REGIONS
SECURITIES LLC

# Tax Reform and Related Implications for Business Owners
January 2018

# Tax Reform Summary

## Snapshot

### Overview

- On Wednesday, December 20, 2017, Congress approved a sweeping $1.5 trillion tax bill that modified tax rates for corporations, provided new breaks for private businesses, and reorganized the individual tax code. The tax reform was the largest overhaul of the U.S. tax system since 1986
- The Tax Cuts and Jobs Act, or the Act, replaces the graduated corporate income tax with a flat 21.0% rate, the lowest rate since 1939
  - To partially offset the cost of lower rates, the Act would modify or eliminate a number of credits and deductions
  - Many of the major individual provisions, including changes for pass-through businesses, will sunset after 2025
- The Act also includes fundamental changes to the taxation of multinational entities, including a shift from the current system of worldwide taxation with deferral to a hybrid territorial system
  - Features a participation exemption regime with current taxation of certain foreign income, a minimum tax on low-taxed foreign earnings, and new measures to deter base erosion and promote U.S. production
- The Act is expected to reduce government revenue by $1.5 trillion in fiscal years 2018 through 2027 on a static basis, according to a joint analysis from the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT)
  - The reduction in revenue would be partially offset by a $194.0 billion reduction in outlays

**Corporate Rate and Deductions**

- The previous top rate of 35.0% has been replaced by a flat 21.0% corporate income tax rate beginning in the 2018

**Interest Deduction**

- The net interest expense deduction would be limited to 30.0% of a business's adjusted taxable income
- From 2018 through 2021, adjusted taxable income would be considered earnings before interest, taxes, depreciation, and amortization ("EBITDA"). In subsequent years, the deduction would be reduced to earnings before interest and taxes ("EBIT")

**Net Operating Loss Deduction**

- The net operating loss deduction carryover would be limited to 80.0% of a taxpayer's eligible income, computed without consideration of the deduction itself
- The ability to carry back a loss to a previous year would be repealed, but losses could be carried forward indefinitely

**Cost Recovery**

- Allows for full and immediate expensing of capital investments placed in service after Sept. 27, 2017, and before Jan. 1, 2023
- After 2023, "bonus" or "accelerated" depreciation would phase out by 20 percent per year through 2026 (or through 2027 for property that qualified for an extra year of full expensing)

# Tax Reform Summary

## Key Components

| Items | New Legislation | Previous Legislation |
|---|---|---|
| Individual Tax Rates (Effective 2018-2025): | • Seven brackets of rates, starting 10.0% and reaching as high as 37.0% for income above $500,000 for single filers and $600,000 for married, joint filers | • Seven brackets of rates, starting 10.0% and reaching as high as 39.6% for income above $418,401 for single filers and $470,701 for married, joint filers |
| Corporate Tax Rate: | • 21.0%, beginning in 2018 | • 35.0% |
| Corporate Alternative Minimum Tax: | • Repealed | • Applies a 20% rate as part of a parallel tax system that limits tax benefits to prevent large-scale tax avoidance. Companies must calculate their ordinary tax and AMT tax, and pay whichever is higher |
| Cost Recovery (Accelerated Depreciation): | • Businesses could fully and immediately deduct the cost of certain equipment purchased after Sept. 27, 2017 and before Jan. 1, 2023. After that, the percentage of cost that could be immediately deducted would gradually phase down | • Businesses must take depreciation, spreading the recognition of their equipment costs for tax purposes over several years |
| Repatriation: | • U.S. companies' overseas income held as cash would be subject to a 15.5% rate, while non-cash illiquid holdings would face an 8.0% rate | • The U.S. taxes multinationals on their global earnings at the corporate rate of 35%, but allows them to defer taxes on those foreign earnings until they bring them back to the U.S., or "repatriate" them |
| Pass-Through Deduction: | • Owners could apply a 20% deduction to their business income, subject to limits that would begin at $315,000 for married couples (or half that for single taxpayers) | • Pass-through businesses, which include partnerships, limited liability companies, S corporations and sole proprietorships, pass their income to their owners, who pay tax at their individual rates |
| Standard Deduction and Personal Exemptions: | • $12,000 standard deduction for single taxpayers and $24,000 for married couples, filing jointly. Personal exemptions repealed | • $6,350 standard deduction for single taxpayers and $12,700 for married couples, filing jointly. Personal exemptions of $4,050 allowed for each family member |
| Individual State and Local Tax Deductions: | • Individuals can deduct no more than $10,000 worth of the deductions, which could include a combination of property taxes and either sales or income taxes | • Individuals can deduct the state and local taxes they pay, but the value is subject to certain limits for high earners |
| Mortgage Interest Deduction: | • Deductible mortgage interest for new purchases of first or second homes would be capped at loans of $750,000 starting on Jan. 1, 2018 | • Deductible mortgage interest is capped at loans of $1 million |
| Estate Tax: | • Double the thresholds so the levy applies to fewer estates. The higher thresholds would sunset in 2026 | • Applies a 40% levy on estates worth more than $5.49 million for individuals and $10.98 million for couples |

