

THE NEW TAX LAW: *What Businesses Can Expect*

The question we hear most from domestic business owners about the TCJA is, “How much will IRC Section 199A 20 Percent Pass-Through Deduction lower my tax liability in 2018?”

Does TCJA affect the sale of a closely-held business?

TCJA includes changes that both sellers and buyers should consider.

Before TCJA, the maximum combined federal tax rate for the selling corporation/shareholder was just over 50%. TCJA reduced the maximum to 39.8% by reducing the corporate tax to a flat 21%. This makes an actual or deemed asset sale less expensive from the seller's perspective. It may also induce a buyer to agree to gross-up a seller for any additional tax arising out of an asset deal.

TCJA reduced the maximum tax rate on ordinary income recognized by an individual from 39.6% to 37%, while increasing the taxable income threshold at which this rate applies.

For S corporation shareholders or individuals members of partnership/LLCs, ordinary income generated on an asset sale – including depreciation recapture, interest on deferred payments of purchase price, rent paid for the use of property retained by the seller/owner, amounts paid to the seller/owners as compensation or for a non-compete – will be taxed at the reduced rate.

Any adverse changes for sellers?

TCJA limits a taxpayer's loss carryover deduction to 80% of the taxpayer's taxable income for the year; thus, a seller's NOLs may not offset some of the gain from the sale.

What does TCJA do for buyers?

TCJA eliminates the previous two-year carryback but allows the NOLs to be carried forward indefinitely. It limits the carryover deduction for a taxable year to 80% of the taxpayer's taxable income for such year.

TCJA extended and modified the additional first-year depreciation deduction for qualifying property through 2026, increased the allowance from 50% to 100% of the adjusted basis for property placed in service before January 1, 2023, and removed the requirement that the qualifying property's original use must commence with the taxpayer.

Any negatives for the buyer?

TCJA generally limits deduction for business interest incurred or paid by a business to 30% of the business's “adjusted taxable income” for a tax year. Interest deduction so disallowed is carried forward indefinitely.

For a buyer who incurs indebtedness to purchase a target company, this limitation on deducting interest on such indebtedness could make the acquisition more expensive.

In general, the limitation won't apply to a corporation if its average annual gross receipts for the preceding three-taxable-year period does not exceed \$25 million.

Can a taxpayer in a pass-through entity claim the “20%-of-qualified business income deduction” in determining the tax liability from the sale of business assets?

Nope. The definition of “qualified business income” excludes gain arising from the sale of assets used in the business.

Do you foresee changes in M&A activity as a result of TCJA?

That remains to be seen. Most buyers already prefer to cherry-pick target assets and to assume only certain liabilities; they would consider a stock deal only if necessary for business reasons. The reduced corporate tax rate should reinforce that preference and may cause certain corporate sellers and their shareholders to be more amenable to an asset deal.

M&A transaction pricing may, however, be affected by the reduced corporate rate, the limitation on deducting acquisition interest, and the ability to immediately expense part of the purchase price. There are many questions for which it is too early to provide answers. For example:

Will the reduced corporate rate induce an S corporation to give up its “S” election by revoking it, admitting new investors, or changing its capital structure?

Will the reduced rate cause a corporation's shareholders to abandon efforts to by-pass the corporation in connection with the sale of its business?

Will the limitation on the deduction of interest cause a buyer to rely less on borrowed funds?

The answers to these and other questions will depend upon each situation's facts and circumstances.

Sales involve arm's-length transfers of a business. What about TCJA's impact upon gift/testamentary transfers?

The unified credit offsets the federal gift/estate tax up to a specified cumulative amount of lifetime and testamentary

transfers by a taxpayer (the “exemption amount”).

TCJA doubled this exemption amount from \$5.6 million to \$11.2 million per person – \$22.4 million per married couple – for transfers made in 2018, and thereafter adjusts it annually for inflation. The increased exemption expires after 2025. Any portion of an individual's exemption amount that is used during lifetime to offset taxable gifts reduces the exemption amount that remains available at death to offset the taxable value of his estate.

The surviving spouse may elect to use any exemption amount that was not used by the decedent (the “portability election”) during the survivor's life or death.

What's all the talk about stepped-up basis?

“Adjusted basis” represents a taxpayer's unrecovered investment in a property. The basis of property acquired from a decedent is its fair market value on the date of death, which effectively eliminates the recognition of gain on appreciation in the property's value that occurred before the decedent's death.

Depending upon the business entity and its assets, income tax savings resulting from the step-up may be realized as reduced gain on the sale of the business, or as reduced income tax liability from the operation of the business.

TCJA retained the stepped-up basis rule.

What estate tax planning should business owners do?

Many closely held business owners will not be subject to the federal estate tax – at least not through 2025.

Those with larger estates can leverage this increased exemption through gift planning that uses valuation discounts and does not exhaust much of a taxpayer's exemption amount; for example, regular annual-exclusion-gifting (and spousal gift-splitting), and transfers made for partial or full consideration (including GRATs and installment sales).

Otherwise taxable estates – including taxpayers who have already exhausted their exemption amount – may thereby be brought within coverage of the new exemption amount.

The increased exemption amount will also allow many taxpayers to secure a basis step-up for their families, without incurring additional estate tax, by allowing these taxpayers to retain assets.



LOUIS VLACHOS

Partner
 Farrell Fritz, P.C.
 516-227-0639
www.farrellfritz.com

Note: NY will continue imposing an estate tax on estates that may not be subject to the federal tax. The NY estate tax exemption amount for 2018 is \$5.25 million per person (and NY does not allow spousal portability).

What about reviewing estate planning documents?

In light of the increased exemption amount, taxpayers should review their estate plan and documents.

Wills or trusts that provide for a unified credit shelter trust may have to be revised, lest the increased exemption amount defeat one's testamentary plan by directing the entire estate into such a trust.

A more flexible instrument may be warranted – perhaps one that relies upon a surviving spouse's disclaimer.

The buy-out provisions of shareholder and partnership agreements should be reviewed in light of what may be a reduced need for liquidity following the death of an owner.

Taxpayers facing larger estates can utilize the increased exemption amount before it expires in 2026 (or sooner) by making substantial gifts to remove assets, and the income and appreciation thereon, from their estates.

Of course, gifting comes at a cost: the taxpayer's “loss” of the property, and the beneficiaries' loss of a basis stepped-up upon the taxpayer's death.

Other taxpayers may want to bring certain appreciated assets (that they previously gifted to family) back into their estates in order to attain a basis step-up. As always, there may be non-tax reasons for holding onto property, or for structuring the disposition of one's estate, that may outweigh any tax savings.