

Taxes Over Coffee – How Will the New Tax Reform Bill Affect You?

Joan C. Arnold
Steven D. Bortnick
Howard S. Goldberg
Jennifer A. O’Leary
Todd B. Reinstein
David Stauber

Pepper Hamilton LLP
Attorneys at Law

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The screenshot displays the Cisco Webex interface. At the top left, an 'Audio Broadcast' window is open, showing a volume slider and a status of '24.7 Kbps'. A red arrow points from the text below to this window. The main interface includes a top navigation bar with 'Participant', 'Event', and 'Help' menus. On the right, there are icons for 'Participants', 'Chat', and 'Q&A'. Below these, a 'Participants' panel lists 'Brian Dolan (Host)' and 'Webinar Guest (me)'. At the bottom, there is a 'Q&A' section with a dropdown menu set to 'All Panelists' and a 'Send' button. The central area is a large white space, likely for a video or presentation.

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Speaking:

- Panelists: 1
 - Brian Dolan (Host)
- Attendees:
 - Webinar Guest (me)**

Q&A

All (0)

Ask: All Panelists

Select a panelist in the Ask menu first and then type your question here. There is a 256-character limit.

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Q&A

The screenshot displays the Cisco WebEx Event Center interface. The main content area shows a slide titled "Pepper Hamilton Webinar" with the text "Send us questions" overlaid in red. The right-hand sidebar contains a "Participants" list with "Brian Dolan (Host)" and "Webinar Guest (me)". Below this is a "Q&A" section with a dropdown menu set to "All (0)" and a "Send" button. A red arrow points from the "Send us questions" text to the "Q&A" icon in the top right corner of the interface.

Cisco WebEx Event Center

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01

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Q&A

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Panelists: 1

Brian Dolan (Host)

Attendees:

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Q&A

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Ask: All Panelists

Type question here... Send

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Click 'File'

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Chat

Q&A

Speaking:

Panelists: 1

Brian Dolan (Host)

Attendees:

Webinar Guest (me)

Q&A

All (0)

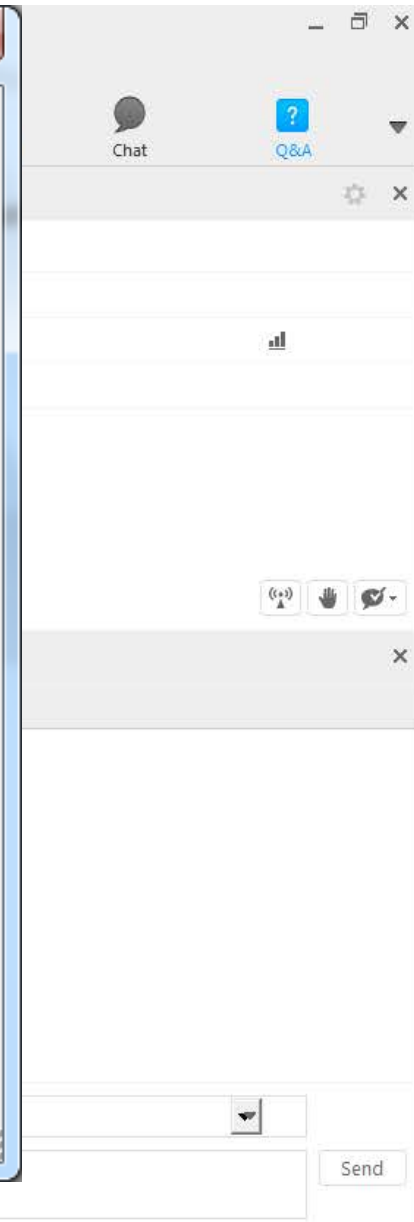
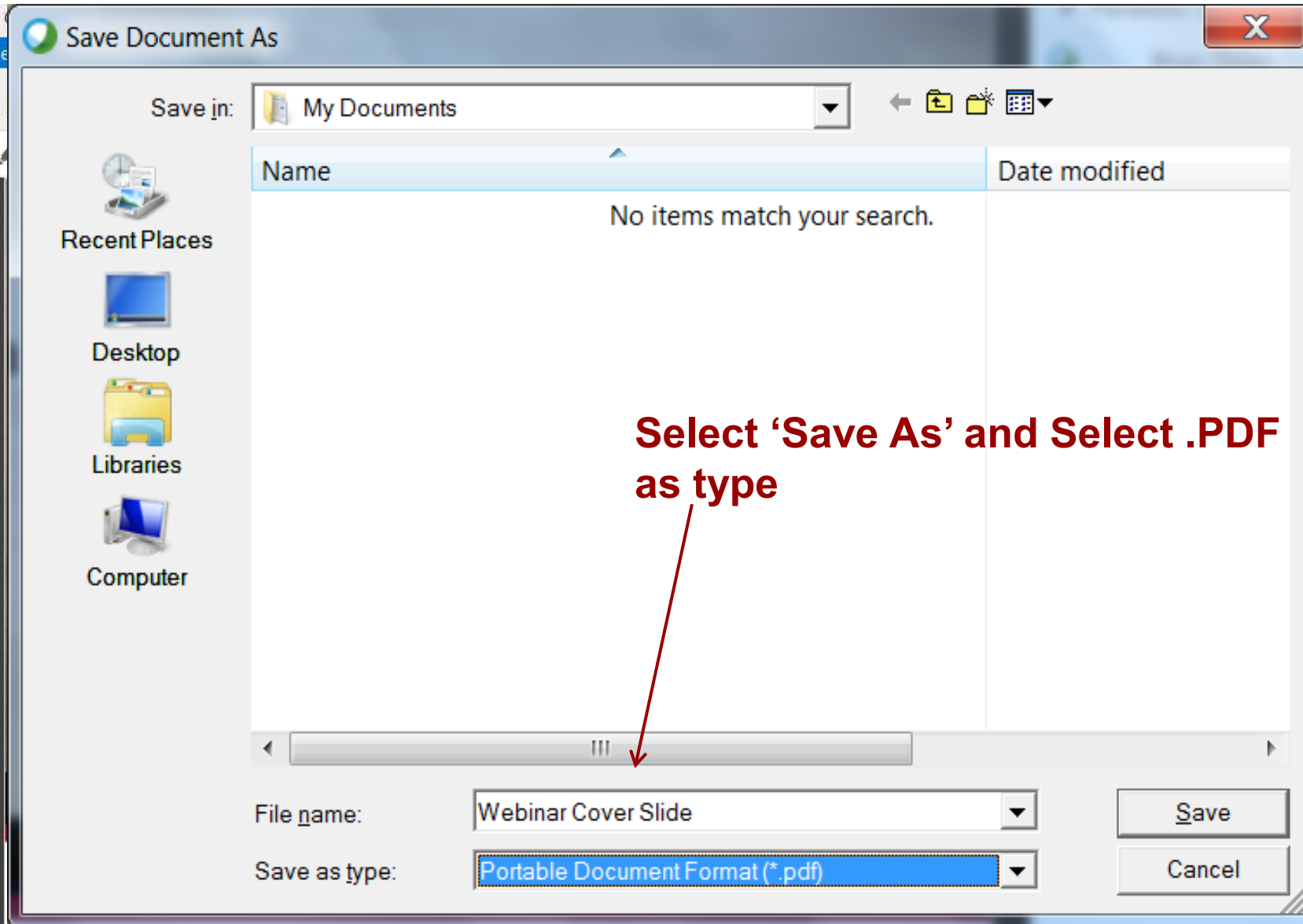
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We will be starting at 9am ET. There is currently no audio until we start.

