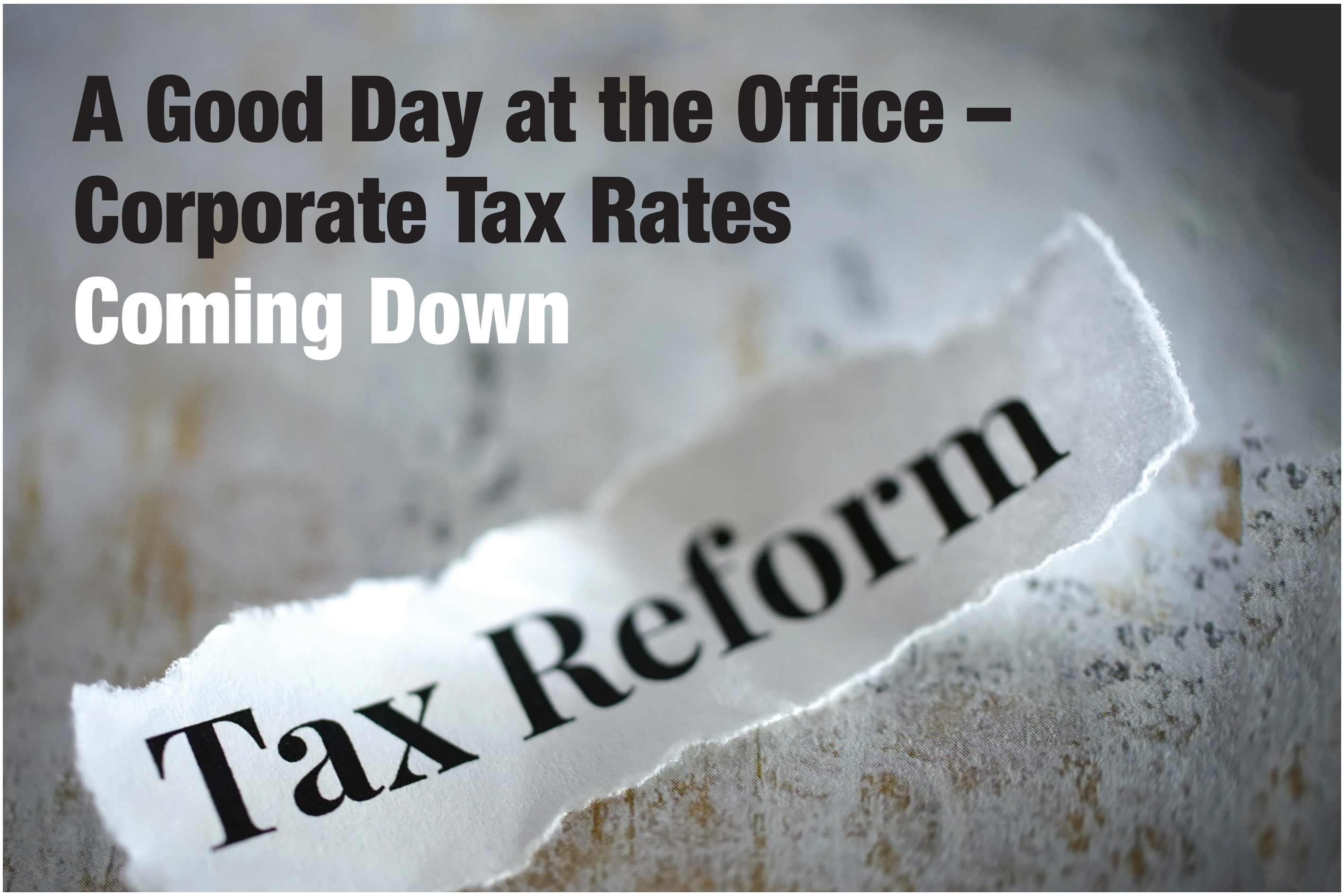
A Good Day at the Office – Corporate Tax Rates Coming Down



By Don Carpenter and Tim Thomasson

This is the third article in a series that is examining the major changes to the tax code resulting from the new tax bill that was enacted at the end of 2017. This article focuses on the changes that affect corporations.

