A Roundtable Discussion

THE NEW TAX LAW:

What Businesses Can Expect

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In late December, Congress passed the biggest overhaul of the U.S. tax system in more than 30 years. Known as the Tax Cuts and Jobs Act, it will impact virtually everyone paying taxes in America, including individual filers up through the largest corporations.

As the changes unfold, Crain's Custom Media asked three Chicago-based tax professionals for their thoughts on some of the law's implications for businesses and business owners.

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What simple tax planning strategies can companies apply when filing their 2017 tax returns?

John Bennecke: Since the 2017 corporate tax rate is considerably higher than the 2018 corporate tax rate, companies with the cash and ability to accelerate tax deductions by making payments related to various tax sensitive accruals items may wish to do just that. This simple tax planning

strategy will allow companies to accelerate deductions under their current tax accounting methods, allowing for more tax benefits. For example, compensation accruals are typically allowed as a current-year tax deduction. The strategy would be to pay as much of the compensation accrual as possible, to maximize the 2017 tax deduction. Many more opportunities may exist depending on a company's tax methods and accounting.

Ryan Vaughan: There's still time to analyze book to tax adjustments and deferred tax assets and liabilities for opportunities to file automatic (tax) accounting method changes to optimize a company's tax position and take advantage of the significant rate reduction from 35 percent to 21 percent. Companies should also consider the impact of the 80 percent limitation on net operating losses (NOLs) generated after Dec. 31, 2017 and, for example, accelerate revenue into 2017 to use the NOL at a higher tax rate, or accelerate deductions into 2017 to stockpile NOLs exempt from the limitation. For 2018, companies should review the changes to nondeductible costs and limitations on deductions and start tracking them separately. For example, entertainment costs are nondeductible and interest expense is limited in 2018. This will make the 2018 tax return process much easier.

Scott Bakal: Certain interest disallowance rules may require an immediate deleveraging and pay-down or restructuring of debt. Companies that do business in multiple states should consider modeling both state and federal income tax consequences. Some of the new provisions—such as the 100 percent expensing of capital improvements or certain rules relating to the repatriation of earnings of controlled foreign corporations—may not be implemented on the state level. The longer one waits to model out 2018 tax liabilities, the less time taxpayers will have to take corrective actions.

How can companies with fiscal years spanning both pre- and post-enactment periods address the corporate tax rate change?

JB: Fiscal year filers will need to compute a blended rate, based on the number of days in each of the periods associated at the higher pre-enactment and lower post- enactment rate. For example, for a fiscal year ending June 30, 2018, the period July 1, 2017 through Dec. 31, 2017 would be taxed at 35 percent on a non-blended rate. The remaining six months—Jan. 1, 2018 through June 30, 2018—would be taxed at 21 percent on a non-blended basis and 10 percent on a proportional basis, yielding a blended 28 percent rate for this fiscal year taxpayer.

RV: Importantly, the blending principle only applies to the corporate tax rate, and not to other deductions or credits. For example, the new limitation on interest expense deduction is effective for tax years beginning after Jan. 1, 2018. Thus, for a fiscal year company, the interest limitation would not be in effect until the fiscal year starting in 2018. Similarly, net operating losses generated for fiscal years beginning in 2017 and ending in 2018 would not be subject to the new 80 percent limitation. Companies that have yet to file their fiscal year return for the year ending 2017 may still take advantage of planning opportunities presented by the significant reduction in the corporate rate. The same acceleration of deduction planning around (tax) accounting method changes would be applicable to fiscal year tax payers that have not filed their return for the year ended 2017.

2017 STRATEGIES

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JOHN P. BENNECKE, TRUE PARTNERS CONSULTING

SB: Fiscal year taxpayers will have other planning opportunities to lower their effective 2018 tax rate. One example is the new Global Intangible Low Taxed Income tax. This tax will cause low taxed income from any activity to be potentially taxable to corporations at a 10.5 percent tax rate. It's effective for tax years of foreign corporations beginning after Dec. 31, 2017, and for tax years of U.S. shareholders in which such tax years of foreign corporations end. This means that this new tax applies to calendar year taxpayers effective with the year beginning Jan. 1, 2018 but would not apply to a taxpayer with a Nov. 30 year-end, for instance, until its tax year beginning Dec. 1, 2018 (effectively exempting 11 months of a taxpayer's 2018 income from this new penalty tax). Foreign companies that would be subject to this tax should consider adopting Nov. 30 fiscal year ends to lower their effective 2018 tax rates.

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BUSINESSES, INDUSTRIES AFFECTED

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How will changes to individual taxes likely impact home builders and real estate companies?

RV: New state and local tax deduction limitations—now capped at $10,000—may affect markets with high property taxes, such as Chicago and the surrounding areas. The reduction in the eligible mortgage interest deduction cap—from $1 million to $750,00—and the repeal of interest deductions for home equity loans will most directly affect the market for luxury real estate. Both these changes could drive down home prices and demand, negatively impacting home builders. Real estate companies will be less impacted by the changes, as taxes and interest will still be deductible business expenses. Additionally, the 20 percent pass-through business deduction, section 1031 exchanges, cost recovery, and real estate tax credits maintain or create significant tax advantages for real estate companies.

SB: On the other hand, home builders in certain regions of the country, which are known for lower property taxes and low or no state income tax, might benefit from the changes. Certain of our clients in Illinois and relatively high tax states such as New York, who have been talking of moving to Florida for state tax reasons, have been discussing that with greater urgency.

What will be the likely impact on financing startups?