Joan C. Arnold

Partner, Tax Practice Group

215.981.4362

arnoldj@pepperlaw.com

- ▶ Chair of the Tax Practice Group, and focuses her practice on federal and international income tax
- ▶ Has more than 35 years of significant experience in domestic and cross border M&A, and corporate international tax counseling, including substantial tax experience in the private equity arena
- ▶ Immediate past president of the American College of Tax Counsel, immediate past vice chair of the Tax Section of the American Bar Association, vice president and a member of the executive committee of the U.S. Branch of the International Fiscal Association, and on the executive committee of the George Washington/IRS Annual International Tax Institute
- ▶ Resident in the Philadelphia office.



Steven D. Bortnick

Partner, Tax Practice Group

609.951.4117

bortnicks@pepperlaw.com

- ▶ Focuses his practice on domestic and international tax and private equity matters
- ▶ Handles a broad range of transactions, including asset, stock, cross-border and domestic acquisitions, recapitalizations and reorganizations
- ▶ Experienced in, and a significant portion of his practice is devoted to, the structuring of domestic and international transactions and is involved in the formation of private equity and hedge funds
- ▶ Resident in the Princeton and New York offices.



Howard S. Goldberg

Partner, Tax Practice Group

215.981.4955

goldbergh@pepperlaw.com

- ▶ Focuses his practice on tax planning for domestic and international transactions. His practice includes advising on mergers, acquisitions, reorganizations, dispositions, private equity transactions, capital markets transactions and restructurings in and out of bankruptcy.
- ▶ Frequent speaker on a variety of transactional tax matters
- ▶ Resident in the Philadelphia office.



Jennifer A. O'Leary

Partner, Tax Practice Group

215.981.4184

olearyj@pepperlaw.com

- ▶ Focuses her practice on the federal income tax aspects of pass-throughs, private investment funds, domestic and international mergers and acquisitions, dispositions, corporate tax restructuring, debt restructuring, regulated investment companies and real estate investments trusts
- ▶ Resident in the Philadelphia office.



Todd B. Reinstein

Partner, Tax Practice Group

202.220.1520

reinstaint@pepperlaw.com

- ▶ Focuses his practice on advising clients on federal corporate tax law, including the overall structuring of taxable and tax-free transactions, deemed asset purchases, shareholder redemptions, stock basis and earnings and profits calculations, eligibility for the U.S. manufacturing deduction, simplifying corporate structures and minimizing the impact of complex consolidated return issues and tax due diligence
- ▶ Also has experience with corporate loss limitation studies (Section 382) and the tax aspects of bankruptcy and workouts, including issues involving restructuring or retirement of indebtedness.
- ▶ Resident in the Washington, D.C. office.



Pepper Hamilton LLP
Attorneys at Law

David Stauber

Of Counsel, Tax Practice Group

212.808.2705

stauberd@pepperlaw.com

- ▶ Focuses his practice on the federal income tax aspects of mergers and acquisitions, fund formation, and securities offerings matters. He handles a broad range of transactions including cross-border transactions and corporate restructurings, and has considerable experience with both inbound and outbound international tax matters
- ▶ Resident in the New York office.



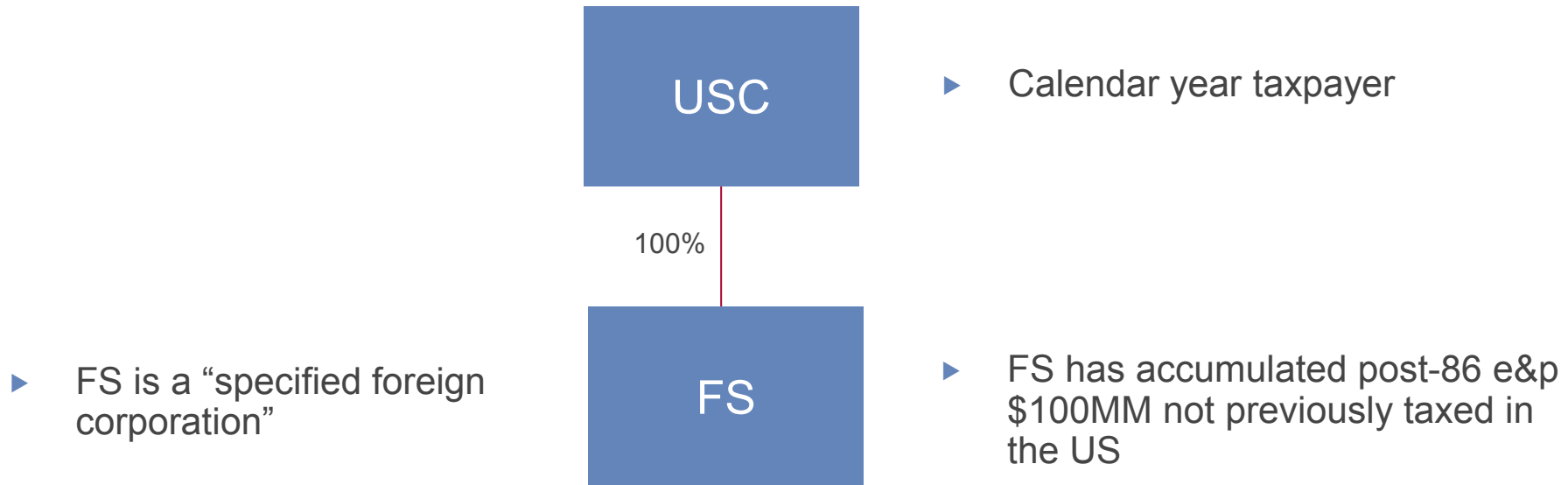
Welcome and Introduction

What's The Status Of The Bill?

