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Tax Reform 101: Provision and Perspective

March 2018

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The Tax Cuts and Jobs Act (TCJA) was signed into law on December 22, 2017 with changes primarily effective as of January 1, 2018. As one of the most significant tax reforms in history, it is crucial individuals and businesses alike understand how they will be affected. We partnered with RSM, an international audit, tax and consulting firm, to provide an overview of the TCJA and how the provisions will affect businesses moving forward.

Provided is a summary of the reform affecting privately held corporations, private equity firms and the overall M&A market. For further perspective, we included examples of key provisions as financial models including a pre- and post-reform depiction for corporate and pass-through entities. While additional technical corrections and guidance will be released from the Department of the Treasury and IRS in the coming months, this piece is intended to be an introductory guide based on the provisions that we believe will have the largest impact.

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M&A Implications

<table>
<tr><th>Tax Reform Provision</th><th>Description</th><th>Perspective</th><th>Illustration</th></tr>
<tr>
<td>Corporate Rate Reduction</td>
<td>Corporate tax rate reduced from 35% to 21%.</td>
<td>
• Lower corporate tax rate drives higher after-tax free cash flows
• The reduction creates >22% improvement in after-tax free cash flows
• Implies higher M&A valuation levels
• Flow-through entities may consider a conversion to corporate status
• Future acquisitions may favor corporate structure
</td>
<td>
<table>
<tr><th></th><th>Before</th><th>After</th></tr>
<tr><td>Pre-Tax Income</td><td>$100</td><td>$100</td></tr>
<tr><td>Tax Rate</td><td>35%</td><td>21%</td></tr>
<tr><td>Tax Expense</td><td>($35)</td><td>($21)</td></tr>
<tr><td>Net Income</td><td>$65</td><td>$79</td></tr>
<tr><td>% Improvement</td><td></td><td>22%</td></tr>
</table>
</td>
</tr>
<tr>
<td>Interest Deductibility</td>
<td>Business interest deduction limited to 30% of EBITDA (EBIT in 2022 and beyond). Note that EBITDA and EBIT are based on tax basis financials. Disallowed interest carried forward indefinitely.</td>
<td>
• Limits interest tax shield in high-leverage and high-yield situation
• No grandfathering of existing debt
• Expect limited impact in current low rate environment, except for low EBITDA situations
• M&A implications primarily in highly levered deals and those with high-cost subordinated or mezzanine debt, which may drive returns down with lower after-tax cash flows or higher initial equity requirements
</td>
<td>
<table>
<tr><td>EBITDA</td><td>$120</td></tr>
<tr><td>Deductible Interest (30%)</td><td>$36</td></tr>
</table>
<table>
<tr><th>Leverage</th><th>Debt Levels</th><th>Full Deduction If Rate Is Below:</th></tr>
<tr><td>3.0x</td><td>$360</td><td>10.0%</td></tr>
<tr><td>4.0x</td><td>$480</td><td>7.5%</td></tr>
<tr><td>5.0x</td><td>$600</td><td>6.0%</td></tr>
<tr><td>6.0x</td><td>$720</td><td>5.0%</td></tr>
</table>
</td>
</tr>
<tr>
<td>Full Capital Expensing</td>
<td>Immediate write-off for capital equipment purchased (generally tax depreciable life less than 20 years). Sunsets 20% per year starting in 2023.</td>
<td>
• Lowers cost of capital investments (new and used property)
• Asset purchases in M&A are potentially more attractive given immediate purchase price expensing for eligible assets by buyer, with reduced tax leakage by seller via the lower corporate tax rate
• Most states do not allow full expensing
</td>
<td>
Purchase Price Allocated to Fixed Assets: $5,000,000
Before 5-Year Depreciable Life (Subject to Original Use Limitations)
<table>
<tr><th></th><th>Deduction</th><th>Tax Benefit at 21%</th><th>Present Value at 5%</th></tr>
<tr><td>Year 1</td><td>$1,000,000</td><td>$210,000</td><td>$909,190</td></tr>
<tr><td>Year 2</td><td>$1,000,000</td><td>$210,000</td><td></td></tr>
<tr><td>Year 3</td><td>$1,000,000</td><td>$210,000</td><td></td></tr>
<tr><td>Year 4</td><td>$1,000,000</td><td>$210,000</td><td></td></tr>
<tr><td>Year 5</td><td>$1,000,000</td><td>$210,000</td><td></td></tr>
</table>
After Immediate Full Expensing
<table>
<tr><th></th><th>Deduction</th><th>Tax Benefit at 21%</th><th>Present Value at 5%</th></tr>
<tr><td>Year 1</td><td>$5,000,000</td><td>$1,050,000</td><td>$1,000,000</td></tr>
</table>
</td>
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</table>

