AICPA/FMS: Securities Industry Conference Tax Panel

October 17, 2018

2017 Tax Reconciliation Act – Observations

	Tax Reform Act of 1986	Public Law 115-97
Overall Budget Impact	Revenue-neutral over budget window	Net loss of $1.46 trillion over budget window
Distributional Impact	Distributionally neutral over budget window	Variation in distribution at all income levels, changing markedly over budget window (due largely to sunsets)
Breadth of Political Support	Broad Final Passage: 74-23 in Senate; 292-136 in House	Narrow Zero Democratic support at any stage of process
Date of Introduction	December 3, 1985	November 2, 2017
Date of Enactment	October 22, 1986	December 22, 2017
Release of JCT Bluebook	May 15, 1987	??

“Tax Reform 2.0” and other tax priorities

- Protecting Middle-Class and Small Business Tax Cuts
  - Make permanent 2017’s individual tax changes, including new brackets/rates, doubled standard deduction and child tax credit, and deduction for passthrough entities (§199A)
    - CBO estimated cost = $650bn over 10 years
    - JCT macroeconomic “dynamic” cost = $545bn over 10 years
- Promoting Family Savings
  - Universal Savings Accounts, a “fully flexible savings tool”
  - Expanded 529 education accounts
  - New “baby savings,” allowing retirement accounts to be tapped (and later replenished) penalty-free for new child expenses
- Spurring New Business Innovation
  - Allow new businesses to write off more of their start-up costs
  - “Remove barriers to growth” for start-ups
- Also includes permanent extension of SALT cap and other revenue-raising provisions from the Tax Act
- House approved all three bills in late September

Still waiting on technical corrections

Technical Corrections

- **By precedent are technical and/or conforming in nature (*i.e., non-substantive*)**
- **Reflect intent of drafters, so CBO/JCT generally assign no budget impact**
- **Signed-off on by chair and ranking member of Finance and W&M, as well as JCT and Treasury (*a high hurdle this year*)**
- **No budget impact, so cannot move under filibuster-proof budget reconciliation process (*need 60 votes in Senate*)**

2017 Tax Act Overview

A. Overview of Major Domestic Tax Reform Provisions

- Tax Rates
  - 21% corporate tax rate
  - 37% top marginal individual tax rate (some additional tax rate reductions and exemption benefits for income in lower brackets)
  - 20% deduction for qualified business income to individuals (directly or through “flow-through” entities)

- Individuals: Principal amounts qualifying for mortgage interest deduction reduced to $750,000

- Individuals: State and local tax deduction limited to $10,000

- Businesses: Investments in depreciable property eligible for 100% expensing
  - N/A to real estate

Overview of Major Domestic Tax Reform Provisions

- Businesses interest expense deductions limitations:
  - Applies only to “Business” interest expense
  - Applies only if Taxpayer has net business interest expense (business interest expense in excess of interest income)
  - Disallowance amount equals net business interest expense in excess of 30% EBITDA
  - Disallowed interest expense can be carried forward and used in subsequent years (when limitations are no longer applicable based on future income and debt levels)
  - For partnerships, the interest expense disallowance is determined at the partnership level
  - In 2022, the 30% of EBITDA limitation is changed to 30% of EBIT
- Net Operating Losses (NOLs)
  - For post-enactment NOLs, there are no longer any carry-backs of NOLs, and the use of NOL carry-forwards is limited to 80% of pre-NOL taxable income in the year of use
- Opportunity Zones: Tax incentives for long-term investments in economically distressed communities.