Transition Tax

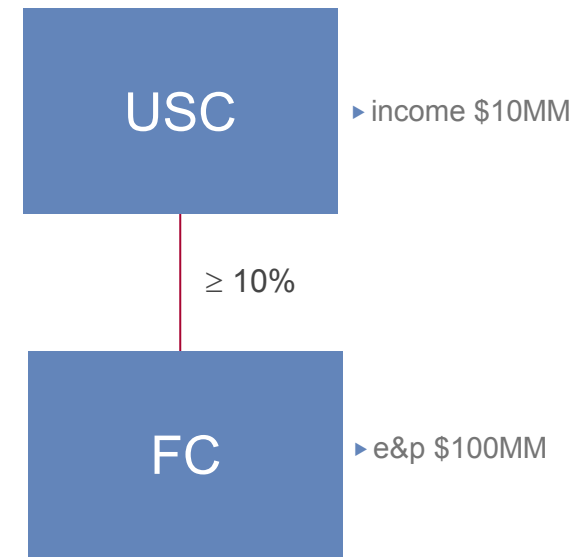
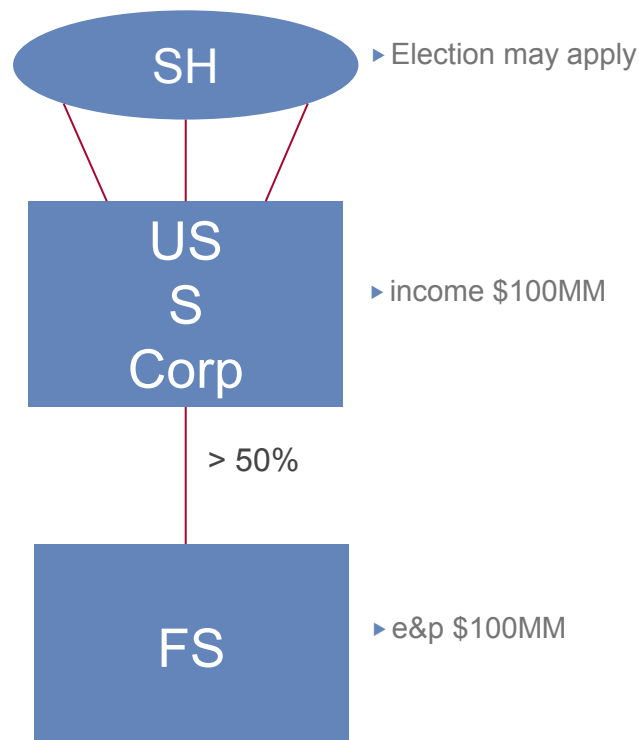
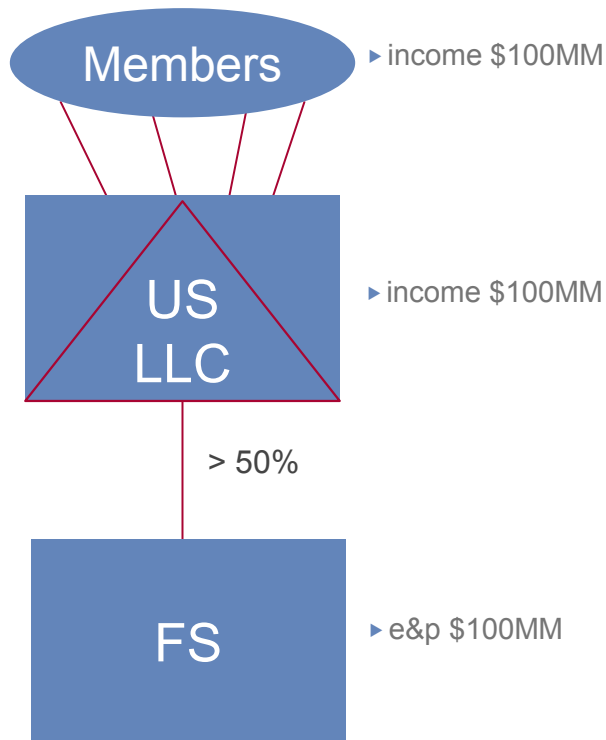
Transition Tax – Are You Ready For The Income?

Base Case



- ▶ USC has an income inclusion in 2017 equal to \$100MM
- ▶ Taxed at lower rates (15.5% on cash/cash equivalents, 8% remainder)
- ▶ Tax may be paid in installments
- ▶ Tax attributes of USC (e.g., NOLs, FTC) may reduce impact

It Also Hits:

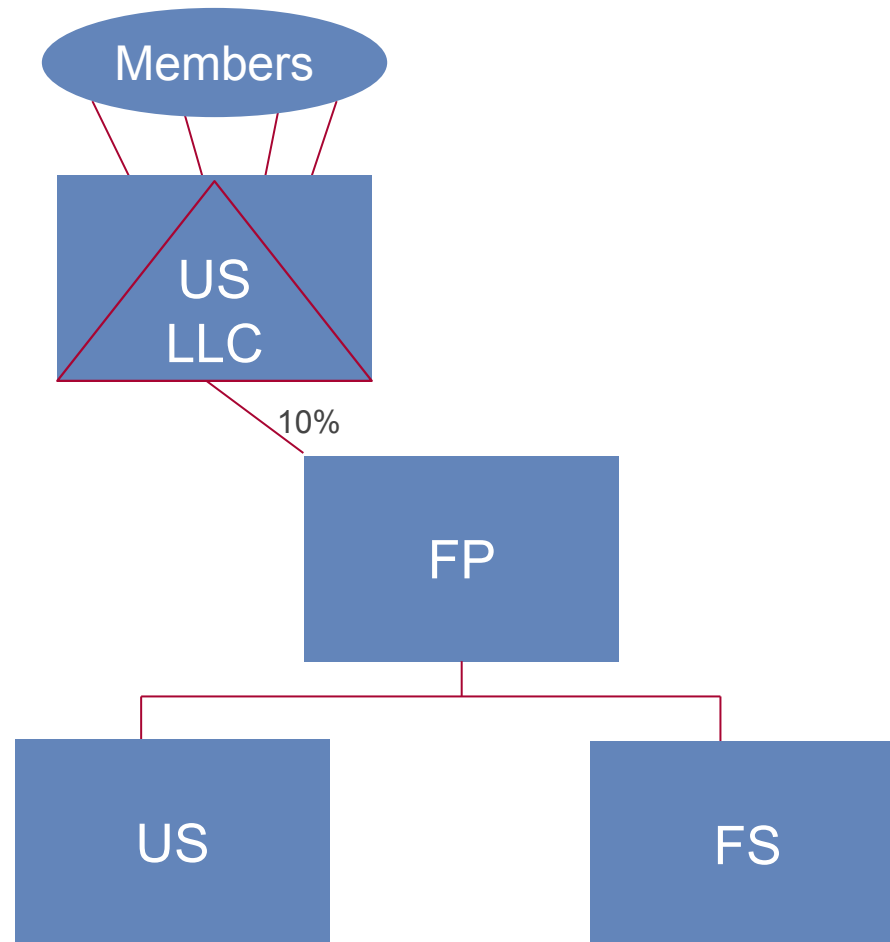


- ▶ Income to US LLC
- ▶ Included in K-1 of Members

- ▶ Income to S Corp
- ▶ Includable in K-1 to SH
- ▶ Special election to defer

- ▶ FC need not be a CFC for USC to have a pick up, just need a 10% or more C Corp shareholder