*Sources: Bloomberg, PWC, Deloitte, Moody's*

# Interest Expense Deduction Limitation

## Impact of Limitation on Interest Expense Deduction

- Among the extensive changes to U.S. federal income taxation, the Act contains a new limitation on the deductibility of net business interest expense that exceeds 30% of a taxpayer's "adjusted taxable income"
- The new limitation, which will replace the existing "earnings stripping" rules of Section 163(j) of the Internal Revenue Code, generally applies to all debt incurred by a taxpayer, including third-party debt
- The new limitation generally applies to corporations and partnerships with respect to taxable years beginning after December 31, 2017, with no grandfathering for existing debt. Any interest expense disallowed under the limitation may be carried forward indefinitely

### Overview

- **Net business interest expense**: The 30% limitation applies only to net business interest expense, or the excess of business interest expense over business interest income. For taxpayers such as banks that generally earn business interest income in excess of business interest expense, the limitation is unlikely to have a meaningful impact
- **Adjusted taxable income**: The limitation is based on "adjusted taxable income." For taxable years beginning before January 1, 2022, "adjusted taxable income" will be roughly equivalent to a taxpayer's EBITDA. For subsequent taxable years, "adjusted taxable income" will no longer include an add-back for depreciation and amortization. Thus, absent a further change in law before 2022, the definition may become much more limiting in 2022
- **Partnerships**: The limitation for partnerships is applied at the partnership level. To the extent that the partnership's business interest expense is less than the limit, the partners may be entitled to use the excess limitation in determining their allowable deduction for their separate, non-partnership interest expense
- **Exceptions:** Real property businesses may elect out of the limitation. In addition, the limitation does not apply to small businesses with average gross receipts of $25 million or less, or to regulated public utilities. The limitation also does not apply to interest on certain indebtedness used to finance the acquisition of motor vehicles held for sale or lease

### Impact

- **Anticipated impact of new limitation**: The basic tenets of corporate finance suggest that the Act will make debt financing less attractive in LBOs and other financing transactions that risk disallowance of interest deduction. In the near term, the impact of such disallowance may be relatively muted to the extent that the interest rate environment remains near historic nominal lows
- **Multinational groups**: In establishing the capital structure of a multinational group, it might be more efficient to incur debt at non-U.S. members of the group, where a larger tax deduction may be available under the laws of a non-U.S. jurisdiction compared to the tax deduction available for U.S. tax purposes. Other provisions of the tax reform legislation that would reduce the effective U.S. tax rate of corporate taxpayers, such as the reduction of the U.S. corporate income tax rate to 21% and the allowance of the immediate deduction of the cost of tangible property, would further reduce the value of an interest expense deduction in the United States
- **Debt vs. Equity Financing:** In cases where the new limitation would defer all or a significant portion of a taxpayer's interest expense, the use of preferred equity might be more efficient than debt financing. In making that evaluation, the tax profile of the expected lenders/holders would need to be considered, including whether dividends on preferred equity would attract withholding tax