M&A Implications

<table>
<tr><th>Tax Reform Provision</th><th>Description</th><th>Perspective</th><th>Illustration</th></tr>
<tr><td>Net Operating Losses (NOLs)</td><td>Repeals two-year carryback and changes carryforward from 20 years to indefinite. Limits deduction to 80% of taxable income each year. Pre-2018 NOLs remain eligible for 100% income utilization subject to prior expiration schedule.</td><td>• Eliminates ability to carryback stub period loss in M&A for the benefit of sellers and shifts the negotiation to receiving future benefits from transaction-related losses
• Tax attributes are less valuable with lower tax rate and capped annual utilization</td><td><table>
<tr><th></th><th>Before</th><th>After</th></tr>
<tr><td>Taxable Income</td><td>$100</td><td>$100</td></tr>
<tr><td>NOL Cap</td><td>0%</td><td>80%</td></tr>
<tr><td>NOLs Utilized</td><td>$100</td><td>$80</td></tr>
<tr><td>Remaining Taxable Income</td><td>$0</td><td>$20</td></tr>
<tr><td>Tax Rate</td><td>35%</td><td>21%</td></tr>
<tr><td>Cash Tax Payable</td><td>$0</td><td>$4</td></tr>
</table></td></tr>
<tr><td>Pass-Through Business Rate Reduction</td><td>Allows deduction of 20% of pass-through income for qualified businesses. For full deduction, qualified businesses must meet certain criteria for level of wage payments and/or tangible, depreciable assets in the business.</td><td>• Pass-through rate reduction in the top individual bracket from 39.6% to 29.6%, resulting in a 17% improvement in after-tax cash flows
• New corporate rate is lower, but pass-through form eliminates the potential for a double layer of taxation</td><td><table>
<tr><th></th><th>Before</th><th>After</th></tr>
<tr><td>Business Income</td><td>$100</td><td>$100</td></tr>
<tr><td>Deduction</td><td>$0</td><td>($20)</td></tr>
<tr><td>Taxable Income</td><td>$100</td><td>$80</td></tr>
<tr><td>Tax Rate</td><td>39.6%</td><td>37.0%</td></tr>
<tr><td>Tax Expense</td><td>($40)</td><td>($30)</td></tr>
<tr><td>Owner Net Income</td><td>$60</td><td>$70</td></tr>
<tr><td>Effective Tax Rate</td><td>39.6%</td><td>29.6%</td></tr>
<tr><td>% Improvement</td><td></td><td>17%</td></tr>
</table></td></tr>
<tr><td>Carried Interest</td><td>Three-year holding period imposed to achieve long-term capital gain treatment.</td><td>• Constrains opportunistic sales by PE owners within the three year period. However, resulting short-term capital gain can be managed with other capital losses
• No significant M&A impact expected given typical hold periods</td><td><table>
<tr><th></th><th>2-Year</th><th>4-Year</th></tr>
<tr><td>Carried Interest Gain</td><td>$200</td><td>$200</td></tr>
<tr><td>Capital Gain Tax Rate</td><td>37%</td><td>20%</td></tr>
<tr><td>Tax Liability</td><td>($74)</td><td>($40)</td></tr>
<tr><td>After-Tax Income</td><td>$126</td><td>$160</td></tr>
<tr><td>% Improvement</td><td></td><td>27%</td></tr>
</table></td></tr>
<tr><td>International Tax-Repatriation</td><td>One-time mandatory deemed repatriation of foreign earnings and profits. All entities with foreign earnings & profits are taxed at reduced rates for cash (15.5%) and illiquid assets (8%). Installment payment plan over eight years is available.</td><td>• Enables significantly more offshore cash to be available for use in U.S. acquisitions immediately and in the future as generated
• Reduces current cash on balance sheet
• Estimated $2-3 trillion of offshore cash is held by U.S. corporations</td><td><table>
<tr><td>U.S. Cash</td><td>$300</td></tr>
<tr><td>Offshore Cash</td><td>$100</td></tr>
<tr><td>Offshore Cash Tax Rate</td><td>15.5%</td></tr>
<tr><td>Offshore Illiquid Assets</td><td>$50</td></tr>
<tr><td>Illiquid Asset Tax Rate</td><td>8%</td></tr>
<tr><td>Tax Liability (8 years)</td><td>$19</td></tr>
<tr><td>Available Cash - Pre Tax</td><td>$300</td></tr>
<tr><td>Available Cash - After Tax</td><td>$380</td></tr>
</table></td></tr>
</table>

Case Study 1: Corporate Entity

The following case studies highlight the impact on net after-tax cash flow resulting from various changes in the federal tax law from the TCJA. Note that state tax impacts are not included in this analysis and are beyond the scope of this discussion but can have a material impact on the analysis.