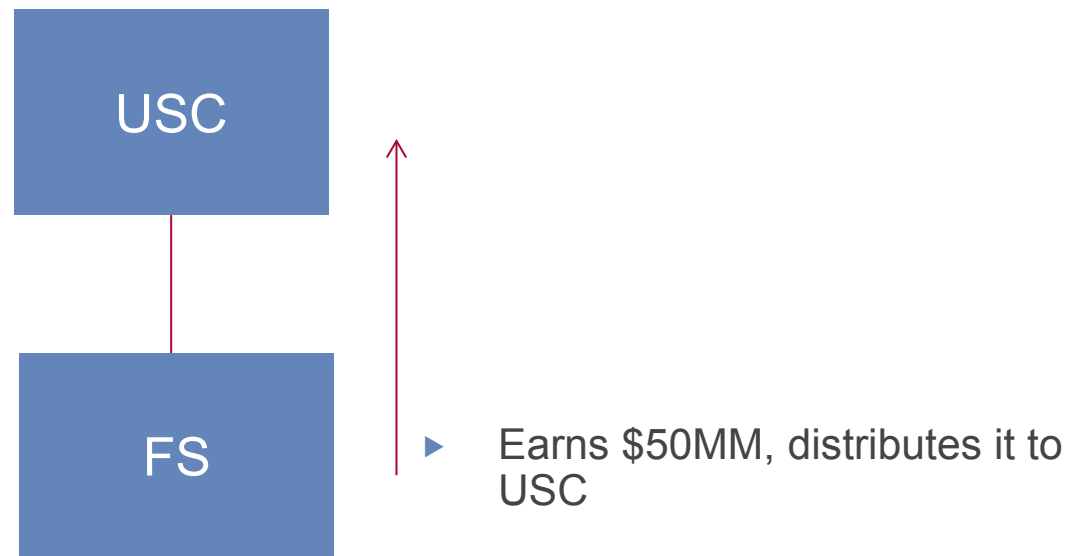
And, An Unusual Circumstance



- ▶ Under the bill, because of a change in attribution rules, US is deemed to own what FP owns
- ▶ US owns 100% of FS and FS is now a CFC as of January 1, 2017
- ▶ US LLC has an income inclusion based on e&p of FS, flows through to Members
- ▶ Legislative history indicates this is too broad of an application, but how to fix?

Transition To What? “Territorial” System

2018 and Forward



- ▶ USC has income of \$50MM, but has 100% dividend received deduction
- ▶ Transition tax meant to create new starting point for e&p calculations
- ▶ Cleans out historical e&p
- ▶ Note that non-C corporate shareholders do not benefit from the “territorial” system, but are nonetheless subject to the transition tax

Transition Tax Inclusion

- ▶ Based on post 1986 e&p of specified foreign corporation (SFC)
 - while it was a CFC
 - or while it had a 10% US C Corp shareholder
 - Example: USC bought the stock of FC on 6/1/17. At all times prior to that, FC was owned by non-US persons. FC became a CFC on 6/1/17. While it might have post 1986 e&p, only the e&p from 6/1/17 to 12/31/17 is subject to the transition tax, whether or not USC made an election (§338(g)) to purge prior e&p
- ▶ The positive e&p of one SFC may be offset by deficits in e&p of other related FCs
- ▶ Open issues in calculating e&p
- ▶ SOL extended an anti-abuse rule

What Is (Are?) Earnings And Profits?

- ▶ Generally accepted that for US companies you start with taxable income and then make required adjustments
- ▶ In theory, e&p is an economic measure of a corporation's ability to make distributions to shareholders without distributing any capital contributed by shareholders or creditors, and is not to be reflective of tax policy

Can We Just Use Retained Earnings?

- ▶ Maybe, but not likely – see, e.g.,
 - timing and permanent differences
 - purchase accounting adjustments
 - tax free reorganizations
- ▶ Recent experience
 - US company had <\$200M> deficit in retained earnings
 - E&P was positive \$100MM
 - Difference due to write offs of value that are not recognized for tax purposes

Calculating E&P

To compute E&P for the year, start with the corporation's taxable income, then generally:

Add	Subtract
Economic income not included in taxable income	Economic outflows not allowed as deductions
Deductions to taxable income, not economic outflows	

- Adjust for timing differences between reporting income and expenses for taxable income purposes vs. reporting income and expenses for E&P purposes

Foreign E&P

Foreign corporate E&P is determined in substantially the same manner as domestic corporations

