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Corporate tax changes under the Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act made major changes to the corporate income tax, including a dramatic rate cut from almost 40% to 21%.

This article, third in a series on the effects of the Tax Cuts and Jobs Act, reviews the corporate tax changes, with particular focus on the impact of the changes on choice of entity and purchase and sale of businesses.

You have seen the headlines: Corporate tax rates slashed! The changes are indeed historic. The old U.S. combined rate of 38.9% was the highest among OECD nations. The new rate of 21% places the U.S. below the OECD average of 23.75%.

In addition, unlike the individual alternative minimum tax, the corporate alternative minimum tax is repealed.

Further, unlike many of the changes for individuals and pass-through entities, the rate change is permanent.

At the same time as these changes to the corporate tax rate, numerous changes were made to the tax base.

First and foremost, 100% of new and used tangible assets acquired for a business can now be expensed in the year placed in service. This expands bonus depreciation to used assets that are new to the taxpayer. This 100% bonus appreciation began on Sept. 27, 2017 and begins to phase out in 2023 or 2024.

At the same time, the ability to deduct interest is limited for large businesses. The deduction is now capped at 30% of the taxpayer's adjusted taxable income for the year. The

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amount of business income that is not allowed as a deduction is carried forward to future years.

Of note, the limitation on the deduction of business interest and the 100% expensing are linked. The legislative history indicates Congress's view was that a taxpayer should not be able to buy an asset with borrowed money, deduct 100% of the value of the asset, and then deduct the interest on the money borrowed to buy it. (Some tax gambits are too much even for Donald Trump!)

The rules for net operating losses are also changed significantly. The deduction for net operating losses is now limited to 80% of taxable income for losses arising in future tax years. Losses can now be carried forward indefinitely, instead of the 20 years under prior law, but they cannot be carried back.

What are the implications of the change in rates for choosing an entity for a new business?

To analyze this issue, I turned to my colleague, Diana Clarkson, who is an engineer turned tax attorney with a mathematical bent.

Diana's calculations reveal that notwithstanding the decreased corporate rate, pass-through entities still produce a lower tax burden. The results are striking: an effective federal tax rate of 39.8% applies to moneys earned and distributed by a C corporation, where the pass-through rate is a mere 29.6%. The pass-through is clearly superior. (Note that all of Diana's calculations assume a 37% marginal individual tax rate, and that all pass-through income is qualified business income. They ignore state taxes.)

These computations, however, assume that all income is flushed out of the business. That is not necessarily the case. For example, businesses may reinvest their earnings to generate growth.

If all earnings are left in the C corporation, the tax rate is 21%. However, for a pass-through, the same 29.6% marginal rate would apply whether or not the earnings are reinvested. If all the cash is kept in the business, the corporation is the clear winner.

Most businesses likely fall somewhere in between these two models, so the specific circumstances will need to be analyzed to determine the optimal form of entity.

There may also be non-tax reasons that favor the choice of one business entity over another. Many institutional investors, for example, often prefer to invest in C corporations.

The changes in bonus depreciation also have implications for corporate acquisitions. Specifically, it is now possible to expense 100% of property acquired in a corporate acquisition other than intangible property. This creates significant advantages to asset acquisitions (or deemed asset acquisitions)—especially for targets with significant tangible property.

The buyer of such a company will be able to immediately deduct all of the purchase price allocated to tangible property. In contrast, if the buyer purchased the stock of the business, none of the purchase price would be deductible.

However, for the seller a stock purchase is generally more advantageous. The seller simply has taxable gain equal to the difference between basis and proceeds from the sale. In contrast, in an asset purchase followed by liquidation, the seller would pay tax at the corporate level and then again on the liquidating distribution. Even with reduced corporate rates, the two layers of tax are more costly.

The question for each sale is whether it is worth it for the buyer to pay the seller the difference in tax arising from an asset deal in order to be able to fully depreciate the purchase price. This will depend on the economics of the specific deal.

The world of corporate tax has been turned upside down by the recent law changes. Long-held assumptions about choice of a business entity and deal structuring have been altered. In addition, the annual tax returns of a company may look very different.

In general, these changes are favorable to corporations but, as with any change in the law, there are winners and losers. There is only one piece of general advice I can offer: Consult your tax lawyer!

Joshua E. Gewolb is a tax partner at Harter Secrest & Emery LLP. His colleague Diana Clarkson contributed to this article.