
# Transaction planning with rising taxes on the horizon

# Presenters

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### Senior manager, Plante Moran National Tax Office

Working within the firm's National Tax Office, Stephen focuses on tax policy, legislation, and other emerging tax issues. He consults with clients across all service and industry lines, advising them on these developments to ensure that they are considering available tax planning opportunities. Stephen is a frequent writer and speaker on these topics and contributes to developments through national organizations.

## Kris Ker, CPA

### Manager, Plante Moran National Tax Office

Kris focuses on various merger and acquisition tax consulting services, which include buy and sell-side tax due diligence, tax structuring, integration consulting, tax attribute studies, tax modeling, sale projections, transaction cost analyses, and transaction tax compliance (e.g., for partnerships, S corporations, and C corporations). Kris assists clients as they undergo transaction related matters to identify risks and opportunities during the process.

## Don Stanovcak, J.D.

### Senior manager, Plante Moran National Tax Office

Don is an attorney and a member of Plante Moran's National Tax Office. He provides tax compliance and consulting services to closely held owner-operated corporations, consolidated corporations, single and multitiered partnerships domestic, as well as multinational private equity funds and portfolio companies in manufacturing, distribution, and other service-related industries. Don's technical experience includes structuring sales and acquisitions, entity choice, and tax reform.

# Overview of today's discussion

## What's coming?

- Tax proposals & legislative developments
- Other tax trends

## Projected impact of developments on transactions

- Sell-side impacts & planning opportunities
- Buy-side impacts & planning opportunities
- Approaching due diligence in light of recent changes
- Fund-level impacts

## Questions

# What’s coming?

*Perspectives on tax proposals & potential for changes*

# How did we get here?

**Tax Cuts & Jobs Act (TCJA)**

- The most significant tax legislation in at least a generation
- Significant reduction in taxes on individuals and businesses
- Deduction trade-offs: Some acceleration, but new limitations imposed on others
- Imposition of new international tax regimes
- Most changes are temporary and apply to 2018 through 2025

**COVID-19-related legislation**

- Legislation enacted in response to the COVID-19 pandemic
- Primary focus was provided direct support to businesses and individuals during the pandemic
- Income tax changes were employed to some, limited degree
- The payroll tax system was utilized in many new ways to accelerate the recognition of cash benefits by businesses

**What's next?**

- Biden administration is pursuing significant tax changes in Congress
- Proposals build on campaign promises and target key TCJA changes
- Would generally increase taxes on corporations and on individuals above certain income thresholds
- The focus now shifts to Congress where negotiations are expected to continue for at least several months

# Summary of Biden proposals

## General trends

- Tax increases on corporations and higher-income individuals
- Movement to eliminate investment income preference above a specified income threshold
- Continued evolution of international tax regime toward modified territorial regime with income-shifting guardrails

## What do the proposals mean?

- The proposals from the Biden administration are the starting point for discussions
- The omission of key details and topics leaves room for negotiation
- Individual members of Congress, especially Democratic senators, will have significant roles in shaping any legislation

# Tax legislation: Then and now

**Jan. 20, 2017**
President Trump inaugurated

**April 26, 2017**
Outline of Trump tax proposals announced
Congressional Republicans begin consideration of proposals

**July 28, 2017**
Healthcare reform bill fails in Senate with 3 Republicans voting against
- All attention shifts to tax reform

**Nov. 2, 2017**
House Republican leadership introduces tax reform plan

**Dec. 22, 2017**
President Trump signs TCJA into law following final passage in congress

**Jan. 20, 2021**
President Biden Inaugurated

**April 28, 2021**
Fact sheet of Biden tax proposals (AFP) announced
- Infrastructure plans outlined on March 31

Legislation introduced?
**??**

Passage of one or more bills?
**??**

## Congressional balance THEN

### House
- Republican — 239
- Democratic — 193

### Senate
- Republican — 52
- Democratic caucus — 48 *(includes independents)*

## Congressional balance NOW

### House
- Democratic — 219
- Republican — 212

### Senate
- Democratic caucus — 50 *(includes independents)*
- Republican — 50

# Will anything change?

## Current momentum

- There appears to be momentum for some significant tax legislation this year
- However, current positioning of Democratic members of Congress indicates difficult negotiations to come