Assumptions	
EBITDA	$100
Leverage Multiple	5.0x
Debt	$500
Interest Rate	7%
Actual Interest Expenditures	$35
Interest Expense Limitation	$30
Current Year CapEx	$5
D&A (assets previously placed in service)	$4

	Pre-TCJA	**TCJA**	**TCJA**	**TCJA**
EBITDA	100.0	100.0	100.0	100.0
Interest Expense	(35.0)	(30.0)	(30.0)	(30.0)
CapEx Immediate Expensing	(2.5)	(5.0)	(5.0)	(5.0)
Depreciation & Amortization (D&A)	(4.0)	(4.0)	(4.0)	(4.0)
Taxable Federal Income	58.5	61.0	61.0	61.0
Federal Corporate Income Tax Rate	35%	21%	21%	21%
Federal Corporate Income Taxes	20.5	12.8	12.8	12.8
Dividend	**10.0**	**10.0**	**20.0**	**30.0**
Shareholder Income Tax Rate	23.8%	23.8%	23.8%	23.8%
Shareholder Income Tax	2.4	2.4	4.8	7.1
Cash Flow:				
Corporate Taxable Income	58.5	61.0	61.0	61.0
Non-Cash D&A	4.0	4.0	4.0	4.0
CapEx Not Immediately Expensed	(2.5)	-	-	-
Interest Expense Limitation	-	(5.0)	(5.0)	(5.0)
Corporate Tax	(20.5)	(12.8)	(12.8)	(12.8)
Individual Tax	(2.4)	**(2.4)**	**(4.8)**	**(7.1)**
Net Combined After-Tax Cash Flow	37.2	44.8	42.4	40.0
After-Tax Cash Flow % Increase		21%		

Commentary

Due to the amount of leverage the corporation has utilized, the limitation on business interest deductions becomes an immediate issue, with $5 of interest expense subject to the limitation. Under prior law, the corporation would have been able to deduct $35 of interest expense but is now limited to a $30 deduction, equal to 30% of its EBITDA. Although the limited portion carries forward for an indefinite period of time, the value of the carry forward asset would need to be assessed based on future EBITDA (EBIT starting in 2022) and leverage modeling.

The corporation enjoys the benefit of the increased capital expensing provisions of the TCJA and is allowed to deduct 100% of the $5 it plans to spend on qualified capital expenditures, rather than 50% under pre-TCJA.

Although the maximum corporate tax rate dropped 14 percentage points from 35% to 21% (a 40% reduction), the corporation in this example receives only a 37% reduction in its corporate level tax due to the cumulative impact of additional bonus depreciation and the interest limitation. In addition, assuming the corporation distributes $10 to its shareholders as a dividend, the example reflects the second layer of tax paid by the shareholders ($2.4 assuming a 20% rate on qualified dividend income plus 3.8% net investment income tax). Layering in this second level of tax results in a combined increase in net after-tax cash of only 21%.

Although the full “windfall” of the corporate rate reduction is not achieved in this example, the corporation may choose to payout a portion of the excess cash it does retain to its shareholders. The increase in dividends further reduces the combined net after-tax cash flow, perhaps making it more advantageous for the company to use the cash flow benefits for further investments in its people, capital or reduction of debt.

Case Study 2 : Pass-Through Entity

Case Study 2 contains the same financial assumptions as Case Study 1, but assumes the company operates in a pass-through, rather than corporate entity structure. The results of the increased bonus depreciation and business interest limitation are the same as Case Study 1, as both of these items apply at the entity rather than the shareholder level. In both cases, the income of the company increases from $58.5 to $61. However, Case Study 2 assumes that the company is a qualified trade or business that would allow its shareholders to claim an additional 20% deduction against their pass-through income.

