of the taxpayerôs taxable income (taxable income determined without regard to the net operating loss deduction) starting in 2018. Unused net operating losses can be carried forward indefinitely, but net operating losses may no longer be carried back. These new rules effect only net operating losses arising for taxable years beginning after December 31, 2017. Accordingly, pre-2018 net operating losses are subject to those tax rules which existed prior to January 1, 2018 (which was that net operating losses could be carried back two (2) years and carried forward twenty (20) years, and offset hundred percent (100%) of the taxpayerôs income).

Since new net operating losses may not be carried back these losses will not be able to be used to offset in a business acquisition the acquired target businessôs taxable income for prior taxable years. Additionally, the acquirer of the target business cannot rely upon using net operating losses to offset tax issues that might arise for taxable years prior to the year in which such net operating losses were created. The result is that the target businessôs net operating losses are not as valuable as they were before the new *Tax Act*.

6. ***Tax-Free Reorganizations.***

The new *Tax Act* did not change the tax-free reorganization rules of §368. The lower corporate level income tax rate of 21% and the ability to expense certain personal property will reduce the tax advantages of structuring a business acquisition as a tax-free reorganization. However, the ability to use §368 to obtain tax-free treatment for the sellers of a corporate owned business will encourage the use of C corporations by persons who may want to sell their business in the future by taking back stock in publicly traded companies.

7. ***With the Expensing of Personal Property, Asset Sales are Now Tax Favored for the Acquiring Entity.***

The new *Tax Act* allows ñbonus depreciationò of one hundred percent (100%) first year depreciation for tangible personal property placed into service between September 27, 2017 and January 1, 2023. Thus, machinery and equipment acquired in a businessôs asset sale can be expensed by the acquirer. These expensing rules allow 100% expensing by the acquirer of the target businessôs machinery, most software, and equipment (including used property). If all of the bonus depreciation cannot be used by the acquirer in the year of the assetsô purchase then a net operating loss is generated which the acquirer can carry forward to future years. This ability to expense personal property does not apply to the target companyôs goodwill and intangible property, which still must be amortized over fifteen (15) years under §197.

These new bonus depreciation rules make it more tax advantageous for the acquirer to structure a business acquisition as an asset purchase. However, the selling target entity will still have recognized gain on the sale of its personal property and other assets. Furthermore, an asset sale could impose a state sales and use tax as to certain assets.

The acquiring entity will want to consider utilizing the §338 and §336(e) tax elections in a stock purchase in order to produce the tax effect of an asset purchase. These provisions will create a deemed asset sale and a step-up in the income tax basis of the target corporationôs assets. On the other hand, there will be a taxable recognition of gain on such a tax election. Potentially, this recognized gain can be reduced by either net operating losses or by expensing newly acquired property.

There are provisions for phasing out the bonus depreciation rules between January 1, 2023 and December 31, 2026, which then subjects such personal property to only partial expensing.

The new *Tax Act* also increases the ability to expense qualifying property under §179 (rather than capitalizing and depreciating the cost of such property). This §179 expensing provision increased the expensing limitation to $1 million, with a phase-out at $2.5 million. In other words, the $1 million amount is reduced by the amount which the qualifying property placed in service during the tax year exceeds $2.5 million. Both of these dollar amounts are indexed for inflation starting in 2018. This new §179 provision applies to property placed in service beginning after December 31, 2017. This expensing has been expanded to personal property in connection with lodging (such as beds and furniture) and in some cases taxpayers can use this provision for roof replacements, HVAC systems, fire protection, and security systems.

8. ***Sale of Self-Created Intellectual Property Rights is Ordinary Income.***

When patents, inventions, designs, copyrights, literary, musical or artistic composition rights created by the personal efforts of a taxpayer are sold, that saleôs gain will be ordinary income and not long-term capital gain, under new *Tax Act's* §1221(a)(3). Thus, sales of these patents or intellectual property rights by the taxpayer that created such property (or by the transferee who acquired such asset in a carryover basis from the taxpayer) will generate ordinary income.

9. ***New Tax Act Changes the Taxation of Carried Interests of Partnerships and Limited Liability Companies.***

Partnerships (which also includes limited liability companies) used in business acquisitions often have ñwaterfallò distributions of income, in which the manager, general partner or promoter receives a promotional or service partnership interest without having contributed any capital to that partnership.

The promotional interests in the partnership or limited liability company are referred to as ñprofits interestsò or ñcarried interestsò. The *Tax Act* requires in new §1061 that partnership interests issued in connection with the performance of services (a so called **"carried interest"**) be held for at least three (3) years in order for such partnership carried interest to receive favorable long-term capital gain treatment when the promoterôs partnership interest is sold. The new carried interest rules of §1061 will cover promoters of funds that do business acquisitions.