*Sources: Bloomberg, Cahill Gordan & Reindel*

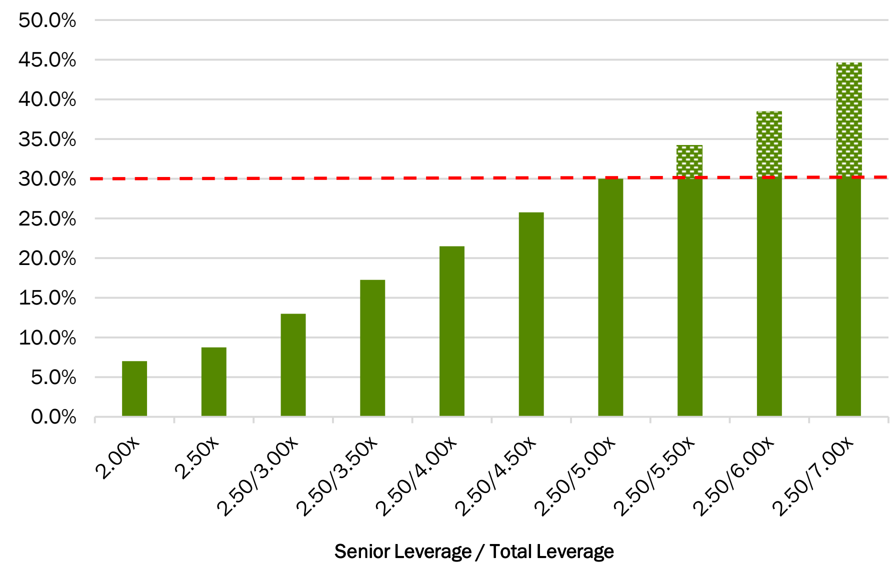
# Interest Expense Deduction Limitation

## Impact On The Use of Leverage

### Summary

- At higher leverage points, the new legislation will be particularly impactful to the structures that financial sponsors and strategic buyers use to finance transactions
- The chart to the right and below demonstrate the leverage points and interest rates at which the interest deduction limit will come into effect, denoted in red
- This analysis is indicative only, and should not be construed to represent any particular company. Among others, the below analysis relies on the following assumptions:
  - Assumes a $100.0MM revenue US company with 10.0% EBITDA margins, purchased at a 10x multiple
  - Mezzanine Debt priced 5.00% greater than Senior Debt at each level

### Interest Deductibility Limited With Increased Leverage(1)




### Interest Expense to EBITDA By Leverage and Interest Rate

| | | Senior Leverage / Total Leverage | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Senior Debt (LIBOR Equivalent)(2) | Blended/2nd Lien Mezzanine Debt | 2.00x | 2.50x | 2.50x/3.00x | 2.50x/3.50x | 2.50x/4.00x | 2.50x/4.50x | 2.50x/5.00x | 2.50x/5.50x | 2.50x/6.00x |
| 3.50% (L + 117) | 8.50% | 7.00% | 8.75% | 13.00% | 17.25% | 21.50% | 25.75% | 30.00% | 34.25% | 38.50% |
| 3.75% (L + 142) | 8.75% | 7.50% | 9.38% | 13.75% | 18.13% | 22.50% | 26.88% | 31.25% | 25.63% | 40.00% |
| 4.00% (L + 167) | 9.00% | 8.00% | 10.00% | 14.50% | 19.00% | 23.50% | 28.00% | 32.50% | 37.00% | 41.50% |
| 4.25% (L + 192) | 9.25% | 8.50% | 10.63% | 15.25% | 19.88% | 24.50% | 29.13% | 33.75% | 38.38% | 43.00% |
| 4.50% (L + 217) | 9.50% | 9.00% | 11.25% | 16.00% | 20.75% | 25.50% | 30.25% | 35.00% | 39.75% | 44.50% |

(1) *Assumes a 3.50% and 8.50% interest rate on Senior Debt and Blended/2nd Lien Mezzanine Debt, respectively*
(2) *Assumes a 5 year swap rate of 233 bps per Bloomberg as of 1/8/2018*