## Most likely changes

- Corporate tax rate increase (potentially between 24 and 28%)
- Increasing the top individual tax bracket from 37 to 39.6% (Pre-TCJA highest bracket)
- Other individual tax changes for taxpayers over certain thresholds
- Evolution of international taxes with increased global coordination

**Overall, it's likely that modified versions of some proposals will be enacted, but there is still time for surprises.**

# Another trend: Looming tax enforcement

## Developments in Congress and the IRS indicate a future of increased tax enforcement

- Congressional hearings have focused on the tax gap (e.g., uncollected, but expected tax revenue)
- Several proposals would add substantially to the IRS enforcement budget
- Partnership K-1 reporting continues to be enhanced for more transparency (for partners and the IRS)
- Key takeaway: plan for a future of increased audits

## What can be done today?

- Focus on documentation and substantiation of tax positions
- Scrutinize tax representations and tax sections of agreements
- Consider whether current escrows and insurance adequately covers potential exposure
- Consider Form 8594 matching for asset and deemed asset acquisitions

# Transaction planning

*Key tax proposals & planning options*

# Key proposals impacting M&A

## Biden administration proposals

- Increasing the corporate tax from 21 to 28%
- Increasing the top individual tax bracket from 37 to 39.6%
- Subjecting capital gains and dividends to the 39.6% rate for households earning over $1 million of AGI (43.4% with NIIT)
- Applying the 3.8% net investment income tax (NIIT) or self-employment tax to active business income over $400,000
- Taxing unrealized capital gains at death, gift, and other transfers, but deferring tax for family-owned businesses, farms, and nonliquid assets
- Creation of another set of carried interest rules to apply in addition to current Section 1061 (more details later in the discussion)

## Some items from the Biden campaign platform have been omitted from current proposals.

# Framework for capital gain proposals

| Key aspects | Proposed changes | What will occur? |
|---|---|---|
| **Highest tax rate:** | 39.6% (43.4% with NIIT) for qualified dividends and long-term capital gains for taxpayers exceeding the threshold | ? |
| **Threshold at which rate applies:** | Taxpayers with over $1 million of AGI ($500,000 if married filing separate) | ? |
| **Effective date:** | Retroactive to April 28, 2021 | ? |

*Notes:*

- *It's likely that some of these aspects will get modified during negotiations.*
- *Senator Manchin has suggested that the top rate should only be 28%.*

# Taxes on capital gains/dividends

| | C corporation | | Pass-throughs | |
|---|---|---|---|---|
| | Stock sale | Asset sale | Entity sale | Asset sale |
| Current entity-level tax | -- | 21.00% | -- | 20.00% |
| Proposed tax | -- | 28.00% | | 43.40% |
| Change | -- | +7.00% | | +23.40% |
| | | | | |
| Current owner-level tax | 23.80% | 23.80% | 20.00% | -- |
| Proposed | 43.40% | 43.40% | 43.40% | -- |
| Change | +19.60% | +19.60% | +23.40% | -- |
| | | | | |
| Current combined effective tax rate | 23.80% | 39.80% | 20.00% | 20.00% |
| Proposed combined effective tax rate | 43.40% | 59.25% | 43.40% | 43.40% |
| Change | +19.60% | +19.45% | +23.40% | +23.40% |

This exceeds the ordinary rate with QBID.

**Assumptions:**

- Shareholders and pass-through owners are all subject to the highest tax rates.
- Pass-through owners are active in the business operation.
- NIIT currently only applies to C corporation dividends but will be imposed on all income for those in the highest tax brackets under the Biden proposals.
- Pass-through owners have sufficient tax basis to receive cash distributions without recognizing gain.
- Corporate distributions are characterized as dividends.