B. Overview of Major International Tax Reform Provisions

- Deemed Repatriation from foreign subsidiaries:
  - There is a one-time, taxable deemed repatriation of accumulated earnings of foreign subsidiaries (as if repatriated to their US Parent Companies).
  - For financial services firms, the accumulated earnings of foreign subsidiaries are typically invested in liquid assets, which causes the earnings to be taxed at a 15.5% tax rate, with a portion of the underlying foreign taxes being available to reduce the cost of the repatriation tax, via foreign tax credits.
  - This deemed repatriation tax has prompted many companies, across many industries, to actually repatriate cash to the US, because there is no incremental US tax for actually repatriating
  - Actual repatriations are expected to be used in numerous ways: US Parent Company debt pay-downs, dividends, share buy backs, new facilities, acquisitions, new hires

Overview of Major International Tax Reform Provisions

- BEAT:
  - An alternative “Base Erosion Anti-Abuse” (BEAT) tax applies only to certain US Companies with substantial expenses paid to foreign affiliated entities
    - Particularly concerning for Foreign-based Companies with US subsidiaries, where the Foreign Parent Company has provided debt funding to the US subsidiary group
- GILTI:
  - Global Intangible Low-Taxed Income (“GILTI”): Going forward, US Companies with foreign subsidiaries are annually required to include in US taxable income that portion of their foreign subsidiary’s earnings which constitutes GILTI income. For financial services firms, it is typical that the earnings of foreign subsidiaries is entirely GILTI income. Due to availability of foreign tax credits and other factors, if the average foreign tax rate on the combined earnings of all foreign subsidiaries exceeds 13.125%, there would generally be no incremental US taxes incurred on the annual GILTI income inclusion.

C. Key Tax Reform Provisions: Before and After Snapshot

Before	After
35% corporate tax rate	21% corporate tax rate
39.6% top individual tax rate	37%, or 30% for qualified business income
No limit on state and local tax deduction for individuals	Deduction capped at $10,000
Depreciation over specified lives	100% expensing (not for real estate)
Interest Expense: Largely deductible	Net interest expense limited to 30% of EBITDA
NOL’s: carry back and carry forward	Carry forward only, usage limited to 80% taxable income
Defer tax on foreign subsidiary earnings	One-time deemed repatriation tax, which permits actual repatriation
	Other New Provisions: GILTI, BEAT, Opportunity Zones

Industry Implications: How Does the Act Impact You

What Does This Mean For Business?

- We are seeing an increase in M&A activity.

- Importantly we are seeing an increase in “creative” M&A activity which takes advantage of pre-existing tax code provisions (e.g., qualified small business stock) and planning around new limitations (e.g., interest expense limitation under IRC Sec. 163(j)).

- We are also seeing enormous interest in qualified opportunity zones – an enormous tax benefit, but requires careful planning (discussed further).

TCJA – Impact on C-Suite and Investors

- Asset acquisitions even more appealing due to bonus depreciation.
- Creation of “fresh” NOLs that can be carried forward indefinitely is an additional driver in deals.
- In asset purchases, incentive to push allocation of purchase price to hard assets.
- Lower tax rate makes U.S. competitive globally. Will we see migration of foreign operations and manufacturing to the U.S.? Will we see increased foreign investment?

M&A Impact - Section 163(j)

- **<u>The Old Section 163(j</u>**): imposed limitations on the ability to deduct interest expense. Prior limitations based on debt/equity ratios, amount of taxable income, and relationship between parties. Effectively repealed.

- **<u>The New Section 163(j)</u>:** applies to any debt outstanding on January 1, 2018 – there is no grandfathering of debt incurred prior to this date. The focus is on **business interest** expense.
  - Applies to all taxpayers and all debt.
    - Domestic and foreign.
    - Individuals, C corporations, S corporations, REITs and partnerships.
    - Applies to both related party debt and debt with third parties.
  - <u>The Limitation</u>: for any taxable year, the interest expense deduction (paid or accrued) for a taxpayer is limited to the sum of three components:
    - All "business interest income" plus;
    - 30% of **"adjusted taxable income"** (discussed on next slide); plus
    - All "floor plan financing interest."
  - <u>Excluded Trades or Businesses</u>:
    - Real property trade or business has the option to elect out of Section 163(j). The election is irrevocable.
      - Trade-off: election requires usage of longer depreciation periods (ADS).
    - Certain regulated public utilities
    - Small business (i.e., taxpayers meeting the three-year $25 million gross receipts test of Section 448(c)).