The perceived competitive disadvantage of U.S. business and the increased relocation of these businesses to low-taxed jurisdictions were driving forces behind tax reform. And as the legislation developed, much debate centered on the tax benefits of the bill's provisions for "big business" relative to individual taxpayers.

The corporate rate was reduced to 21 percent from the 35 percent rate that had been in effect since 1993. Both houses of Congress had originally proposed at 20 percent corporate rate, but the Senate version would have delayed the reduction until 2019. Ultimately, a 21 percent rate was agreed upon, but effective from 2018.

Corporations with less than $50,000 of taxable income will see an increase in their tax liability as the 21 percent rate is a flat rate and eliminates the 15 percent rate on what was the initial tranche of the prior graduated rate schedule. Conversely, professional service corporations, which are common in such professions as health services, accounting, engineering and law, are subject to tax at the highest rate in effect for corporations. Accordingly, the tax rate for these entities is now reduced from 35 percent to the new rate of 21 percent.

Although not broadly applicable, corporations that receive significant dividends from investment in less than 80 percent owned corporations will not benefit from the rate reduction on these dividends. The dividends received deduction (DRD) from "20 percent to less than 80 percent owned corporations" was reduced from 80 percent to 65 percent and for "less than 20 percent owned" from 70 percent to 50 percent. The effective tax rate on these dividends remains at roughly 10 percent. This result is surprising given that other forms of passive income such

Figure 1

	Prior Law	New Law
Dividend (79% owned)	$100	$100
DRD (80% / 65%)	(80)	(65)
Taxable Dividend	$20	$35
Tax (35% / 21%)	$7	$7

as interest and capital gains benefit from the rate reduction. The calculation in Figure 1 illustrates the above result.

Companies may also find that with the lower tax rate, tax credits may be limited. Under the general business credit computation, most tax credits are combined and available to offset up to 75 percent of tax liability. With a lower tax liability, taxpayers will see a lower cap on tax credit capacity, which can alter the economics of projects or tax credit driven transactions.

Domestic Production Activities Deduction Eliminated

In conjunction with the corporate rate reduction, Congress eliminated the 9 percent deduction for taxable income from domestic production activities (DAP). This deduction was included in the American Jobs Creation Act of 2004 and was intended to encourage manufacturing and similar production activities in the United States. Although still beneficial, the current rate reduction is not as dramatic for businesses that qualified for the DAP deduction as illustrated in Figure 2.

Figure 2

	DAP Qualified	Non-Qualified
Income	100	100
DAP Deduction	(9)	-
Net	91	100
Tax on Net at 35%	32	35
Tax on Gross at 21%	21	21
Tax Reduction	11	14

One Headache Gone – AMT is History

The new tax act has been criticized for not achieving the simplification that was a major justification for tax reform. The repeal of the corporate alternative minimum tax (AMT) is a striking exception and is arguably the lone major simplification in the legislation. The corporate AMT was intended to ensure that corporations pay at least some level of tax by limiting or eliminating specified tax deductions and credits. Had the corporate AMT provisions been retained, the reduction in the corporate rate could have caused more corporations to be subject to the AMT.

Prior to repeal of the AMT, corporations were allowed a credit against future regular tax liability for any AMT paid to ensure that AMT tax adjustments were not subject to both AMT and regular tax. Under the new law, any remaining AMT credit carryforward as of 2018 can be used to reduce tax liability for the 2018 to 2020 tax years. To the extent the credit exceeds the liability for these years, 50 percent of the excess is refundable, with any remaining balance being refundable in 2021. See the illustration in Figure 3.

