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# How tax reform might impact your business from formation to exit

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With President Donald Trump's Dec. 22 signature making the Tax Cuts and Jobs Act the law of the land, business owners no doubt are wondering what it means to them.

For the business community, the act is generally expected to impact all phases of the investment lifecycle, starting with formation, moving through the operational/maturation phase, and ending with a liquidity/exit event. Here's a look at the legislation that most affect these three parts of the lifecycle and what it means for you.

**Phase #1 – Formation: Choice of entity considerations**

*Reduction in the corporate tax rate.* The act reduces the corporate tax rate from a maximum graduated rate of 35 percent to a rate of 21 percent for taxable years beginning after Dec. 31, 2017.

*Key takeaway.* The new corporate tax rate will generally present less of a potential tax drag on earnings generated in corporate form, as compared with the 29.6 percent rate applicable to "qualified business income" derived from certain qualifying "pass-through" entities or the top 37 percent marginal rate applicable to individuals.

In addition, the ability to potentially utilize the existing 100 percent exclusion from U.S. federal income tax under Section 1202 of the Internal Revenue Code (the "Code"), as well as the tax-free rollover provisions of Section 368 of the Code on exit, may also prove beneficial to holders of stock in taxable corporations relative to pass-through equity interests.

**Phase #2 – Operation**

*100 percent asset expensing.* The act allows taxpayers to take a bonus depreciation deduction equal to 100 percent of the adjusted basis of certain qualifying tangible property (including used property) acquired and placed in service after Sept. 27, 2017 and before Jan. 1, 2023.

*Limitation on interest deductions.* The act also limits interest expense deductions by providing that most businesses, regardless of form, may deduct net business interest expense in any year only up to 30 percent of "adjusted taxable income." These changes became effective on January 1 and do not include any grandfathering provision for interest on existing debt. Disallowed interest deductions can be carried forward indefinitely. Businesses whose average annual gross receipts do not exceed $25 million are exempt from the limitation.

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*Limitation on net operating losses.* The act modifies the rules for net operating losses ("NOLs"). First, for losses generated in 2018 or later, the act generally eliminates the prior ability of corporations to carry back NOLs for two years and instead permits an unlimited NOL carry-forward period replacing the former maximum of 20 years, with some limited exceptions. In addition, again for losses generated in 2018 or later, not more than 80 percent of the taxpayer's income can be offset by otherwise available NOL carry-forwards.

*Key takeaways.* The 100 percent asset expensing provision will be important to enterprises that need to make certain capital investments in tangible property, but will obviously be less valuable to technology and other companies that develop and invest in intellectual property and other types of intangible assets. The interest deduction provision will also be highly important to more mature businesses above the $25 million revenue threshold, but generally should not affect startups and other pre-revenue stage enterprises. Finally, because the NOL provisions do not affect losses generated prior to 2018, NOL carryforwards from pre-2018 years will generally be more valuable than losses generated in 2018 or later.

**Phase #3 – Exit**

*Capital gains rates/Carried interests.* The act did not affect the U.S. federal long-term capital gains rate that generally applies to corporate stock sales, which remains at 20 percent (plus the potential net investment income tax of 3.8 percent). The act does, however, impose a three-year holding period requirement for gains from certain partnership profits interests to qualify for long-term capital gain treatment (commonly referred to as "carried interests").

*Key takeaways.* In general, for most sellers the after-tax proceeds from a sale of corporate stock will still continue to exceed those derived from a taxable sale of corporate assets. However, in certain circumstances, the new 21 percent corporate level tax, when combined with target net operating losses (particularly, those before 2018), may make a taxable asset sale a viable alternative. This may have the benefit of giving the buyer an amortizable step-up in the tax basis of the acquired assets, or possibly a 100 percent immediate expensing of any qualifying tangible assets.

As regards the change to the carried interest holding period, many investment funds typically already hold their investment assets for three or more years. The new carried interest holding period therefore is not expected to have a tremendous impact. In particular, we note that many venture capital funds already have an incentive to hold certain stock investments for at least five years in order to claim the 100 percent gain exclusion that is potentially available under Section 1202.