Assumptions

EBITDA	$100
Leverage Multiple	5.0x
Debt	$500
Interest Rate	7%
Actual Interest Expenditure	$35
Interest Expense Limitation	$30
Current Year CapEx	$5
D&A (assets previously placed in service)	$4
Pass-Through Assumptions:	
100% Qualified Business Income (QBI)	
QBI Deduction	20%
Individual Income Tax Rate	37%
Effective Individual Tax Rate after QBI Deduction	29.6%

Commentary

Applying the 20% deduction, coupled with the decrease in the top individual tax rate from 39.6% to 37%, results in an effective tax rate on the pass-through income of 29.6%. Although the individual shareholders recognize a 25.2% reduction in the tax rate on their income, the actual reduction in tax from $23.2 to $18.1 is just over 22%, again due to the additional bonus depreciation but offset by the interest limitation.

Case Study 2 also assumes that the shareholders of the pass-through entity would not only distribute cash out of the entity to fund their tax liabilities, they would also distribute another $10 in excess of their tax distribution, similar to the corporate entity structure. While these distributions lead to a second layer of tax in the corporate entity analysis, both the tax and non-tax distributions from the pass-through entity are non-taxable to the pass-through shareholders and simply reduce the basis of their stock. Therefore, the second layer of tax is avoided in the pass-through structure. In addition, the shareholders in the pass-through entity achieve a net increase in their stock basis of $32.9.

	Pre-TCJA	TCJA	TCJA	TCJA
EBITDA	100.0	100.0	100.0	100.0
Interest Expense	(35.0)	(30.0)	(30.0)	(30.0)
CapEx Immediate Expensing	**(2.5)**	(5.0)	(5.0)	(5.0)
D&A	(4.0)	(4.0)	(4.0)	(4.0)
Taxable Federal Income	**58.5**	61.0	61.0	61.0
Effective Individual Income Tax Rate	**39.6%**	29.6%	29.6%	29.6%
Individual Income Taxes	**23.2**	18.1	18.1	18.1
Tax Distribution	23.2	18.1	18.1	18.1
Non-Tax Distribution	**10.0**	**10.0**	**20.0**	**30.0**
Total Distribution	33.2	28.1	38.1	48.1
Tax on Distribution	-	-	-	-
Increase in Shareholder Outside Basis	25.3	32.9	22.9	12.9
Cash Flow:				
Corporate Taxable Income	58.5	61.0	61.0	61.0
Non-Cash D&A	4.0	4.0	4.0	4.0
CapEx Not Immediately Expensed	(2.5)	-	-	-
Interest Expense Limitation	-	(5.0)	(5.0)	(5.0)
Corporate Tax	-	-	-	-
Individual Tax	**(23.2)**	(18.1)	(18.1)	(18.1)
Net Combined After-Tax Cash Flow	36.8	41.9	41.9	41.9
After-Tax Cash Flow % Increase		14%		

Corporate vs. Pass-Through Entity Considerations

An important question now being asked by any taxpayer currently structured as a pass-through entity is whether or not to consider a conversion to corporate entity status. The two case studies also offer a comparison of the net after-tax cash flow under a corporate entity or pass-through structure assuming the same financial results at the company level. Under the base assumption of a $10 non-tax dividend, the corporate entity structure nets a combined after-tax cash amount of $44.8, compared to $41.9 under the pass-through structure. However, if the cash flow needs of the shareholders dictate a larger distribution, the double tax in a corporate entity structure starts to offset the benefit of the lower corporate tax rate. The case studies reflect that a $30 non-tax dividend results in the net after-tax benefit of the pass-through entity exceeding that of the corporate entity.

In addition to the above considerations, there are many other factors which need to be considered when making the decision whether or not to change your current pass-through entity structure. Among the most important is the eventual exit strategy of the business and the timing of that exit. The building of stock basis in a pass-through entity structure will be foregone upon a conversion, which could have a significant impact on the amount of gain recognized upon a future sale. Additional pass-through vs. corporate entity considerations are outlined here, but each taxpayer situation is unique. We recommend consulting your tax advisor to assist in making any decisions regarding a change in entity status.

Pass-Through Entity Advantages

- Build basis and generally distribute cash tax-free
- Single level of tax
- Attractive target in an exit
- Tax efficiency with estate planning

Pass-Through Entity Disadvantages

- 37% top individuals tax rate (29.6% if a qualified business)
- State income tax deduction limitation
- Complex shareholder returns

Corporate Entity Advantages

- 21% tax rate
- Cash needs at the entity level/low level of discretionary dividends
- Deduction for state taxes available
- Reduced shareholder compliance cost

Corporate Entity Disadvantages

- Double layer of tax/high level of discretionary dividends
- No building of outside stock basis
- Step up not achieved by buyer in an exit

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