# Tax Reform Impact on M&A Market

## Macro Implications

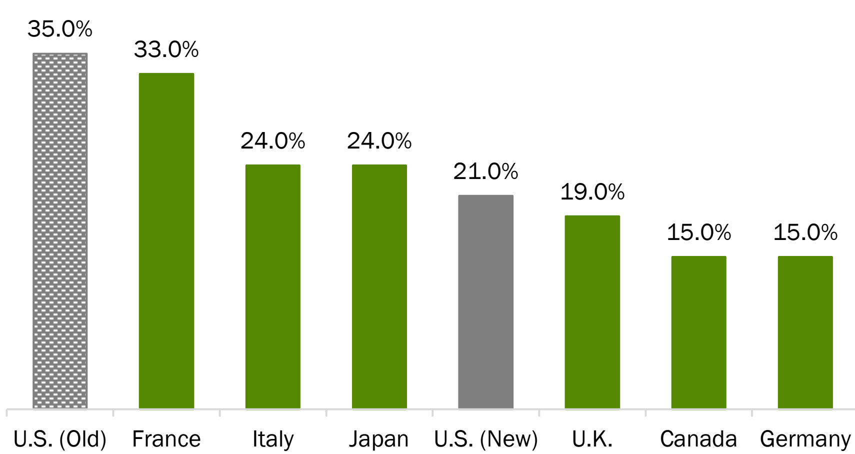
### Fixed Income and Equity Markets

- From a fixed income perspective, the Act will likely encourage investment grade companies to repatriate cash, thereby reducing liquidity needs that would typically be met through the issuance of investment grade bonds
  - If companies repatriate adequate capital, 2018 investment grade issuance will decrease, potentially creating issues for asset managers looking to maintain allocations to fixed-income assets. The reduction of interest expense deductibility may have a similar supply effect in the high yield market
- In the weeks leading up to the finalization of the Act, equities of high-tax S&P 500 companies experienced an increase in price compared to their low-tax counterparts
  - Corporations may use the bulk of the tax savings on increasing dividends, share buybacks and corporate acquisitions, which may push U.S. equity markets higher

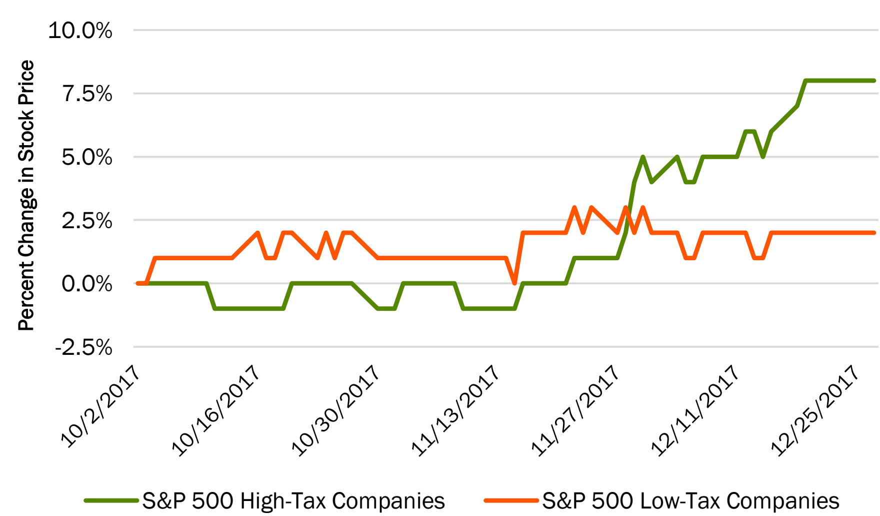
### Transaction Market

- Reductions in the corporate tax rate from 35.0% to 21.0% is expected to have a positive impact on M&A activity
  - Corporations may have been apprehensive to sell assets or subsidiaries due to proportionately higher tax bills incurred on sale
  - The reduction in cash taxes increases cash flow available to service indebtedness and other capital, enhancing funding capabilities
- New repatriation legislation is also expected to create conditions that are favorable for increased transaction activity
  - Corporations may be encouraged to repatriate large amounts of cash held overseas, potentially creating an influx of funds available for acquisitions and capital expenditure