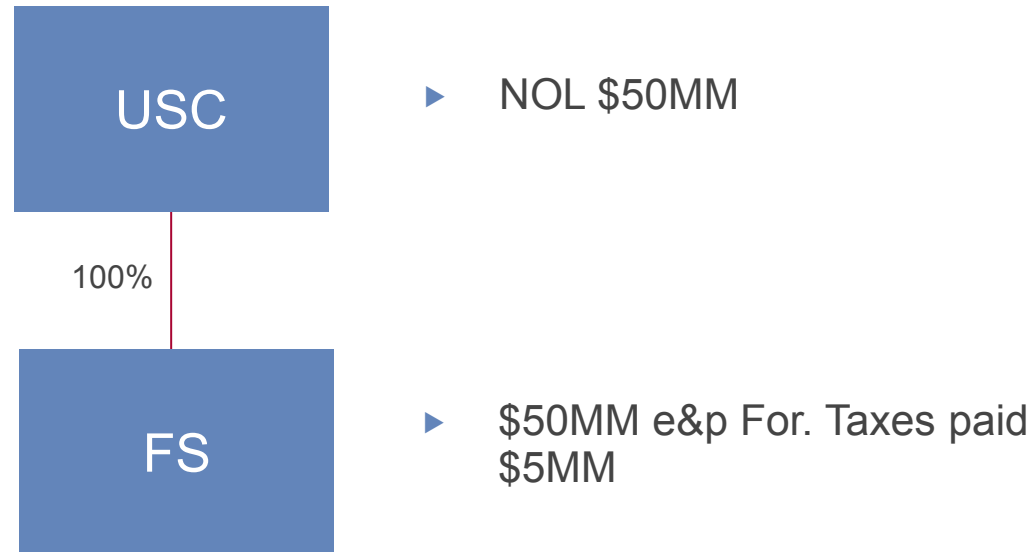
Three Step Approach

1. Prepare a local country P&L
2. Make adjustments to conform the P&L to US GAAP
 - a) Material adjustments – facts and circumstances
 - b) e.g. social reserves, warranty reserves, risk reserves and certain foreign pension deductions, etc., are not permitted
3. Make adjustments to conform to US tax accounting standards
 - a) Includes adjustments necessary to reflect US tax accounting methods permitted under Section 446.

US SH Filed Form 5471 With Respect to FS – Can It Rely On That?

- ▶ Experience shows forms 5471 may not be very robust in efforts to determine e&p
- ▶ Some US shareholders did not have a prior obligation to file form 5471

Using Tax Attributes



- ▶ Transition tax results in \$50MM of income includable in USC income in 2017
- ▶ Can use the NOL to shelter the income, resulting in no taxable income for corporation tax
- ▶ Can elect out to use foreign tax credits, preserving NOL
- ▶ What if you don't elect out?

Using Tax Attributes

- ▶ Is NOL fully vetted and available?
 - Any §382 limitation?
- ▶ Foreign tax credit is subject to haircuts that may reduce the value

Transition Tax – Rates

- ▶ 15.5% to the extent inclusion is attributable to the foreign entity's aggregate cash position
- ▶ 8% on the remainder
- ▶ Cash
 - all cash;
 - net accounts receivables;
 - the fair market value of similarly liquid assets, such as personal property actively traded on an established financial market (except for stock in specified foreign corporations);
 - government securities;
 - certificates of deposit;
 - short-term obligations; and
 - Treasury secretary "may identify other assets that are economically equivalent" that can also be treated as cash
- ▶ Open questions – net receivables with payables?

Transition Taxes – Payment

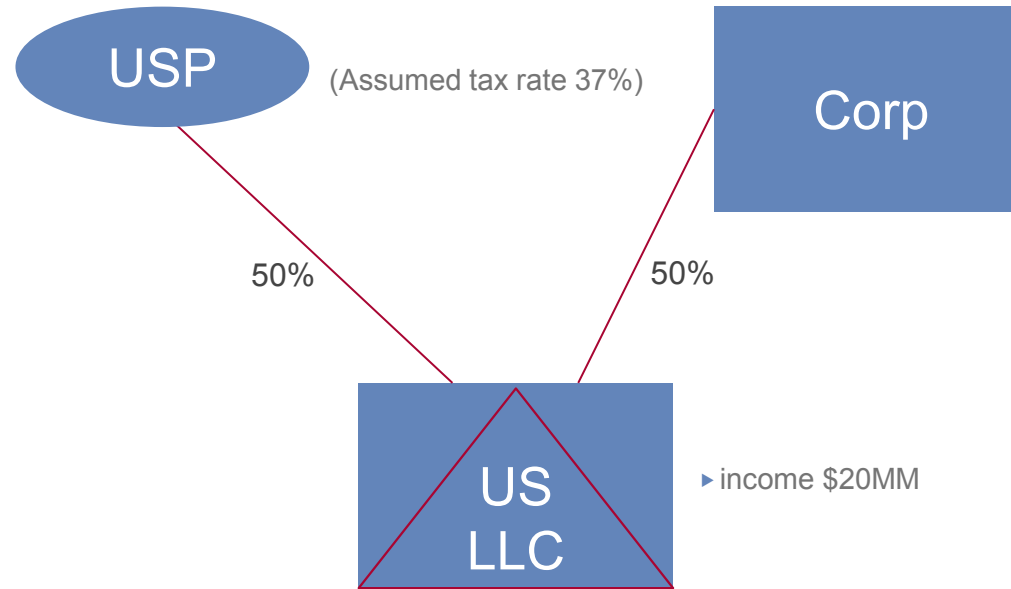
- ▶ Elect to pay over 8 years
 - 8% in first 5 years
 - 15% in 6th year
 - 20% in 7th year
 - 25% in 8th year
- ▶ S corporation shareholders may elect to defer until a “trigger” event
- ▶ How does deferral work for LLCs? Why don't LLCs get same option as S corporation?

Impact on Deal Structuring

Deal Structures

- ▶ Change of C Corp tax rate 35% → 21% starting in 2018, permanent
- ▶ Alternative Minimum Tax repealed
- ▶ Certain international rules can increase rate for cross border payments
- ▶ NOLs no longer carried back, but post 2017 NOLs carried forward indefinitely. Use of post 2017 NOLs limited to 80% of income
- ▶ Reduction in rates of non-corporate owners of certain pass through structures for 2018-2025, via increased deduction
- ▶ Expensing of investments
 - Government support of acquisition
- ▶ Limits on deductibility of interest

Taxation of Pass Through Income – The Basics



- ▶ US LLC is actively involved in a qualified business (other than a specified business), \$10MM is allocated to USP on her K-1
- ▶ Assuming US LLC has sufficient W-2 wages or assets, USP may be able to claim 20% deduction of taxable income
 - if USP can claim deduction of 20% of \$10MM, USP has reduced the assumed tax rate of 37%, to an effective tax rate of 29.6%

Pass Through Details

- ▶ The deductible amount for a qualified trade or business (QTB) is limited to the lesser of
 - 20% of Qualified Business Income, or
 - the greater of
 - (i) 50% of W-2 wages for QTB or
 - (ii) sum of 25% of W-2 wages for QTB and 2.5% of unadjusted basis of all qualified property immediately after acquisition
- ▶ Result is that the 20% deduction may be reduced if there aren't sufficient W-2 wages or assets supporting the business
- ▶ Only applies 2018-2025

Pass Through Details

- ▶ Qualified trade or business – only if effectively connected with conduct of trade or business in US (or Puerto Rico under certain rules)
 - QBI doesn't include:
 - investment income
 - reasonable compensation/guaranteed payments
 - income from a specified service business

