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2017 New Tax Law: Business Tax Reform—Impacts on Corporations and Portfolio Companies

*This client alert is part of a special series on the Tax Cuts and Jobs Act and related changes to the tax code, where Blank Rome's lawyers share their analysis of different provisions in the Act and how they may affect you and your business, along with specific action items. To see the full list of client alerts in this series, please click **here**.*

On December 22, 2017, the president signed into law the Tax Cuts and Jobs Act of 2017 (the "Act"), which represents one of the most extensive modifications to the U.S. tax code in recent history, significantly modifying U.S. taxation for individuals and businesses. This client alert, which focuses on C corporations[1] and the impacts on structuring and financing M&A transactions, is one in a series that will address significant changes to the federal business tax regime. In the upcoming weeks, we will publish additional client alerts of interest to businesses that will focus on pass-through entities and businesses with international operations.

The summary below is general in nature. The impacts of the Act vary on a taxpayer by taxpayer basis, as well as on an industry basis. In addition, these rules are complex and leave many questions unanswered, leaving businesses to make reasoned interpretations pending further guidance from the Internal Revenue Service and the Treasury Department. You should contact us to determine how these rules apply to your business and to discuss tax planning opportunities.

LOWER CORPORATE TAX RATE AND REPEAL OF CORPORATE ALTERNATIVE MINIMUM TAX ("AMT")

Under pre-Act law, corporations were subject to graduated income tax rates, with the highest rate being 35 percent for corporations with taxable income greater than $10 million. For tax years beginning after December 31, 2017, the Act permanently reduces the corporate income tax rate to 21 percent for all corporations and eliminates the corporate AMT. Corporations with AMT credit carryforwards may be entitled to refunds in tax years beginning after 2017 and before 2022. As a result of the reduced tax rate, the dividend received deduction ("DRD") is also reduced.[2]

1. Unless otherwise noted, all references to corporations contained herein are to C corporations. S corporations will be addressed in greater detail in the business tax installment on pass-through entities.

2. The DRD is a corporate deduction with respect to dividends received from other taxable domestic corporations. Under prior law, the DRD was generally equal to 70 percent of the dividend received, 80 percent if received from corporation in which it holds a 20 percent interest, and 100 percent if received from another member of the corporation's affiliated group. The Act reduces the 70 percent and 80 percent DRD rates to 50 percent and 65 percent, respectively.

Although the Act provides that certain pass-through entities may be entitled to up to a 20 percent deduction for qualified business income (the "Qualified Business Income Deduction"),[3] the sizeable reduction in the corporate income tax rate, the repeal of the corporate AMT, and various other provisions of the Act, including the uncapped corporate deduction for state and local taxes, may make it more attractive to operate a business as a corporation. For example, although corporations are subject to "double taxation" (i.e., a tax at the corporate level and potentially at the shareholder level), converting a business to a corporation may be attractive to owners who do not intend to pay dividends in the short term and/or will invest any earnings directly back into the business.

Business owners should revisit their choice of entity (i.e., corporation versus a pass-through entity) in light of all of the changes to the business tax regime. Similarly, private equity sponsors should consider whether, in light of the various changes in the Act, it is more advantageous to make portfolio investments through fully-blocked structures versus through pass-through structures with upper-tier blockers. This will depend on numerous factors, including the tax status of the fund's limited partners, tax attributes of the target and the anticipated structure and timing of the investment exit.

INTEREST EXPENSE DEDUCTION

Under prior law, subject to a number of limitations, interest paid or accrued by a business generally was deductible. Section 163(j)[4] could disallow a deduction for disqualified interest paid or accrued by a corporation in a tax year if: (1) the payor's debt-to-equity ratio exceeded 1.5 to 1.0 (the safe harbor ratio); and (2) the payor's net interest expense exceeded 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under Section 199, depreciation, amortization, and depletion).

The Act, however, expanded Section 163(j), with significant impacts on private equity funds and highly leveraged businesses. All businesses (not only corporations) are now subject to a disallowance of a deduction for net interest expense in excess of 30 percent of the business's adjusted taxable income, which generally, for tax years beginning before January 1, 2022, is equal to EBITDA, and for tax years beginning on or after January 1, 2022, is equal to EBIT (likely further limiting interest expense deductions).[5] Any disallowed business interest expense can be carried forward indefinitely. Unfortunately, debt existing prior to the enactment of the Act is not grandfathered.

With this new limitation on interest expense in place, business owners, particularly private equity funds, will need to carefully evaluate the methods by which they finance the acquisition and operation of their businesses. For example, it may be more advantageous for corporations caught by this limitation to consider alternative forms of financing outside of debt, such as preferred stock. Similarly, multinational groups may consider issuing more of their debt abroad. Of course, with the overall lower corporate tax rate, the effect of this limitation may be mitigated on a net basis. Nonetheless, due to the lack of grandfathering, any business subject to these limits should project its adjusted taxable income, and revise its financial models accordingly.

NET OPERATING LOSSES ("NOLS")

Under prior law, corporations were generally allowed to carry back NOLs two years and carry forward NOLs twenty years to offset taxable income in such years.

3. The Qualified Business Income Deduction is beyond the scope of this summary. It will be covered in greater detail in the business tax installment on pass-through entities. However, it should be noted that (1) not all taxpayers are eligible for the Qualified Business Income Deduction, and (2) unlike the changes to the corporate income tax rate, which are permanent, the Qualified Business Income Deduction does not apply to taxable years beginning after December 31, 2025.