Figure 3

Assume Company A ended 2017 with a $20mm AMT credit carryforward. The company has tax losses for 2018 and 2019 and has a tax liability in 2019 of $2mm. Under these assumptions, the credit would be utilized as follows:

	Offset Liability	Excess Refunded	Total Used
2018	-0-	$10.0mm	$10.0mm
2019	-0-	$5.0mm	$5.0mm
2020	$2mm	$1.5mm	$3.5mm
2021		$1.5mm	$ 1.5mm
Total			$20.0mm

But is AMT Really Gone? The Use of Tax Losses Changes Considerably

Although the complicated system of AMT tax preferences items was repealed, the new provisions retain the philosophy that every corporate taxpayer should pay a minimum level of tax. This is now achieved through a limitation on the deduction of net operating losses (NOLs). NOLs from any tax years beginning after Dec. 31, 2017, may only be deductible against 80 percent of a subsequent year's taxable income.

Under prior law, NOLs could be carried back to the two previous years and carried forward for 20 years. During this period, the NOL was fully deductible to the extent of a corporation's taxable income. For tax years ending prior to 2018, these rules still apply to NOLs generated before 2018. But for NOLs after that point, the calculation changes significantly.

For NOLs from tax years ending after Dec. 31, 2017, the two-year carryback provision has been eliminated. Henceforth, losses may only be carried forward. However, the carryforward

Figure 4

Assume that ABC, Inc. has an NOL of $500mm in 2018 due to tax deductions that it cannot control (i.e., legal settlement, pension funding, stock options exercised). The corporation regularly has about $150 of taxable income each year. The NOL would be utilized over four subsequent years:

	2018	2019	2020	2021	2022	2023
Taxable Income	(500)	150.0	150.0	150.0	150.0	150.0
Utilization of 2018 NOL		(120.0)	(120.0)	(120.0)	(120.0)	(20.0)
Remaining Taxable Income		30.0	30.0	30.0	30.0	130.0
Tax (21%)		6.3	6.3	6.3	6.3	27.3

Had ABC, Inc. been able to accelerate the deductions that created the NOL into 2017, $300mm of the NOL would have resulted in an immediate refund of $105mm from carryback against the $150 taxable income in each of the two prior years and then carried forward to reduce the two subsequent years subject to the 80 percent limitation.

	2015	2016	2017	2018	2019
Taxable Income	150.0	150.0	(500.0)	150.0	150.0
Utilization of 2017 NOL	(150.0)	(150.0)		(120.0)	(80.0)
Remaining Taxable Income	-0-	-0-		30.0	70.0
Tax (35% / 21%)	(52.5)	(52.5)		6.3	14.7

Two additional points are worth noting:

1. The language of the new law does not make clear how the 80 percent limitation on the deductibility of post-2017 NOLs will be calculated if a corporation also has pre-2018 NOLs. If the limitation is calculated in the current year's taxable income without reduction for the earlier NOLs (which are not limited), the corporation will be able to deduct a larger portion of the later NOLs than if the 80 percent limitation is computed after deduction of the pre-2018 loss.
2. The underscore of "beginning" and "ending" above is to emphasize that the limitation of deductibility of NOLs and the carryback/carryforward periods are not identical for fiscal year corporations. NOLs for a fiscal year that began between Jan. 2, 2017 and Dec. 31, 2017 could only be carried forward, albeit indefinitely, but would be fully deductible against future years' taxable income.

We will consider later how the interplay between the limitation on deductibility of NOLs and accelerated capital cost recovery might alter investment decisions.

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period is no longer limited to 20 years, but is indefinite. The new provisions do not address the carryback of capital losses, so presumably the three-year capital loss carryback remains in effect. See Figure 4 for an illustration of the impact of this change.

Rethinking the Form of Doing Business One More Time

In the previous article regarding the taxation of pass-through entities, we discussed how the new law might cause taxpayers to favor one type of pass-through entity in lieu of another. But taxpayers should also consider the relative merits of pass-through entities as compared to corporations.