# Other proposals

## QBID amendment from Sen. Wyden

- Eliminates the SSTB category and the W-2 and UBIA limitations
- Applies a full phaseout for taxpayers beginning at $400,000 (subject to inflation adjustment)
- Denies the deduction to an estate or trust

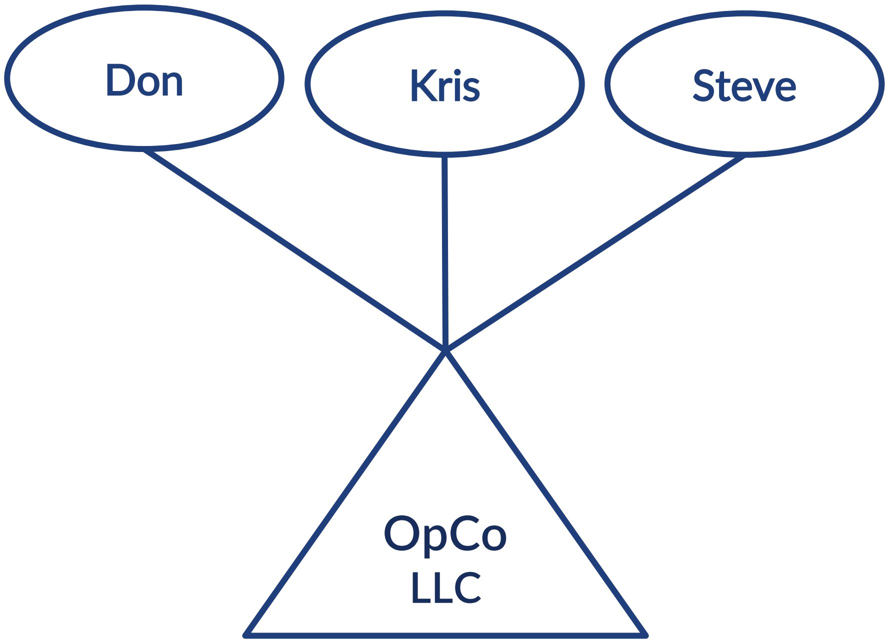
## Corporate and international proposals from Biden administration

- Imposing a 15% minimum tax on the book income of corporations with greater than $2 billion of book income
- Modifications to global intangible low-tax income (GILTI) regime
- Elimination of foreign-derived intangible income (FDII) deduction
- Calculation of foreign tax credits on a per-country basis
- Replacing the base erosion and anti-abuse tax (BEAT) with a new regime

# Sell-side planning

*Impact of potentially rising taxes & available options*

# Seller example: Assumed facts




## Initial facts

- Opco, LLC operates a trade or business.
- It's owned equally by Don, Kris, and Steve.
- The partners aren't active in the business, so the net investment income tax will apply.

## Transaction proposal

- Don, Kris, and Steve will sell 100% of their partnership interests to a buyer in exchange for cash consideration.
- Current EBITDA is $5.0 million, and buyer is willing to pay a 7.0x multiple ($35 million EV).
- Buyer will pay cash equal to the EV, and no working capital adjustments are expected.

## Tax characteristics

- Don, Kris, and Steve have tax bases in their LLC units equal to their share of liabilities.
- No net hot asset gain (Sec. 751) will be recognized due to the agreed upon purchase price allocation.

# Impact of proposals: Base case

| | Current federal tax rate | Proposed federal tax rate |
|---|---|---|
| EBITDA | $5.0 million | $5.0 million |
| Multiple on EBITDA | 7x | 7x |
| Enterprise value | $35.0 | $35.0 |
| | | |
| Aggregate taxable gain – Long-term capital | $35.0 million | $35.0 million |
| Less, federal tax on LTCG | ($8.33 million) | ($15.19 million) |
| Net – after-tax proceeds | $26.67 million | $19.81 million |
| | | |
| Change in after-tax proceeds from current | -- | ($6.86 million) |
| % change from current | -- | (25.72%) |
| | | |
| Enterprise value needed to reach parity | | $47.12 million |

Assumptions:
- Taxpayers are all subject to the highest tax rates.
- Net investment income tax (NIIT) fully applies.
- Zero cash tax basis (basis equals liability assumption, if any)

# Increasing value to offset taxes

## After-tax impact can be mitigated by a combination of:

- Growth in EBITDA — requires longer time for growth
- Negotiating a higher multiple — depends on market and business type

*An enterprise value of $47.12 million is needed to overcome the proposed 43.4% rate.*