### Corporate Tax Rates in G7 Nations




### Equity Markets Reacting to Tax Reform[1]



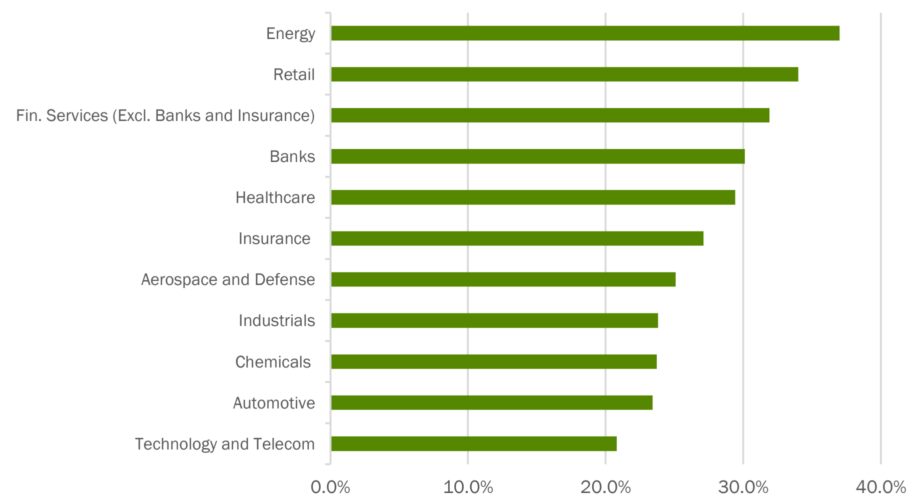

*(1) S&P 500 firms with the 50 highest and 50 lowest 10-year effective tax rates*
*Sources: Bloomberg, PWC, S&P, NYU-Stern Research*

# Tax Reform Impact on M&A Market

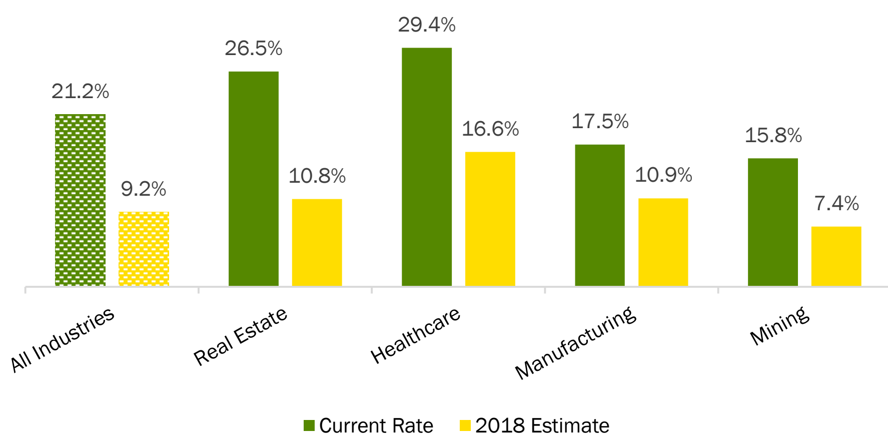
## Sector-Specific Impacts

- Industries such as Energy, Healthcare, Retail, and Financial Services have traditionally paid higher effective tax rates, and are likely to see immediate benefits from the Act, particularly in the decrease in the corporate rate from 35.0% to 21.0%
  - Traditionally capital-intensive industries such as the energy and industrials sectors will also benefit from the cost recovery legislation that allows for full and immediate expensing of capital investments
- The Act's limitation on interest deductibility may have a significant effect on private equity and financial sponsor transaction activity that has traditionally relied on high levels of debt to finance transactions
  - The aggressive use of leveraged debt to fund acquisitions may become more expensive on an after-tax basis, possibly leading to lower valuations, decreased transaction activity, or alternative financing strategies
  - Sponsors may look to fixed-rate financing solutions to avoid variation in interest rates, enhancing predictability of interest deduction