What if a business qualifies for the QBI deduction that was the subject of the prior article, but given the taxpayer's income, the deduction is not available? With the reduced corporate tax rate, would a C corporation yield a lower effective tax rate, even with full distribution of after-tax profits? To illustrate, assume Ted is in the top marginal rate of 37 percent. He operates a CPA business through two alternative structures, an S corporation and a C corporation, both of which generate $200,000 taxable income after wages to employees. The total tax liability, whether paid by the entity or Ted, is shown in Figure 5.

Figure 5

	S Corporation	C Corporation
Taxable Income	$200,000	$200,000
Tax at entity level (21%)	N/A	$42,000
Tax on distribution of profits	N/A	$ 37,604
Tax on flow-through profits	$74,000	N/A
Total tax liability	$74,000	$79,604

Based on the above, operation of the CPA firm through an S corporation results in a total lower tax burden for Ted, although the margin is very small. He would incur a $74,000 tax liability on his distributive share of S corporation income. As a C corporation, the business would incur corporate tax at a rate of 21 percent. Upon distribution of the after-tax profits, Ted would incur taxes of $37,604 based on a combined income and net investment tax rate of 23.8 percent. Therefore, the total tax liability would be $79,604.

Many other factors should be considered, however, including state income taxes, AMT, employment taxes and plans for distributions of profits. For example:

- If Ted was able to benefit from the QBI, his tax liability under the pass-through would be even further reduced.
- If Ted did not plan to fully distribute all after-tax profits but rather re-invest them in the business, the C Corporation liability could be reduced even below the pass-through liability.

After considering the new deduction for pass-through entities and the lower tax rates for both individuals and corporations, a few additional items might alter a structuring decision in very specific circumstances:

- If a corporation is likely to have significant dividends from less than 80 percent owned corporate investments, the relatively high effective corporate tax rate on these dividends might justify placing these investments in a pass-through entity.
- Likewise, the limitation on the deductibility of corporate NOLs might encourage an owner/operator of a business to consider a pass-through entity.
- But the elimination of the AMT for corporations might tilt certain businesses to corporate form particularly if the business has material accelerated depreciation or percentage depletion, which remain preference items for individual AMT.

Everything Comes with a Cost

Before we discuss the major changes that were made to capital cost recovery, we should consider three areas where corporations will see modifications to deductions that could increase taxable income and, in some circumstances, increase it significantly.

In conjunction with lowering the corporate tax rate, Congress made modifications to the limitations on deductibility of interest expense. The changes in this area are complex enough to justify an in-depth analysis and will be the subject of the next article in this series.

The deduction for meals, entertainment and other fringe benefits was also further restricted as part of the new law. These modifications are not limited to corporations.

In addition to club membership dues that have not been deductible for some time, expenses for entertainment or recreation, as well as costs for company-owned or leased recreational facilities, are no longer deductible. These costs are not deductible even if incurred in conjunction with the conduct of the taxpayer's business.

In addition, any expenditures to provide or reimburse employees for commuting costs between their home and office are no longer deductible. This includes subsidies for public transportation and employer-provided parking.

The 50 percent limitation on the deduction for meals associated with conducting business has been retained and has been expanded to include most meal costs that were previously 100 percent deductible, such as meals provided on-premises and meals provided for the convenience of the employer. These costs are deductible if the employer elects to include them in the taxable income of employees.

The new law also expanded the disallowance for otherwise ordinary and necessary business expenses to include payments (included attorney fees) related to sexual harassment or abuse claims if the payments are subject to a nondisclosure agreement.

Deduction for Executive Compensation Changes Significantly

In recent years, there has been considerable discussion regarding the level of executive compensation when compared to the compensation of lower and mid-level workers. The stagnation of wages since the 2008 financial crisis only helped to fuel the debate. The new law included revisions to the rules regarding the deduction for executive pay that makes it significantly more expensive to pay the level of compensation executives have come to expect in public companies.

There has been a long-standing restriction on the deduction for compensation to highly paid executives in public companies. And it should be noted that these restrictions were limited to public companies. The new law expands the restrictions to companies with publicly traded debt and foreign companies traded on the exchanges using American Depository Receipts (ADRs).