**Enterprise Values at Exit - Based on Biden capital gain proposal**

| EBITDA | 7.00 | 7.50 | 8.00 | 8.50 | 9.00 | 9.50 | 10.00 |
|---|---|---|---|---|---|---|---|
| **7,000,000** | 49,000,000 | 52,500,000 | 56,000,000 | 59,500,000 | 63,000,000 | 66,500,000 | 70,000,000 |
| **6,750,000** | 47,250,000 | 50,625,000 | 54,000,000 | 57,375,000 | 60,750,000 | 64,125,000 | 67,500,000 |
| **6,500,000** | 45,500,000 | 48,750,000 | 52,000,000 | 55,250,000 | 58,500,000 | 61,750,000 | 65,000,000 |
| **6,250,000** | 43,750,000 | 46,875,000 | 50,000,000 | 53,125,000 | 56,250,000 | 59,375,000 | 62,500,000 |
| **6,000,000** | 42,000,000 | 45,000,000 | 48,000,000 | 51,000,000 | 54,000,000 | 57,000,000 | 60,000,000 |
| **5,750,000** | 40,250,000 | 43,125,000 | 46,000,000 | 48,875,000 | 51,750,000 | 54,625,000 | 57,500,000 |
| **5,500,000** | 38,500,000 | 41,250,000 | 44,000,000 | 46,750,000 | 49,500,000 | 52,250,000 | 55,000,000 |
| **5,250,000** | 36,750,000 | 39,375,000 | 42,000,000 | 44,625,000 | 47,250,000 | 49,875,000 | 52,500,000 |
| **5,000,000** | **35,000,000** | 37,500,000 | 40,000,000 | 42,500,000 | 45,000,000 | 47,500,000 | 50,000,000 |
| **4,750,000** | 33,250,000 | 35,625,000 | 38,000,000 | 40,375,000 | 42,750,000 | 45,125,000 | 47,500,000 |
| **4,500,000** | 31,500,000 | 33,750,000 | 36,000,000 | 38,250,000 | 40,500,000 | 42,750,000 | 45,000,000 |
| **4,250,000** | 29,750,000 | 31,875,000 | 34,000,000 | 36,125,000 | 38,250,000 | 40,375,000 | 42,500,000 |
| **4,000,000** | 28,000,000 | 30,000,000 | 32,000,000 | 34,000,000 | 36,000,000 | 38,000,000 | 40,000,000 |

**Multiple**

# Possible alternative

## What if Congress only raises the long-term capital gain rate to 33.8% (30.0%, plus 3.8% NIIT)?

*Assume all other facts are the same*

| | Current federal tax rate | Proposed federal tax rate | Alternative — 33.8% federal rate |
|---|---|---|---|
| EBITDA | $5.0 million | $5.0 million | **$5.0 million** |
| Multiple on EBITDA | 7x | 7x | **7x** |
| Enterprise value | $35.0 | $35.0 | **$35.0** |
| | | | |
| Aggregate taxable gain — Long-term capital | $35.0 million | $35.0 million | **$35.0 million** |
| Less, federal tax | ($8.33 million) | ($15.19 million) | **($11.83 million)** |
| Net — after-tax | $26.67 million | $19.81 million | **$23.17 million** |
| | | | |
| **Change from current** | **--** | **($6.86 million)** | **($3.50 million)** |
| % change from current | -- | (25.72%) | **(13.12%)** |
| | | | |
| Enterprise value needed to reach parity | | $47.12 million | **$40.29 million** |

# Alternative: Assuming lower rates

## Dramatically lower impact:

- Would only need $40.29 million of EV to achieve parity
- Overall increase of $5.29 million versus $12.12 million

*An enterprise value of $40.29 million is needed to overcome an alternative 33.8% rate.*