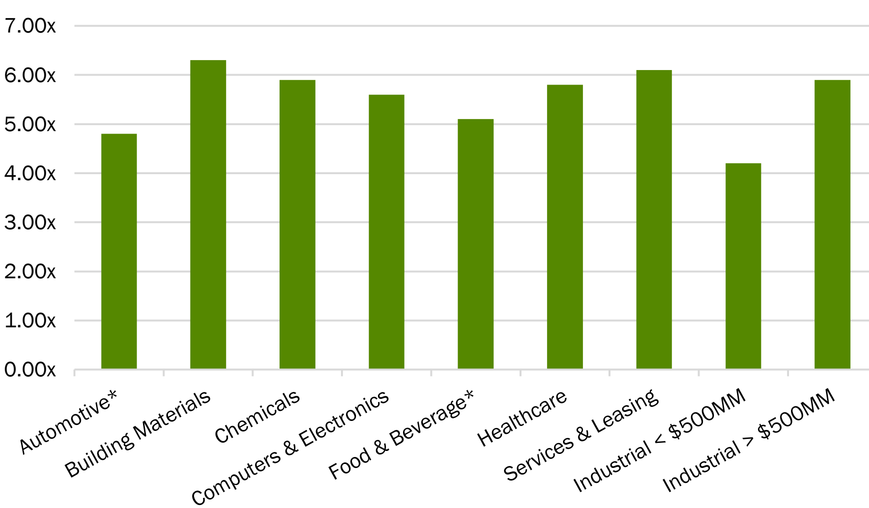
### Average Tax Rate by Industry




### Largest First-Year Benefits by Industry




### Debt/EBITDA of LBOs by Industry




** References 2016 numbers due to lack of data in 2017*
*Sources: S&P, NYU-Stern Research, Penn Wharton Budget Model Estimates*



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# Tax Reform Impact on Specific Industries

## Industry/Sector Specific Impact

| Industry | Details |
|---|---|
| **Autos:** | • The auto industry is a capital and infrastructure intensive industry that is likely to see benefits from the Act attributable to the corporate rate cut, the reduction on levies for repatriating overseas profits, accelerated depreciation, and the preservation of the tax credits towards electric vehicles<br>• Auto makers will also benefit from income-tax credits of up to $7,500 for electric cars that were preserved in the Act<br>• With respect to automotive dealerships, family-owned franchises will also benefit from exemption of vehicle financing from the interest deduction limitation and from estate tax reform |
| **Asset Managers:** | • U.S. based asset managers have traditionally been subject to high effective tax rates. Rate cuts will allow these firms to retain more of the income generated from operations<br>• Asset managers may also see increased demand for ancillary services such as wealth management and estate planning, which will be attributable to tax cuts for individuals and small businesses |
| **Banks:** | • Traditionally a highly taxed segment of the market, the U.S. banking industry is likely to receive immediate benefit from the corporate rate decrease, which may also allow U.S. lenders to be more competitive with their lower-taxed international counterparts<br>• Banks may also see their investment banking services benefit from the repatriation legislation and a corresponding increase in U.S. corporate M&A activity, primarily in industries where companies have held large amounts of cash in foreign countries<br>• Reduction on interest-expense deductions will weigh on bank earnings, as the provision may lead companies to borrow less. Institutions with large exposure to real estate and commercial loans may see greater reductions in demand |
| **Consumer Retail:** | • The Consumer Retail industry has historically paid one of the highest average corporate-tax rates, an average of 30.6% in 2016, and may be one of the largest beneficiaries of the Act<br>• Brick and mortar retailers have mostly U.S.-based operations and little manufacturing or research and development, subsequently benefitting less from deductions on those activities as other capital intensive businesses<br>• The Act may benefit traditional retailers as they look to compete with Amazon.com. Traditional retailers have generally paid higher taxes than online retailers, which can often place intellectual property in countries with lower rates and benefit from jurisdictions that offer more extensive deductions<br>• An implied increase in consumer discretionary spending from personal tax rate cuts may additionally create increased demand |

*Sources: Bloomberg, PWC, Moody's*

# Tax Reform Impact on Specific Industries

## Industry/Sector Specific Impact

| Industry | Details |
|---|---|
| **Energy:** | • Oil and gas companies have traditionally been subject to the second-highest effective tax rate of any sector, and is likely to see substantial benefits from the Act<br>• Traditionally, refiners have not been able to take advantage of tax offsets such as deductions for drilling costs and most do not maintain overseas assets, making independent US-based refiners proportionately large recipients of benefits under the Act<br>• The coal industry, in particular, will also see benefits arise from the elimination of the corporate alternative minimum tax. |
| **Healthcare:** | • Health insurers, an overwhelmingly domestic industry, will reap benefits from the Act's reduction in the corporate rate<br>• Benefits from the corporate rate cut may be tempered by changes to the individual mandate penalty under the Affordable Care Act, which may decrease the number of people who elect to purchase coverage, ultimately leading to negative impacts on health insurers and hospitals<br>• Many nonprofits, a category that includes certain hospitals and insurers, will also see a drop in their tax bills, but not as large as their for-profit competitors<br>• U.S. pharmaceuticals have traditionally held large amounts of earnings overseas, and will subsequently enjoy a significant potential benefit from the ability to repatriate cash at lower rates and return capital to the U.S. |
| **Industrials:** | • Industrial companies, traditionally capital intensive businesses with relatively long payback periods on capital projects, will reap benefits from multiple components of the new legislation<br>• Legislation changing the repatriation and taxation of overseas profits will generally favor domestic manufacturers that export from the U.S. or companies with production in the country<br>• U.S. industrials will also benefit from the corporate rate cut, and the accelerated depreciation provision that grants the ability to immediately write off the costs of equipment purchases |