Pass Through Details

- ▶ Specified service business
 - include performance of services in law, health, accounting, actuarial science, consulting, athletics, financial services, etc. and any trade or businesses where the principal asset of such trade or business is the reputation or skill of one or more of its employees.
 - Also includes certain investment management services
- ▶ There is a limited exception for specified service businesses, but only up to a threshold of (\$157,500 + 50,000 for a single filer of \$315,000 + 100,000 for married filing jointly)
 - This threshold amount also applies to QTB. If the QBI is under the threshold amount, the wage limitations don't apply
 - Solo practitioner lawyers may use this

Thinking of the Impact on Deal Structures

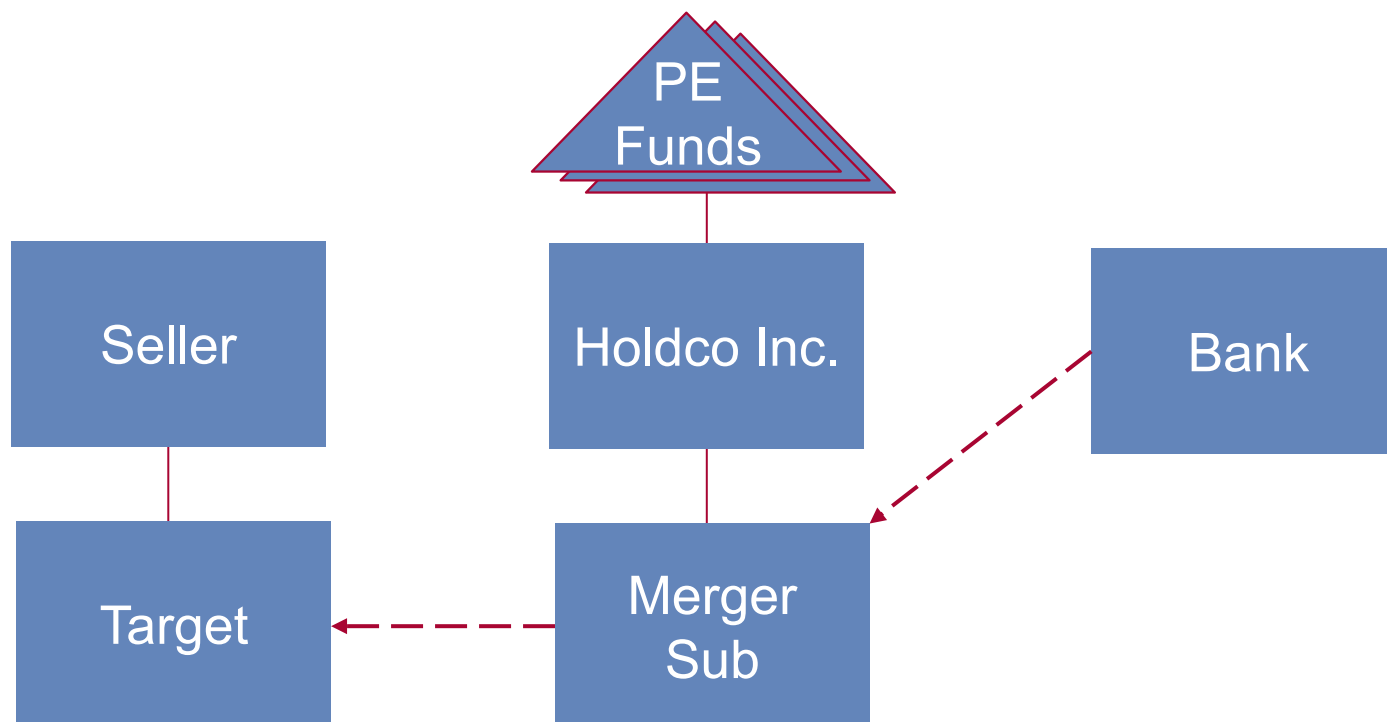
- ▶ Is a C Corp with 21% federal rate preferred?
 - Great for cash flow (watch AET)
 - Still have double tax on distributed earnings (37% federal rate)
 - On sale, could sale qualify for small business rate of 0% for individuals?
 - Can an asset sale be done more efficiently?

Thinking of the Impact on Deal Structures

- ▶ Is a flow through preferred?
 - If QBI, at best, maximum federal tax rate for individual is 29.6% through 2025
 - Allows for single level of tax on distributed earnings
 - On exit, does it matter if you sell assets or LLC units?

