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320 N Broadway, Green Bay, WI

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April 4, 2018 | 5:00 to 7:00 PM
The Drake Hotel
23010 York Road, Oak Brook IL

MBBI Wisconsin Event
Train Your Brain for Success
May 16, 2018 | 1:00 – 6:00pm
Wisconsin Club
900 West Wisconsin Avenue
Milwaukee, WI

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MBBI Newsletter March 2018

Tax Changes Are More Than Meet the Eye

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The Tax Cuts and Jobs Act (the Act) signed into law on December 22, 2017 makes key changes that impact important business decisions made by company owners. The federal corporate tax rate is cut from 35% to 21%. The top federal tax rate for pass-through entities (S-Corps, LLCs, and sole proprietorships) is cut from 39.6% to 37%. Pass-through entities are allowed a deduction equal to 20% of qualified business income subject to certain limits. Capital expenditures are now 100% expensed against taxes in the year they are incurred. Interest is deductible up to 30% of operating income plus depreciation and amortization.

We offer the following additional points to consider as part of your business planning for 2018 and beyond.

Corporate Tax Cuts Are What They Appear To Be

The federal corporate tax rate reduction from 35% to 21% is permanent. The central intent of the tax law changes was to make U.S. corporations more competitive on a world stage and to encourage more domestic production activity. The Act accomplishes this by putting U.S. corporate tax rates at levels competitive with those of other countries. The 21% tax rate is permanent absent new legislation.

Pass-Through Cuts May Not Be What They Seem

First, the top federal individual rate cut from 39.6% to 37% is temporary and expires December 31, 2025. The 20% deduction for qualified business income, that may not be fully available in some situations, reduces the 37% tax rate to 29.6%, and is also temporary. It expires in 2025. For the reduction to be available beyond 2025, Congress must pass and the President must sign (vetoes are rarely overridden) an extension. We cannot know what the economic or political conditions will be when changes are considered. Without an extension, in 2026 the maximum individual rate will revert back to 39.6%, and the 20% qualified business income deduction goes away.

In addition, the 20% qualified business income deduction is means-tested. If one's income is greater than $415,000 then the deduction cannot exceed the greater of: (i) 50% of total company wages; or (ii) 25% of total company wages plus 2.5% of the original cost of tangible property owned by the taxpayer. Obviously, there is some complexity in calculating the amount of the deduction and without it, the tax rate could be as high as 37%. In a business sale, the chances are higher that the wage and asset tests will significantly limit the deduction subjecting the seller to the higher tax rates for ordinary income portions of sale proceeds not taxed as capital gains.

In any case, the benefits of the 20% business income deduction for sole proprietorships and pass-throughs are not as clear cut as the permanent corporate tax rate reduction.

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Midwest Business Brokers and Intermediaries Newsletter is published monthly. All MBBI members are invited to submit articles for publication. **MBBI.org**

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Now is a Good Time to be Expanding Your Business

Much of the tax changes are pro-growth measures targeting manufacturers and producers. The law specifically rewards companies that engage in expansion by permitting a 100% write-off of capital expenditures in the year of purchase. The 100% of capital expenditures write-off applies to tangible property with a recovery period of 20 years or less, software (if not acquired in a business purchase transaction), and non-residential leasehold improvements. By deducting 100% of the cost of capital expenditures in the year incurred from 2018 through 2022, the U.S. government is encouraging businesses to invest now.

Now is A Good Time to be a Business Buyer

As a buyer, there are several incentives for you to act quickly with your acquisition efforts.

1. 100% of all capital expenditures can be written off in the year they are incurred through 2022. The write-off steps down by 20% per year thereafter. For many buyers, the effect of this rule is that no income taxes will be paid for several years after the purchase. Whether your business is a corporation or pass-through, you benefit from reduced taxes and can use the increased cash flow to pay more for the acquired business, make additional capital expenditures or return money to your shareholders.
2. Interest deductibility is more favorable until January 1, 2022 because a buyer can deduct interest expense up to 30% of operating income plus depreciation and amortization (EBITDA). In 2022 and beyond, the deduction is reduced to 30% of operating income after deducting depreciation and amortization (EBIT). Given the enhanced depreciation rules, interest deductibility will be significantly reduced for many businesses after 2021. Interest deductions not available due to the 30% limitation may be carried forward to future years when they may not be deductible.
3. Lower tax rates enable buyers to have more annual cash flow from the companies they buy.

Now is A Good Time to be a Business Seller

1. Buyers will have more after tax cash flow in 2018 and beyond than in previous years. This is especially true for the next four years as the 30% interest deduction limitation is not effective until 2022. This means that purchase prices offered by buyers will increase noticeably, especially in the next few years.
2. Business confidence is high, credit conditions are favorable and private equity and mezzanine debt funds have a lot of “dry powder” they need to deploy. With more buyers taking advantage of the new tax rules, it is a seller’s market more than ever.
3. As a seller, you will most likely be able to keep more sale proceeds than you would if you sold in 2017.
4. Businesses are currently being sold at multiples that are high by historic measures. One of the reasons for this is that interest rates are at historic lows. When rates increase, and they will, valuation multiples will soften and fall from current levels. For sellers, there is a window of opportunity now: low interest rates + lower taxes = higher prices.

In conclusion, the Act represents a significant improvement to the business tax outlook for C corporations and pass-through entities alike. It is an impact that will stimulate business activity in 2018 and beyond. The next three years may also be the best time to buy or sell a business.

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