M&A Impact – 163(j) (continued)

- **<u>Adjusted Taxable Income</u>**

  - The method of calculation will be different for taxable years beginning after December 31, 2021.

  - **For tax years beginning before January 1, 2022**: adjusted taxable income is calculated under general tax principles (instead of GAAP), but the following items must be added back:
    - Items of income, gain, deduction, or loss not properly allocable to a trade or business;
    - Business interest income and expense;
    - NOL deductions;
    - The 20% deduction under Section 199A (if applicable);
    - Depreciation, amortization or depletion deductions.

  - **For tax years beginning after December 31, 2021**:
    - Same addbacks as above, **except taxpayers cannot add back depreciation, amortization or depletion deductions**.
    - Adjusted taxable income will likely be a lower number for this period.

M&A Impact – 163(j) Buy-Side and Sell-Side Considerations

- **<u>Buy-Side Considerations</u>**:
  - Regardless of choice of entity (flow-through versus corporation), debt financing as part of acquisition is now less attractive under the new Section 163(j).
    - The lower corporate tax rate does mitigate the brunt of any potential interest expense deduction disallowance.
  - Once again, tax modelling critical to comparing choice of entity if debt financing will be utilized for mergers and acquisitions.
    - 5-10 year investments must incorporate the limitation calculation change that will occur for taxable years beginning after December 31, 2021.
      - Depreciation, amortization, etc. will no longer be available as an addback to increase adjusted taxable income for Section 163(j) purposes (i.e., lower adjusted taxable income → lower 30% limit → potentially more interest expense disallowed).

M&A Impact – 163(j) Buy-Side and Sell-Side Considerations

- **<u>Buy-Side Considerations</u>**:
  - Alternatives to explore may include leasing scenarios, equity financing, interest equivalents, or usage of the real estate trade or business exclusion (or other available exception).
  - Significant impact on cross-border mergers and acquisitions.
    - Multinational structures may consider alternative jurisdictions to originate debt in their structures. The U.S. will not be as attractive to originate debt, particularly for tax years beginning after December 31, 2021 when the limitation becomes more stringent.
- **<u>Sell-Side Considerations</u>**:
  - Sellers may experience less opportunities to finance buyers (e.g., accept a note).
  - Any financing should continue to be arm's-length.

M&A Impact – Bonus Depreciation

- For property placed in service after Sept. 27, 2017, and before Jan. 1, 2023, 100% expensing.
- For property placed in service after Dec. 31, 2022, and before Jan. 1, 2024, 80% expensing.
- For property placed in service after Dec. 31, 2023, and before Jan. 1, 2025, 60% expensing.
- For property placed in service after Dec. 31, 2024, and before Jan. 1, 2026, 40% expensing.
- For property placed in service after Dec. 31, 2025, and before Jan. 1, 2027, 20% expensing.

- **TCJA eliminates the requirement that the original use of the qualified property commence with the taxpayer.**

- **Opportunity to create “fresh” NOLs not subject to limitations of legacy NOLs.**

M&A Impact – Bonus Depreciation – Proposed Regulations

- Elaborates on the requirements related to eligible property.
- Taxpayers can elect out of 100% bonus depreciation and opt for 50% bonus depreciation (but the election has to be made across the board for all property).
- Provides clarity as to what is considered “used” property for bonus depreciation purposes. For example, property previously used by taxpayer themselves may be eligible if the taxpayer did not have a depreciable interest in the property (taxpayer leased the property with a purchase option will be eligible).

M&A Impact – Bonus Depreciation – Qualified Improvement Property

- Qualified Improvement Property (“QIP”) is not eligible for 100% bonus depreciation. Example of QIP is interior improvements to buildings.