This three (3) year holding period requirement applies regardless of whether an election under §83(b) with respect to the partnership interest has been made, or whether the recipient of the carried interest included an amount in income when the interest was received.

The new §1061 carried interest provision was targeted at investment fund managers. Thus, the types of ownership interests that are <u>excluded</u> from the new §1061 carried interest rules are a: partnership interest which is a capital interest in that partnership, a partnership interest which is owned by a corporation (which as §1061 reads also <u>excludes</u> an S corporation owned partnership interest), and a partnership interest owned by certain company employees that provide services only for such company.

In summary, unless the requisite three (3) year hold period is met the new carried interest rule <u>denies</u> long-term capital gain tax treatment to a promotorôs or managerôs disposition of its partnership interest or upon the partnershipôs sale of the underlying asset (where that underlying asset is owned less than the three year hold period). If long-term capital gain treatment is denied under this new §1061 carried interest rule, then the promoterôs or managerôs income from the partnershipôs sale of its property is taxed at higher short-term capital gain rates.

> **EXAMPLE:** A managing partner contributes no capital, but only services, to a newly created partnership doing business acquisitions, while the investor partners contribute $50 million of cash to this partnership. The partnership then purchases a manufacturing business for $60 million (using the $50 million of the investor partnersô capital contribution and $10 million of debt borrowed from a bank). Two years later the partnership sells the manufacturing company for $80 million. Under the terms of the partnership agreement, the $10 million of debt is repaid to the bank and the first $50 million of net sales proceeds are distributed to the investor partners, and the remaining $20 million of net sales proceeds ($80 million less $60 million) is split and distributed fifty percent (50%) to the managing partner ($10 million) and fifty percent (50%) to the investor partners ($10 million). The tax result under the new §1061 carried interest rules is that the managing

partner is taxed at short-term capital gains rates on its received $10 million, while the investor partners are taxed at lower long-term capital gains rates on their received $10 million.

10. ***Restrictions Continue on the Use of Guarantees and the Pledges of Stock of Controlled Foreign Corporations.***

The new *Tax Act* continues the income recognition provisions that if a controlled foreign corporation guarantees the financing of a U.S. borrower or pledges its stock in order for such U.S. borrower to obtain acquisition financing, then income will be recognized. Accordingly, U.S. borrowers and their affiliates should not look to controlled foreign corporations to provide guarantees or to provide credit support for their borrowings.

11. ***Repatriation of the Earnings of a U.S. Corporation's Foreign Subsidiaries.***

After 2017 only corporate income earned in the U.S. will be subject to U.S. tax and dividends from foreign subsidiaries will generally be exempt from tax. The new *Tax Act* creates a territorial tax system so that in the future U.S. corporations can exempt out the foreign source portion of dividends received from foreign corporations where the U.S. corporations own at least 10% of the foreign corporation's stock.

The retained earnings of U.S. corporations' foreign subsidiaries for the 2017 year will be subject to a one-time "repatriation" tax of 8% for noncash equivalent property and 15.5% for cash or cash equivalent assets, whether or not such retained earnings are actually distributed to the corporate parent. This is a significant reduction from current tax rates and is designed to encourage corporations to bring assets back into the United States.

12. ***Changes to How Foreign Partners of U.S. Partnerships are Taxed on the Sale of Their Partnership Interests.***

The new *Tax Act* changes the way that foreign partners are taxed on their sale of a U.S. partnership interest.

Under tax rules existing <u>prior</u> to the 2017 Tax Court's ***Grecian Magnesite Mining Co.*** decision gain or loss on the sale by a foreign partner of its U.S. partnership interest was generally treated as income effectively connected with the conduct of a U.S. trade or business and accordingly, such effectively connected income was taxed to such foreign partner. The ***Grecian Magnesite Mining Co.*** case reversed this tax result and held that such foreign partner's partnership interest sale income was <u>not</u> connected with the conduct of a U.S. trade or business.

The *Tax Act* repeals the ***Grecian Magnesite Mining Co.*** result and states that now a foreign partner selling an interest in a U.S. partnership which engages in a U.S. trade or business, will have the gain on the partnership interest sale treated as effectively connected income from the conduct of a U.S. trade or business and taxed. Additionally, beginning in 2018 the buyer of the foreign partner's partnership interest must withhold 10% of the amount realized in connection with the sale of that partnership interest.

Foreign partners who disposed of their U.S. partnership interests prior to November 27, 2017 can still try to take advantage of the favorable tax result in the ***Grecian Magnesite Mining Co.*** Tax Court case.

Nothing in this Newsletter shall be deemed legal or tax advice as to any person, transaction or as to any estate plan. Please feel free to contact Robert A. Briskin if you have any questions as to items in this Newsletter.