4. All Section references contained herein are to the Internal Revenue Code of 1986, as amended.

5. There are exemptions to these rules, including for taxpayers (other than tax shelters) with average annual gross receipts for the three-tax year period ending with the prior taxable year that do not exceed $25 million. In addition, certain businesses, including some real property businesses, may be eligible to elect out of the provision.

Under the Act, for NOLs generated in tax years ending after December 31, 2017, the two-year carryback period is repealed (except for certain farming and insurance company NOLs), but such NOLs can be carried forward indefinitely. However, NOLs generated in tax years beginning after December 31, 2017 may only be used to offset 80 percent of taxable income (determined without regard to the NOL deduction).[6]

While the indefinite carryforward period is a boon for corporations, loss corporations and investors who wish to acquire loss corporations for their NOLs should keep in mind that due to the reduced corporate tax rates, tax assets, including NOLs, are now less valuable.

Further, due to the 80 percent limitation as discussed above, pre-2018 NOLs are now more valuable than those NOLs that are generated after December 31, 2017. Corporations with pre-2018 NOLs should explore opportunities to preserve such NOLs.

These changes to the NOL rules have significant impacts on M&A transactions. Sellers, who try to monetize their transaction tax deductions (which are less valuable under the Act as a result of the reduced corporate income tax rate), may no longer carry back the associated NOLs to tax years prior to the year of the transaction. This could impact, among other things, the consideration received by sellers, the valuation of the corporate target, and/or the timing of transactions. Conversely, a buyer may not be able to rely on the NOLs associated with transaction tax deductions to offset tax exposures in prior tax periods, and this may impact the tax indemnities. Buyers and sellers will need to consider these changes in the context of a transaction.

INCREASED "BONUS" DEPRECIATION AND SECTION 179 EXPENSES

Under pre-Act law, taxpayers were entitled to an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property[7] acquired and placed into service before January 1, 2020.[8] The 50 percent allowance was phased down for property placed into service after December 31, 2017 (50 percent, 40 percent, and 30 percent for property placed into service in 2017, 2018, and 2019, respectively). This additional depreciation was not available for used property.

The Act, however, increases the 50 percent allowance to 100 percent for qualified property acquired and placed into service after September 27, 2017 and before January 1, 2023[9] and now applies to both new and used qualified property. The 100 percent deduction is phased out by 20 percent each year for qualified property placed into service after December 31, 2022 until it is phased out completely for property placed into service after December 31, 2026.[10]

In addition, the Act expanded the ability of a taxpayer to elect under Section 179 to expense the cost of qualifying property (generally certain equipment and computer software used in the active conduct of a trade or business), rather than to recover such costs through depreciation deductions. Given the limitations discussed below, the benefits of Section 179 are designed for small and mid-sized businesses.

Under prior law, the maximum amount that a taxpayer could expense under Section 179 was $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 was reduced (but not below zero) by the

6. Insurance companies, however, are not subject to the 80 percent limitation.
7. Property qualifying for the additional first-year deduction must be: (1) property with a MACRS recovery life of 20 years or less; (2) water utility property; (3) computer software other than computer software covered by Section 179; or (4) qualified improvement property.
8. This was extended to January 1, 2021 for certain property with longer production periods.
9. The placed in service period for certain property with longer production periods (e.g. aircraft or transportation property) is expanded to after Sept. 27, 2017, and before Jan. 1, 2024.
10. The beginning and end dates of the phase-out period for certain property with longer production periods is increased by one year.

amount by which the cost of qualifying property placed into service during the taxable year exceeds $2 million. Under the Act, for property placed into service in tax years beginning after December 31, 2017, the maximum amount that a taxpayer may expense under Section 179 is increased to $1 million and the phase-out threshold is increased to $2.5 million. The $1 million maximum amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed into service during the tax year exceeds $2.5 million. As was the case under prior law, the $1 million maximum expense amount and the $2.5 million commencement of the phase-out are indexed for inflation for tax years beginning after 2018.

Both of the above provisions in the Act related to depreciable property are considerably favorable to taxpayers. Moreover, in the M&A context, a buyer could immediately deduct the costs of certain assets acquired from a third party. Consequently, buyers and sellers should explore ways to structure transactions as actual or deemed (pursuant to Section 338 or 336) asset acquisitions in a mutually beneficial manner. However, buyers should be mindful of the changes to the interest deduction rules, particularly with respect to tax years beginning on or after January 1, 2022, when assessing the value of bonus depreciation.

CARRIED INTERESTS

In addition to the changes described above and numerous other provisions described in other installments of this series, the modifications to the taxation of carried interests contained in the Act impact private equity funds and other investment managers.

For tax years beginning after December 31, 2017, capital gains allocated to a carried interest (a partnership interest held by a fund sponsor that entitles the sponsor to a share of partnership profits that is greater than the sponsor's percentage interest in the partnership) are eligible for long-term capital gain treatment only if the underlying investment/capital asset was sold by the fund after a holding period of more than three years (instead of one year under prior law). This three-year holding period applies regardless of whether a Section 83(b) election has been made with respect to the carried interest. If the underlying investment/capital asset is sold by the fund after a holding period of three years or less, the gain allocated to the carried interest is subject to federal tax rates applicable to ordinary income and short-term capital gains. Unfortunately, there is no grandfathering of previously issued partnership interests.

Although fund sponsors should be mindful of these provisions and monitor additional guidance, the Act did not go as far as the various legislative proposals put forth over the past few years, which would have treated all of the gains allocable to the carried interest as ordinary income.

While this client alert focuses on the most significant changes to the corporate tax regime, there are numerous other provisions in the Act that will impact corporations and private equity funds.

Clients who would like more information about their specific circumstances should contact a member of Blank Rome's Tax, Benefits, and Private Client practice group.

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