But the real meat of the revisions addresses what types of compensation are included and whose compensation is included. Previously, public companies were limited to $1 million in compensation per year for its CEO and another four of its highest paid executives (called "covered employees"). There was a major exception for any compensation that was "performance based," which included bonuses, stock options

THESE CHANGES IN TAX LAW SHOULD CAUSE BUSINESSES TO REVIEW THEIR FORM OF BUSINESS, COMPENSATION PACKAGES FOR HIGHLY COMPENSATED INDIVIDUALS AND THE TIMING OF ASSET PURCHASES.

and restricted performance shares if the payment was based on individual or company performance criteria, such as earnings targets or stock appreciation. Generally, it was not difficult to structure around the $1 million limitation, since a large portion of executive compensation is or can be performance based.

The new provisions eliminate the performance-based exception. All compensation will now be included in the limitation. The new law does provide an exception for compensation granted under a written contract in existence as of Nov. 2, 2017 that is not discretional and cannot subsequently be altered. The example given in the law concerns a new employee who agrees to a deferred compensation plan prior to Nov. 2, 2017. Arguably, this provision will cover stock options and restricted performance shares granted before that date as well, but further clarification may be required.

When under prior law, the CEO and the next four highest compensated individuals were covered employees; the list of covered employees could and often did change annually. Previously, the principal financial officer was excluded from the definition of covered employee, but will be included under the new law. Additionally, an individual was exempt from being a covered employee if he/she was not an employee at the end of the year. This last exception allowed large retirement or severance payments to be exempted from the $1 million limitation. Under the new provisions, the definition of covered employee will include the CEO, chief financial officer and the next three highest paid individuals. And once on the list, an individual remains on the list throughout the period of employment and into retirement. The list can and will grow, and forestalling payments until executives leave the employ of a company will not "cure" the payouts.

To illustrate, ExecuComp, Inc. will pay Ms. Cash (CEO), Mr. Rich (CFO) and Ms. Payme (VP Sales) identical compensation packages consisting of $900,000 of base pay and $3 million bonus that is payable on a sliding scale if the company meets certain earnings and cash flow targets. In addition, Mr. Rich intends to retire in November next year and will vest in a restricted stock grant worth $10 million.

Under the old provisions, the $1 million limitation would not reduce the total compensation deduction of $21.7 million for these three individuals. The $900,000 base pay for each of the individuals is not performance based, but is below the $1 million limitation. The bonuses are exempt as performance-based pay. Mr. Rich's entire compensation package (including restricted stock) is also exempt since he is not an employee at the end of the year.

Under the new provisions and assuming the payments are not grandfathered, the compensation deduction will be limited to only $3 million for these individuals. The remaining $18.7 million is permanently non-deductible, resulting in an increase in tax of $3.9 million.

Potentially, these changes significantly increase the after-tax cost of executive compensation and may drive changes in compensation structure. Companies could consider the following:

- Lengthening the vesting period for stock options and other performance-based compensation to average down the cost per year.
- Reducing total compensation, but increasing the base portion of the package. This would limit the upside for executives and also the risk, and allow companies to better plan both the earnings and cash flow implications of compensation and related taxes.

A Big Bonus in Bonus Depreciation

For small and mid-size businesses, the provision to allow for expensing the purchase of business assets (Sec. 179) was increased. The $500,000 limit on expensing business assets has been increased to $1 million. Furthermore, the dollar-for-dollar phaseout of the deduction has been increased to $2.5 million of asset purchases from the previous $2 million. These limitations will be indexed for inflation.

But the Sec. 179 business asset expense will not be a major factor for most businesses for several years. The new law also increases the 50 percent bonus depreciation deduction to 100 percent for assets purchased from Sept. 27, 2017 until Dec. 31, 2022. The deduction will then reduce to 80 percent in 2023, 60 percent in 2024, 40 percent in 2025 and 20 percent in 2026. Taxpayers may elect 50 percent bonus depreciation for 2018 in lieu of 100 percent. We will discuss when this might be beneficial. The bonus depreciation provisions are elective by asset class, but if elected must apply to all assets in an asset class within a taxable year.