- Tax community believes that this is a legislative error or oversight (it simply does not make sense that QIP should be subject to longer bonus depreciation periods (e.g., 27.5 for residential property and 39 years for commercial property)).

- Proposed regulations pertaining to bonus depreciation did not address this supposed oversight.

- Taxpayers will have to wait for a technical correction.

M&A Impact – Stock versus Asset Acquisition – Buy-Side Considerations

- **STRATEGY**: is it better to structure a transaction as a stock or assets transaction under TCJA?

  - Corporate Buyer: value of step-up in basis now reduced due to lower corporate tax rate.

  - Pass-Through and Individual Buyer(s): value of step-up virtually unchanged as highest individual tax rate reduced slightly from 39.6% to 37% (apart from state income tax and NIIT where applicable).

  - Deal Driver: Bonus depreciation is 100% (with phase-out) and now applicable to previously used property (specifically depreciable tangible property).
    - This provides opportunity to create “fresh” NOLs for Buyer.

M&A Impact – Stock versus Asset Acquisition – Buy-Side Considerations

- **NOLs**:
  - Post-TCJA NOLs (NOLs that are created after 2017) are subject to an 80% limitation. **Legacy pre-TCJA NOLs are not subject to this limitation.**
  - Buyer can immediately expense previously used tangible property.
  - NOLs continue to be subject to potential Section 382 limitations (where applicable).
  - Buyer must consider that NOLs cannot be carried back. Buyer should be mindful of any unresolved tax controversies for a prior year.
    - **Illustration**: Target is acquired in February 2018. Target's federal audit for 2017 corporate income tax audit is open at the time of acquisition. No indemnification agreement. Audit closes in October 2018 with $1M adjustment for 2017. NOLs cannot be carried back to offset.

TCJA – Qualified Opportunity Zones - Background

- Program created through 2017 Tax Cuts and Jobs Act
- Internal Revenue Code Sec. 1400Z
- Intended goal is to utilize market unrealized gains to spur economic growth in certain areas

TCJA – Qualified Opportunity Zones - Background

- Zones have been designated in all 50 states, 5 territories, and Puerto Rico
  - ❑ Federal list of designated Opportunity Zones are available at: CDFI Fund
  - ❑Most states have websites and maps of their designated Opportunity Zones
    - –New York
    - –New Jersey
    - –California
- Taxpayers will receive potentially significant tax benefits
- Subject to further Treasury guidance

TCJA – Deferral and Step-Up of Gains

STEP 1: GAIN DEFERRAL

1. Gain from an "unrelated" party sale or exchange of property
2. Investment in a QOF within 180 days of the sale or exchange of property
3. Gain is deferred until sale of the QOF interest or December 31, 2026, whichever is sooner

TCJA – Deferral and Step-Up of Gains

STEP 2: BASIS ADJUSTMENT

TOTAL 15% REDUCTION OF DEFERRED GAIN

10% REDUCTION OF DEFERRED GAIN

QOF interest is held for **5 years** prior to sale or December 31, 2026

ADDITIONAL 5% REDUCTION OF DEFERRED GAIN

QOF interest is held for **7 years** prior to sale or December 31, 2026

TCJA – Deferral and Step-Up of Gains

STEP 3: FMV Basis Election

NO FEDERAL TAXABLE GAIN ON APPRECIATION OF THE INVESTMENT

Investment in a QOF is held for at least 10 years

What Can We Expect in 2019?

How might the legislative landscape change next year?

- The 2020 race for the White House can now officially begin
- Tax technical corrections possible in the “lame duck” session; Democrats will want sweeteners such as extenders, or maybe other targeted changes
- If Democrats win at least one congressional chamber, President Trump’s personal tax returns could be scrutinized by Ways & Means and made public
- Will President Trump try to make deals with Democrats on issues of overlapping interest (trade, prescription drug pricing, infrastructure)? Or are we in for two years of gridlock?
- Debt limit needs to be raised in 2019 – could be especially challenging with a divided government
- Spending relief from sequester will also be a top priority