SB: Startups may realize more benefits by being structured as a corporation—versus a limited partnership or limited liability company—because lower tax rates will allow more after-tax earnings to be reinvested in the business. There's also a special tax benefit available to individuals for qualified small business corporations: the purchase of "1202 stock." With this technique, if the stock is held for more than five years, the sale of the stock can be 100 percent tax-free. We expect more investors in startups to consider how the startup is structured so they can potentially take advantage of 1202 tax treatment.

RV: The biggest win for private equity and venture capital is the retention of the carried interest provision, although the tax law did change the holding period requirement to at least three years. The limit on the interest expense deduction will negatively impact private equity and venture capital taxes, which could limit deal size. If interest rates increase, it could disrupt the current business model as the cost to borrow rises. Additionally, the 50 percent limit on in-house cafeterias and elimination of the deductibility of employee transportation benefits may bring a change in policies for these common start-up practices.

Will there be changes to the way real estate investment vehicles are structured?

SB: We expect to see more investments made through corporations versus limited partnerships or limited liability companies, and an increase in the use of real estate investment trusts (REITs) to own real estate. U.S. individual shareholders of REITs would be eligible to have their income taxed at an effective tax rate of 29.6 percent—compared to the otherwise maximum rate of 37 percent—because the new 20 percent deduction for pass-through income applies to REIT dividends. By investing through domestically controlled or publicly traded REITs, a foreign investor might be able to avoid capital gain tax on sale of the REIT.

What other businesses or industries will be immediately affected by the new law?

RV: Companies that generate most of their revenue in the United States—such as retail, insurance, transportation/logistics and telecom—will be most affected, as they generally pay the highest effective tax rates, and the rates have now been reduced. The repatriation portion of the bill will benefit companies looking to bring cash back to the United States. Companies looking to add and/or upgrade equipment will benefit from 100 percent immediate expensing on capital equipment. On the other hand, highly leveraged companies may see little, or even negative, impact on their tax bill because of the limits on interest expense deductions. About 30 colleges and universities, including Harvard and Yale, may pay an additional 1.4 percent tax on their endowment investment returns.

SB: Any business that has substantial interest expense will be immediately affected, and not in a good way. Leveraged businesses need to look at the rules that disallow interest deductions when interest expense exceeds 30 percent

of a taxpayer's "adjusted taxable income" and international businesses need to look at the new base erosion and earnings tax and the tax on "global intangible low-taxed income." One change that's not been fully explored is the elimination of the tax deferred like kind exchange rules for anything other than real estate. Our clients have used these over the years to exchange one intangible asset for another—for example, high-end art held for investment in other art—and that technique will no longer be available. Companies with numerous employees may find it costlier to settle sexual harassment claims because of new rules that limit the deductibility of settlements if a non-disclosure agreement is entered into, and that limit the deductibility of legal fees incurred with entering into such settlements.

JB: Companies with a global presence will be the most broadly impacted, given the movement of the corporate tax rate down to 21 percent. However, there are several provisions that will impact them that go well beyond the immediate tax impacts. Most if not all global companies have spent and continue to spend a lot of time managing and creating globally tax efficient organizations that rely on transfer pricing policies that dictate the internal pricing policies for these related party transactions around the globe. Given the new rules, companies will need to re-evaluate these policies to ensure they still make sense and are providing the appropriate results from an accounting and tax perspective. Additionally, outside and independent of U.S. tax reform, the United States and other OECD participating countries have instituted new compliance requirements focused on providing more clarity to how companies do business around the world. These are commonly referred to as the BEPS (Base Erosion and Profit Sharing) reporting requirements that are being rolled out for the 2017 tax reporting, where applicable thresholds are met.

What changes can we expect to see regarding executive compensation for high-level employees of publicly traded corporations?

JB: The tax code has always contained rules around executive compensation and has provided for limits on the deductibility to the corporation; those rules just got a bit stricter. Now, public companies are limited to $1 million in deductible compensation for covered employees, regardless of how it's paid. Historically, certain types of compensation provided to covered employees tied to approved bonus plans were allowed, and not included in the excess compensation computations subject to limitation. This is no longer the case and may result in corporations adjusting their compensation plans for these covered employees.

SB: For example, corporations can no longer deduct stock options, if total compensation paid to specified employees exceeds $1 million. As a result, we may see a shift to more fixed compensation to executives, and less option-based compensation. Also, the same concepts applied to the $1 million compensation cap are now applied to not-for-profit executives.

What's the status of alternative minimum tax (AMT) credits—can companies that have them still use them?

COMPENSATION CHANGES

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JB: The AMT was repealed, but companies that paid AMT in the past and generated credit carryovers can use them over the next four years. For years 2018, 2019 and 2020, taxpayers may claim up to 50 percent of the AMT credit, with any remaining credit being refundable in 2021.

What about companies with significant net operating loss (NOL) carryovers—will they be able to utilize them against future income?

JB: They can be carried back two years and carried forward 20 years without limitation. The exception, however, is the alternative minimum tax limitation of 90 percent. For NOLs generated for tax years post-Dec. 31, 2017, they are no longer allowed as a carryback and must be carried forward subject to limitations in offsetting income to 80 percent of taxable income.

RV: NOLs generated in tax years before Jan. 1, 2018 are not limited in their application against taxable income—a situation which may encourage companies to increase NOLs for the tax year ending Dec. 31, 2017. Fiscal year companies have additional time to plan for NOLs since the limitation applies only to losses arising in tax years beginning after Dec. 31, 2017.