Most surprising is that bonus depreciation can now be applied to "used" property and equipment as long as it was not previously used by the taxpayer or acquired from a related party. This is a material change from prior bonus depreciation provisions and can have a significant impact on acquisitions and purchase price allocations.

The law excludes from bonus depreciation any assets used in the trade or business that is not subject to the net business

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interest expense limitations, which will be discussed in the next article in this series.

Contrary to the 100 percent bonus depreciation allowance, the new law restricts the deduction for research and experimental expenses (R&E), including software development costs. Previously, these costs were deducted as incurred regardless of whether a subsequent patent or commercial application was developed. For expenditures incurred after 2021, these costs must be capitalized and amortized over five years (15 years if conducted outside the United States). The costs continue to be recovered through amortization even if subsequently sold or otherwise disposed of.

Bonus Depreciation and NOL Utilization – Some Planning Needed

The interplay between bonus depreciation and the limitation on the deduction of NOLs will require taxpayers with significant capital expenditures (or acquisitions) relative to taxable income to consider the cash flow implications.

For example, RampUp, Inc. has determined to significantly increase its purchase of delivery trucks as it sees major growth in the company's markets in the next several years. RampUp expects taxable income of $1.0 million in the next two years (before depreciation), but will be acquiring $2 million of new and used equipment.

If the equipment is acquired in 2018, RampUp has two options:

1) Expense the $2 million under the bonus depreciation provisions.
2) Forego bonus depreciation and elect MACRS depreciation.

Depreciation would be:

	2018	2019
Option 1	$2.0	-0-
Option 2	$0.4	$0.6

Neither of these options would eliminate the taxable income in the two years combined, as any NOL from 2018 could only reduce 2019 taxable income by 80 percent. However, if RampUp delayed the purchase of half of the trucks until Jan. 1, 2019, it could eliminate the taxable income for both 2018 and 2019, as the bonus depreciation for assets acquired within a taxable year is not subject to the same limitations as NOLs.

Challenging Assumptions – A Final Thought

For companies that are considering possible acquisitions, the changes should cause a wholesale review of acquisition assumptions and models. Specifically:

- Bonus depreciation for "used" property may allow an immediate deduction for a large portion of purchase price and further encourages asset or Sec. 338 synthetic asset acquisitions rather than stock acquisitions.
- The cash flows of profitable targets should increase as the rate reduction will generally reduce cash tax liabilities. This should also trigger review of long held multiple assumptions like "businesses in our industry sell for X times revenue or Y times EBIT."
- NOLs of targets will have lower valuations than under prior tax law given the reduction in corporate rates and the 80 percent deduction limitation. However, indefinite carryforward mitigates utilization risk.
- Financing costs increase as the tax benefit of interest expense is reduced. The interest expense limitation discussed in the next article must also be considered.
- The tax implications of golden parachutes and other compensation structures must be reviewed given new limitations on the deduction for executive compensation.

In summary, the passage of the new tax law was a good day at the office for business and particularly corporations. The lower tax rate and repeal of AMT have been objectives for American businesses for quite some time. But the limitation on the deduction of NOLs and performance-based executive compensation will have many tax departments and advisors back at the drawing board. Furthermore, the impact of the new law on acquisitions and valuations may change the playing field and redefine who are the winners and who are the losers.

Note that we excluded from the scope of this article major changes to the taxation of a corporation's international operations, including the (1) transition towards a territorial tax system, (2) base erosion avoidance tax and (3) taxation of general low-taxed income. As noted above, we also excluded an analysis of the new limitation on the deduction of interest expense. All of these issues, which are worthy of more in-depth discussion and will be the subject of future articles, will have a significant impact on corporations with international operations and/or significant levels of debt. ■

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