*Sources: Bloomberg, PWC, Moody's*

# Tax Reform Impact on Specific Industries

## Industry/Sector Specific Impact

| Industry | Details |
| --- | --- |
| **Private Equity** | • Private equity firms are likely to experience both positives and negatives effects from the Act<br>• The essential sponsor strategy of using leveraged debt to fund acquisitions may become more expensive through the new interest deduction features of the Act<br>• Alternatively, the corporate rate cut will likely provide private equity backed companies with more cash to fund acquisitions, likely increasing the value of these firms<br>• Strategic buyers, particularly those in higher tax industries or that hold significant cash offshore, may more actively pursue an M&A strategy. As a result the proportion of private equity sales to strategic buyers (which are typically at a premium value) may increase<br>• Existing carried interest laws survived the Act with relatively little change, a positive for private equity firms. Of note, the Act now limits carried interest to gains on assets held for at least three years, rather than one year, which may increase average hold periods and extent non-call periods for non-control financing |
| **Real Estate:** | • Realtors may be negatively effected by provisions of the Act that reduce decades-old perks designed to encourage homeownership<br>• Via an almost doubling of the standard deductions for individual and joint tax filers, the legislation blunts the advantage of the mortgage interest deduction, which is often a key factor in homebuying decisions, particularly in high-priced real estate markets<br>• The legislation also caps the deduction for state and local taxes at $10,000, reducing the benefit of lower individual rates for homeowners in high-tax states<br>• Together, the new legislation will likely diminish incentives designed to encourage homeownership, and subsequent consumer demand that drives the industry |
| **Technology and Telecom:** | • U.S. technology companies, who have traditionally held large amounts of earnings overseas, are likely to enjoy benefits from the ability to repatriate cash at lower rates and return capital to the U.S.<br>• In addition, the telecom industry is a capital and infrastructure intensive industry that traditionally generates the bulk of its revenue through domestic operations<br>• Telecom companies will additionally benefit from the corporate rate cut and the accelerated depreciation legislation |

*Sources: Bloomberg, PWC, Moody's*

# Sunset of Qualified Small Business Stock Exclusion

## The Qualified Small Business Stock ("QSBS") exclusion expires on December 31, 2018

### What Is It?

- A founder or other individual taxpayer may be eligible for up to a 100% exclusion of the gains on the sale of QSBS, including exclusion from the alternative minimum tax ("AMT") and the 3.8% Medicare surtax (i.e., net investment income tax)
- QSBS is C corporation stock acquired by a taxpayer at original issuance or as compensation for services, where:
  - the stock has been held for at least five years,
  - the gross assets of the company were less than $50 million at the time of issuance,
  - the company was founded after August 10, 1993;
  - during substantially all of the taxpayer's holding period for the stock, at least 80% (calculated according to the rule) of the corporation's assets have been used in the active conduct of one or more qualified businesses;
  - the company does not conduct business in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage, banking, insurance, financing, leasing, investing, farming, mining or natural resource production or extraction, operating a hotel or restaurant, or similar service business.

### What Are The Consequences?

- The amount of gain excluded depends on the date of QSBS acquisition, with the exclusion generally limited to the greater of $10 million (less certain gains previously realized) or 10 times the taxpayer's adjusted cost basis

### Why Act Now?

- The QSBS exclusion will sunset at the end of 2018; an owner of QSBS selling stock after December 31, 2018 may face a significantly higher tax burden
- Individuals who may own QSBS should consult their tax advisors regarding their eligibility and potential impact of the QSBS election

*Sources: The ABCs of QSBS: The Benefits, Requirements and Planning Opportunities with Qualified Small Business Stock, The American College of Trust and Estate Counsel, March 2017*

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