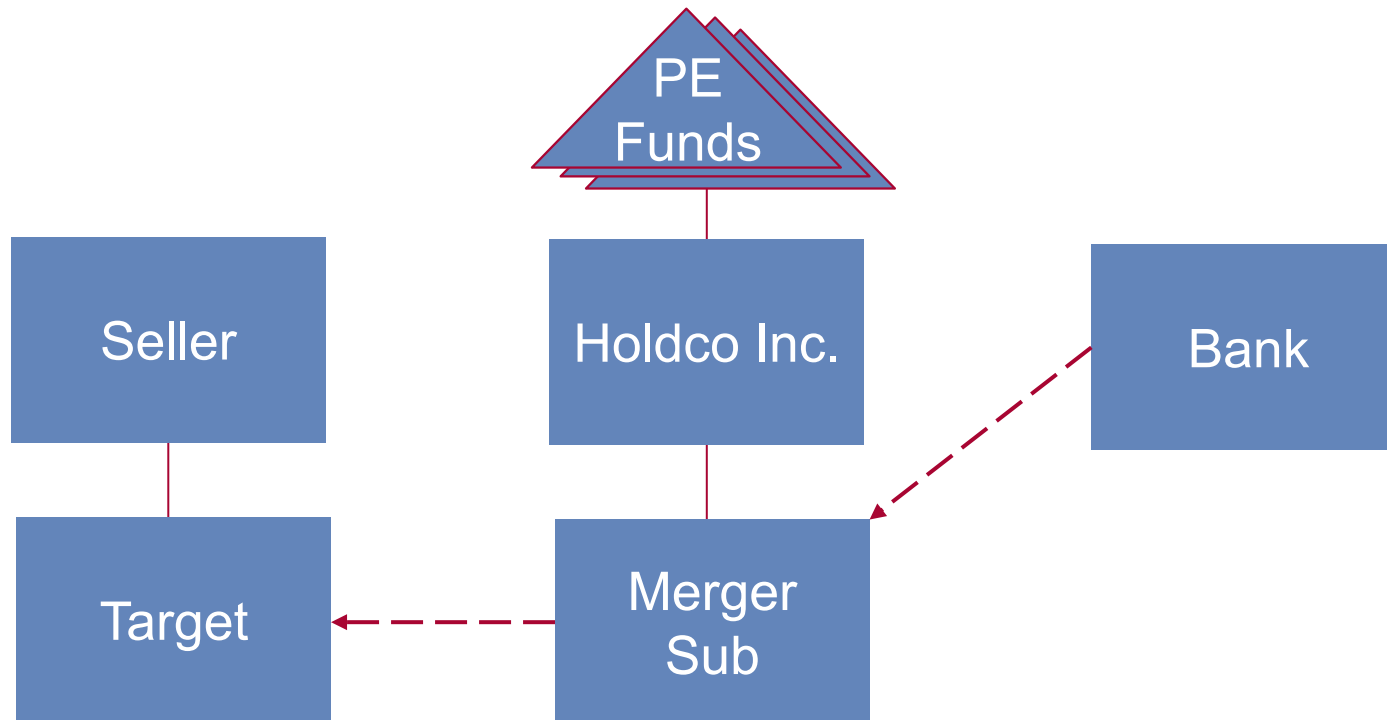
Financing Deals

Base Case: LBOs Under Current Law



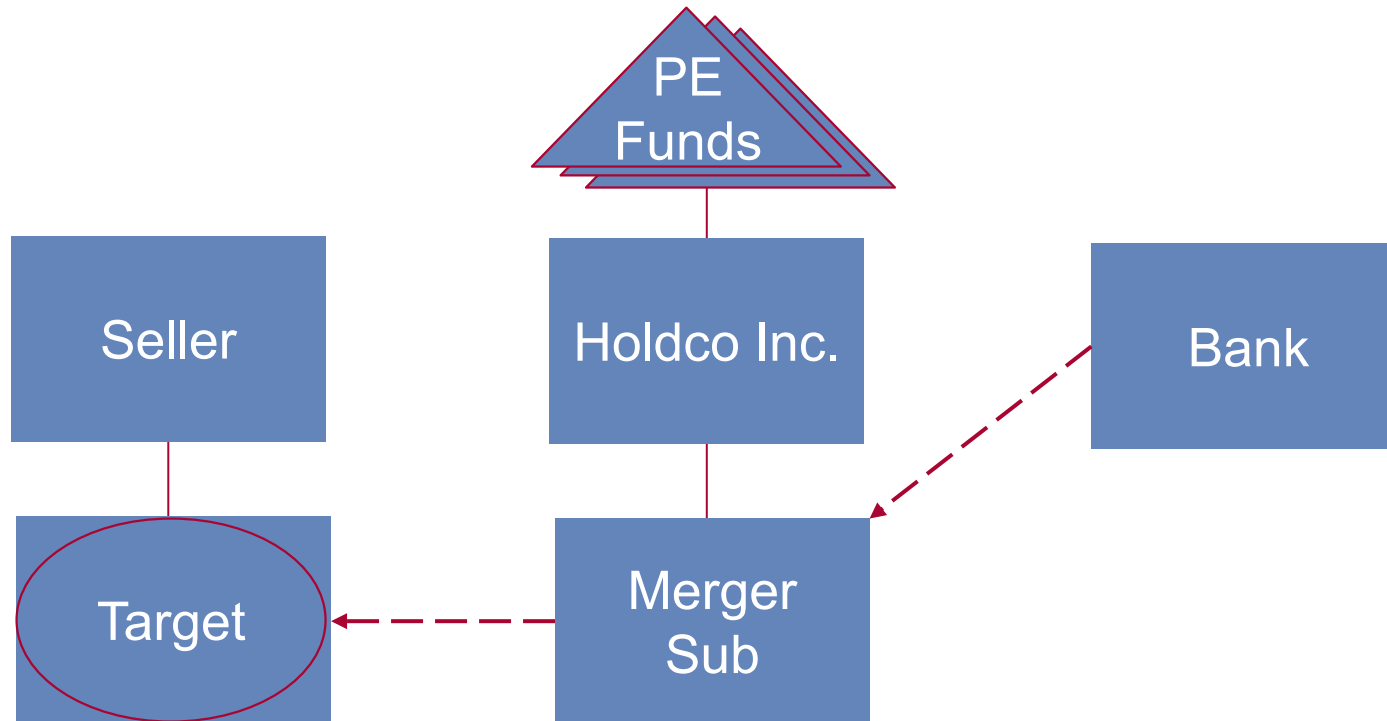
- ▶ Bank lends to Merger Sub, which then merges with and into Target, with Target surviving
- ▶ After the transaction, Target is obligor on debt and pays interest out of operating income
- ▶ Interest payments from Target to Bank will be generally deductible, subject to various limitations (e.g., AHYDO, earnings stripping, debt/equity analysis)

Base Case Under the New Rule



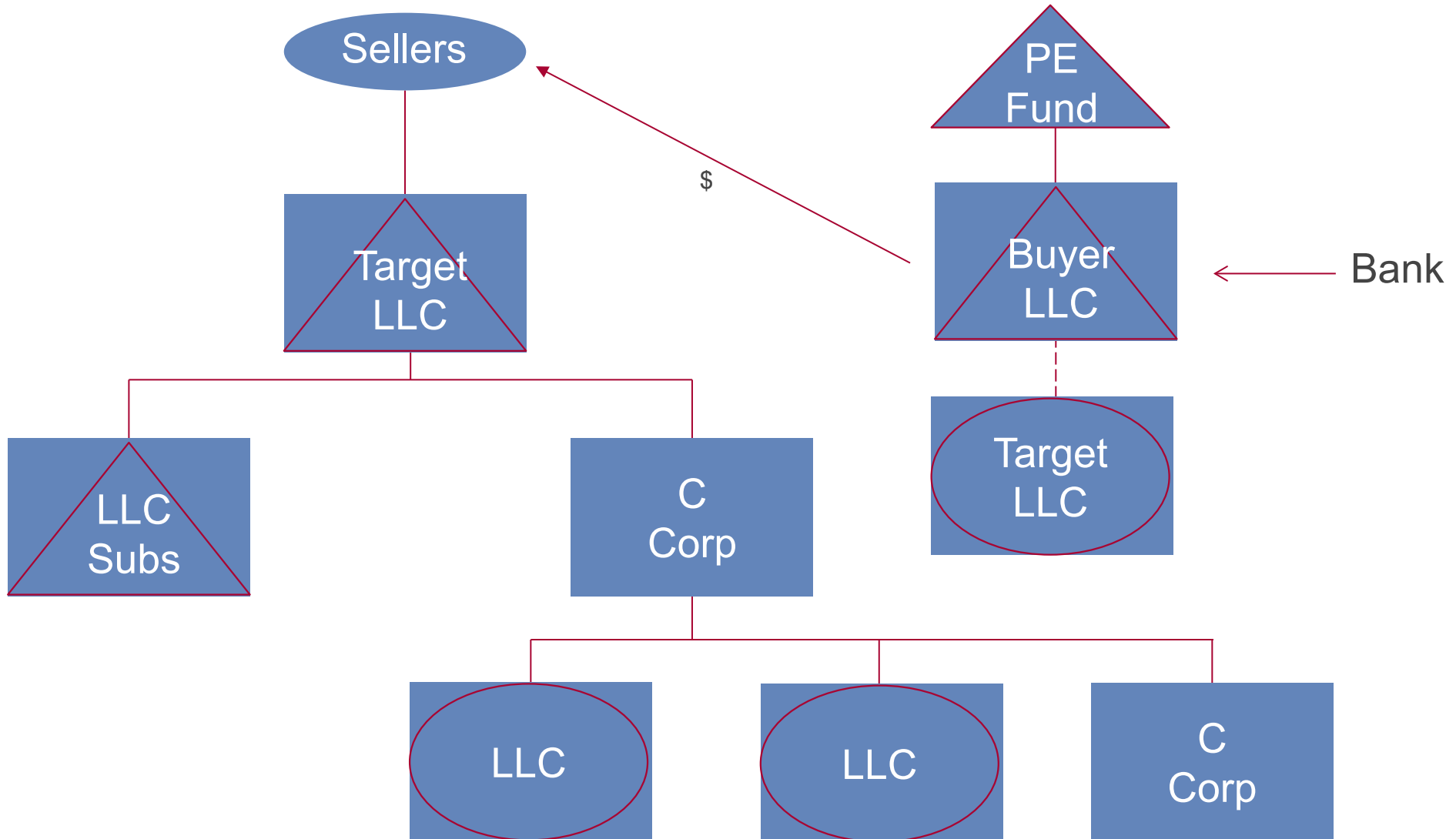
- ▶ Deductibility of interest payments may be significantly reduced
- ▶ Generally, 30% of EBITDA starting in 2018, EBIT after 2022