**Enterprise Values at Exit - Assuming LTCG increase to only 33.8%**

| EBITDA | 7.00 | 7.50 | 8.00 | 8.50 | 9.00 | 9.50 | 10.00 |
|---|---|---|---|---|---|---|---|
| **7,000,000** | 49,000,000 | 52,500,000 | 56,000,000 | 59,500,000 | 63,000,000 | 66,500,000 | 70,000,000 |
| **6,750,000** | 47,250,000 | 50,625,000 | 54,000,000 | 57,375,000 | 60,750,000 | 64,125,000 | 67,500,000 |
| **6,500,000** | 45,500,000 | 48,750,000 | 52,000,000 | 55,250,000 | 58,500,000 | 61,750,000 | 65,000,000 |
| **6,250,000** | 43,750,000 | 46,875,000 | 50,000,000 | 53,125,000 | 56,250,000 | 59,375,000 | 62,500,000 |
| **6,000,000** | 42,000,000 | 45,000,000 | 48,000,000 | 51,000,000 | 54,000,000 | 57,000,000 | 60,000,000 |
| **5,750,000** | 40,250,000 | 43,125,000 | 46,000,000 | 48,875,000 | 51,750,000 | 54,625,000 | 57,500,000 |
| **5,500,000** | 38,500,000 | 41,250,000 | 44,000,000 | 46,750,000 | 49,500,000 | 52,250,000 | 55,000,000 |
| **5,250,000** | 36,750,000 | 39,375,000 | 42,000,000 | 44,625,000 | 47,250,000 | 49,875,000 | 52,500,000 |
| **5,000,000** | **35,000,000** | 37,500,000 | 40,000,000 | 42,500,000 | 45,000,000 | 47,500,000 | 50,000,000 |
| **4,750,000** | 33,250,000 | 35,625,000 | 38,000,000 | 40,375,000 | 42,750,000 | 45,125,000 | 47,500,000 |
| **4,500,000** | 31,500,000 | 33,750,000 | 36,000,000 | 38,250,000 | 40,500,000 | 42,750,000 | 45,000,000 |
| **4,250,000** | 29,750,000 | 31,875,000 | 34,000,000 | 36,125,000 | 38,250,000 | 40,375,000 | 42,500,000 |
| **4,000,000** | 28,000,000 | 30,000,000 | 32,000,000 | 34,000,000 | 36,000,000 | 38,000,000 | 40,000,000 |

**Multiple**

# Transaction planning

## Initial planning option is to accelerate gains

- It may already be too late if Congress makes a retroactive change.
- However, further delays increase the likelihood of higher taxes.

## Future assumptions potentially driving sales today

- Future growth in the business value will not outrun increased taxes.
- Tax rates are likely to increase in the near term.
- Future tax rates will be sufficiently high to undercut value increases.

## Options for mitigating impact of higher exit taxes

- Exclusion of gains under §1202
- Managing annual income recognition through installment sales
- Utilizing opportunity zone investments to defer gain recognition

# Gain exclusion: Section 1202

## What is it?

- Taxpayers selling qualified small business stock (QSBS) may fully exclude gains.
- Maximum exclusion is the greater of: $10 million or 10x basis in the stock.

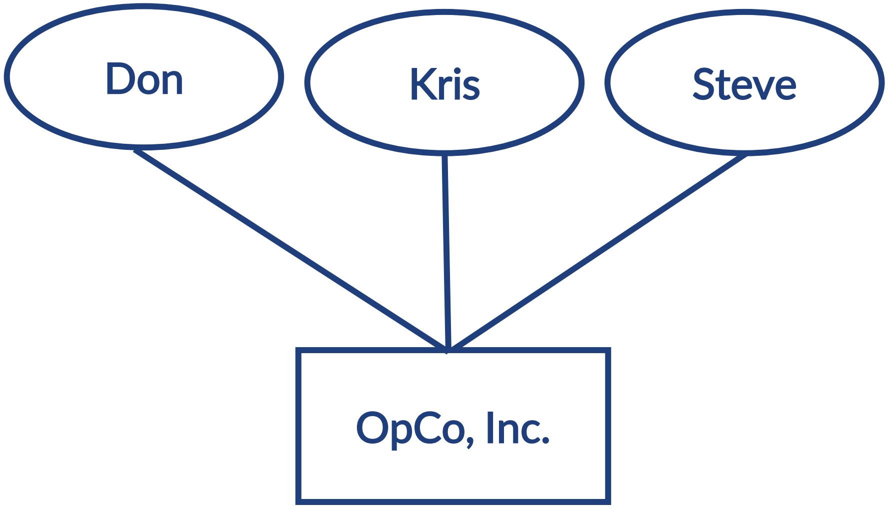
## What is QSBS?

