Turnaround Management Association, New York Chapter

Tax Reform Act of 2017

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Panelists

- Joe Sarachek, Triax Capital Partners, LLC
- Jason Friedman, Managing Director, Marathon Asset Management, Head of Corporate Credit Strategy
- Mark Kronfeld, Managing Director, Tennenbaum Capital Partners, LLC
- Jason Mulvihill, General Counsel, American Investment Council
- Elias Tzavelis, Partner, Deloitte
- Patricia McDonald, Partner, Baker McKenzie
- Richard Levin (Moderator), Partner, Jenner & Block LLP

Corporate Interest Deductibility

- **Before Tax Reform**
  - Outside of specific limitations, corporate business interest was generally fully deductible.
- **Discussions Around Tax Reform**
  - Discussions centered around limiting or fully disallowing a deduction for business interest, which could lower the incentives to lever businesses at high multiples, thereby potentially creating more stable capital structures and eliminating certain risks/loopholes like borrowing from foreign affiliates in low tax jurisdictions. It also would raise money to help pay for broader reforms/other government spending.
- **Tax Cuts and Jobs Act**
  - Corporate net interest deductibility capped at an amount roughly equal to 30% of EBITDA through 2021 and 30% of EBIT beginning in 2022.
  - There is no grandfathering or phase-in for existing debt.
  - Amount of interest deduction in excess of cap may be carried forward indefinitely.
- **Who Can Avoid These Limits**
  - Business with average gross receipts of less than $25mm, employees, certain farming, real property and rate-regulated energy businesses.

Corporate Income Tax Rate / AMT

- **Before Tax Reform:**
  - A federal statutory tax rate was 35% plus an average of the corporate income taxes levied by individual states made the average statutory rate 38.91%.
- **Tax Reform Debate:**
  - President Trump initially advocated for a 15% corporate rate, with Congressional Republicans eyeing rates in the low to mid-20s. There was broad consensus even across party lines that the corporate rate was too high.
- **Tax Cuts and Jobs Act:**
  - 21% flat federal tax rate
  - Corporate Alternative Minimum Tax repealed, with prior year AMT credits refunded over 2018-2021

Carried Interest Capital Gains

- **Before tax reform:**
  - Carried interest required a one year holding period to be treated as long-term capital gains.
    - Tax rate: **23.8%** at the top end of the tax bracket, inclusive of the Medicare tax on investment income.
- **Tax Reform Debate:**
  - Carried interest capital gains was at serious risk with pressure from President Trump, Gary Cohn, Congressional Democrats, select Congressional Republicans, financial services media, and various outspoken influencers.
- **Tax Cuts and Jobs Act:**
  - The holding period to for carried interest to be treated as long-term capital gains changed from **one year** to **three years**.
    - Tax rate remains the same on long-term capital gains; short-term capital gains rate decreased to 37%
  - Limited to applicable partnership interest

Impact of Tax Reform on Repatriation, Deeded Dividends, and Distressed Borrowers

- **Before the Tax Act:**
  - Earnings of a controlled foreign corporation ("CFC") subsidiary of a U.S. parent entity generally were not taxable under U.S. law unless and until the earnings were distributed to the U.S. parent entity (e.g., by dividend).
    - Under IRC §956 and related rules, a CFC is deemed to have made a taxable dividend if, in the context of a U.S. financing transaction, (i) a U.S. parent pledges two-thirds or more of the voting power of the CFC as security, (ii) the CFC provides an upstream guarantee of the obligations of its U.S. parent, or (iii) the CFC grants or pledges its assets to secure the obligations of its U.S. parent.
- **Under the Tax Act,**
  - Notable changes to the tax treatment a CFC's foreign earnings include:

    (1) Mandated one-time inclusion of CFC's 2017 undistributed earnings—essentially a deemed dividend/repatriation but at tax rate of 8% to 15.5% depending on the assets; and

    (2) Subject to certain limitations, etc., the Tax Act now generally permits a U.S. corporation to deduct the full amount any dividend paid to it by a non-US company at least 10% of whose shares are owned by the US corporation.

Impact of Tax Reform on Repatriation, Deeded Dividends, and Distressed Borrowers, cont'd

- **Question:**
  - Given that repatriation of foreign earnings can be achieved tax free, what happened to Section 956? Answer: It's still there! (it wasn't repealed). How do we reconcile?
- **What does this all mean?**
  - What companies/sectors are the winners and losers here?
  - Impact on distressed opportunity set (impact on leveraged borrowers/companies)?
  - Impact on leverage loan market, structure of loan agreements, creditor/borrower negotiations, DIP agreements?

Bonus Depreciation – Overview of Changes

- **Before Tax Reform:**
  - Generally tangible personal property was depreciated under MACRS/ADS with bonus depreciation (50%)
  - Generally intangible property, like goodwill, customer lists and trademarks, amortized over 15 years straight-line
- **Under the Tax Act:**
  - 100% bonus depreciation for "qualified property" (generally tangible personal property) acquired and placed in service after September 27, 2017 and before January 1, 2023 (i.e., immediate expensing for "qualified property" through 2022)
  - Phased down by 20% per calendar year beginning in 2023 (i.e., after 2022, phased down each year through 2026 (2023 = 80%, 2024 = 60%, 2025 = 40%, 2026 = 20%)
  - Certain 'used' property eligible for 100% bonus depreciation
- **"Qualified Property"**
  - Generally includes tangible property with a MACRS recovery period of 20 years or less
  - Generally excludes—Intangible property other than certain computer software and certain film, television, and theatrical productions
- **Implications for M&A and impact to other tax reform provisions**

Choice of Entity (C Corporation Versus Partnership)*

TOPIC	BEFORE TAX REFORM		AFTER TAX REFORM	
	C CORPORATION	PARTNERSHIP	C CORPORATION	PARTNERSHIP
Federal income tax rate	35%	39.6% +3.8%**	21%	➢37% + 3.8% (no Section 199A deduction) ➢29.6% + 3.8% (with Section 199A deduction)
State/local tax deduction	100%	100%	100%	$10,000 cap
Levels of taxation (operationally and on sale of assets)	2 (corporate level on earnings; shareholder level on dividends)	1	2 (corporate level on earnings; shareholder level on dividends)	1
Exit by shareholder/ partner	20% + 3.8%	20% + 3.8% (note if partnership has "hot assets", gain attributable to these assets is taxed at ordinary income rate (e.g., 39.6%))	20% + 3.8%	20% + 3.8% (note if partnership has "hot assets", gain attributable to these assets is taxed at ordinary income rate (e.g., 37%))

*This chart assumes a shareholder in the C corporation, and a partner in the partnership, that is an individual.

**The 3.8% refers to the net investment income tax (commonly referred to as the "Medicare Tax").