Asset Deal As a Potential Alternative



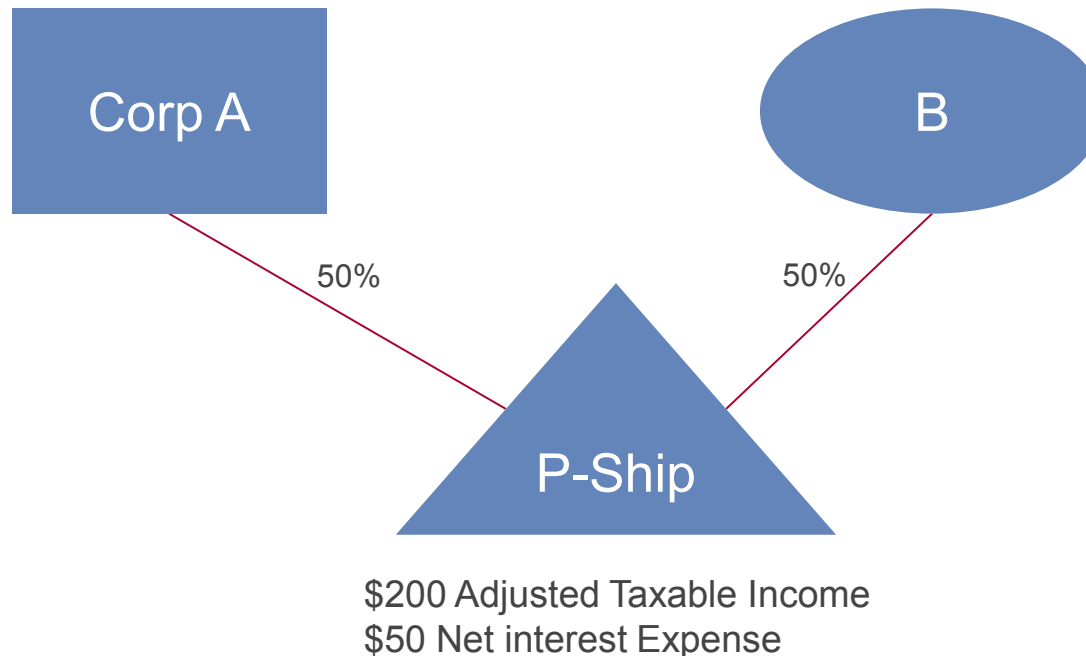
- ▶ As an alternative to a stock acquisition, the LBO is structured as a (deemed or actual) asset purchase
- ▶ Buyer may deduct 100% of purchase price for “qualified property” in year of acquisition
- ▶ Goodwill would still be depreciated over 15 years
- ▶ Where asset sale is not available, will the limitation result in “pure equity” financing?

Calculating the EBITDA Base



- ▶ Does EBITDA Base include that of C Corp?

Partnership Example



- ▶ Corp A and Individual B compute their limitations separately without regard to interest or income of P-ship
- ▶ In this example, no limitation as \$50 of net interest expense is less than 30% of ATI
- ▶ \$5 excess limitation is added to each of Corp A and B's computation of their respective limitation

The New Net Interest Limitation

- ▶ Replaces current “earnings stripping” rule
 - But does not address what happens to a corporations' existing disallowed interest expense for which a deduction was not claimed under current earnings stripping rules
- ▶ Applies to all business regardless of form, with exceptions for taxpayers with average annual gross receipts of less than \$25M for the prior three-year period.
 - ▶ No exception for financial services businesses
- ▶ Limits the deduction for “net business interest expense” to 30% of “adjusted taxable income”
- ▶ Adjusted taxable income is taxable income computed without regard to:
 - any item of interest, gain, deduction or loss that is not properly allocable to a trade or business
 - any business interest or business interest income
 - the amount of any net operating loss deduction
 - the new 20% deduction for certain pass-through income
 - in the case of tax years beginning prior to Jan. 1, 2022, any deduction allowable for depreciation, amortization or depletion
- ▶ Disallowed interest may be carried forward indefinitely.
- ▶ Adjusted taxable income may not be less than zero for this purpose; *i.e.*, current year losses do not increase the limitation

Appendix - Application to Partnerships and S corps

- ▶ Limitation is computed for partnerships and S corps at the *entity* level
- ▶ Double counting rule prevents a partners/shareholder from double counting the entity's adjusted taxable income when determining the partner's/shareholder's business interest limitation.
- ▶ Excess business interest is not carried over by the partnership. Instead, excess business interest is allocated to each partner and is treated as business interest paid by the partner in the next year in which the partner is allocated excess taxable income.
- ▶ Excess limitation is permitted to increase the limitation of each partner

Questions & Answers

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