- C corporation stock received at original issuance by the taxpayer from the corporation and tax basis in assets must be less than $50 million.
- Corporation issuing stock must operate a qualified business and can't have too many assets dedicated to nonqualified businesses or investment activity.
- Stock must be held for at least five years.

## What to do now?

- Current C corporation shareholders: Complete a Section 1202 analysis to substantiate eligibility
- Non-C corporation owners: Evaluate opportunities to restructure in a manner that creates QSBS eligibility

# Impact of proposals: 1202 example




## Updated facts:

- Opco, Inc. operates a qualifying trade or business.
- It's owned equally by Don, Kris, and Steve.
- The shareholders received their stock at original issuance eight years ago in exchange for contributions of $100,000 each.
- The original contribution equals their current tax basis in the stock.

*Assume all other facts are the same with the shareholders selling all of their stock for $35 million in cash purchase price.*

# Impact of proposals: 1202 example

| | Don | Kris | Steve | TOTAL |
|---|---|---|---|---|
| Total value received | $11.67 million | $11.67 million | $11.67 million | 35.0 million |
| Less, stock basis | ($0.1 million) | ($0.1 million) | ($0.1 million) | ($0.3 million) |
| **Preliminary stock sale gain realized** | **$11.57 million** | **$11.57 million** | **$11.57 million** | **$34.7 million** |
| | | | | |
| **Section 1202 gain exclusion — greater of:** | | | | |
| $10 million, or | $10.0 million | $10.0 million | $10.0 million | $10.0 million |
| 10x original basis | $1.0 million | $1.0 million | $1.0 million | $1.0 million |
| Sec. 1202 gain exclusion used | $10.0 million | $10.0 million | $10.0 million | $10.0 million |
| | | | | |
| Taxable gain recognized | $1.57 million | $1.57 million | $1.57 million | $4.7 million |
| Less, federal LTCG tax (43.4%) | ($0.68 million) | ($0.68 million) | ($0.68 million) | ($2.04 million) |
| | | | | |
| **After-tax value utilizing Sec. 1202** | **$10.99 million** | **$10.99 million** | **$10.99 million** | **$32.96 million** |
| For comparison — after-tax values if no Sec. 1202 | | | | |
| Current LTCG rates – 23.8% | $8.91 million | $8.91 million | $8.91 million | $26.74 million |
| Biden proposal – 43.4% | $6.65 million | $6.65 million | $6.65 million | $19.94 million |
| Alternative option – 33.8% | $7.76 million | $7.76 million | $7.76 million | $23.27 million |

# Incremental recognition: Installment sales

## Planning opportunity

- The capital gains proposals indicate that an annual threshold would be applied.
- Installment sales allow taxpayers to recognize incremental amounts of capital gains annually to stay under the threshold.
- This could stretch out recognition far enough into the future to wait out the next tax law change.
- This could potentially mitigate the impact of a retroactive tax change.

## Key questions

- At what threshold will any increased capital gains taxes apply?
- Will any anti-abuse rules be created to target installment sale transactions?

# Installment sale: Alternative

## Updated assumptions:

- Congress raises the long-term capital gain rate to 43.4% but includes a $10 million annual threshold and no rules against installment sales.
- Don, Kris, and Steve sell their interests in exchange for 50% cash at closing and 50% payable on the one-year anniversary of closing.

*Assume all other facts are the same as the base case.*

| | Don | Kris | Steve | TOTAL |
|---|---|---|---|---|
| Total value | $11.67 million | $11.67 million | $11.67 million | 35.0 million |
| | | | | |
| Annual taxable gain (Years 1 & 2) | $5.83 million | $5.83 million | $5.83 million | $17.5 million |
| Less, federal LTCG tax (23.8%) | ($1.39 million) | ($1.39 million) | ($1.39 million) | ($4.17 million) |
| Subtotal – Annual after-tax | $4.44 million | $4.44 million | $4.44 million | $13.33 million |
| | | | | |
| Total – After-tax value (2 years) | $8.88 million | $8.88 million | $8.88 million | $26.67 million |
| *After-tax if recognized in Year 1 | $6.60 million | $6.60 million | $6.60 million | $19.81 million |
| Difference due to installment sale | +$2.28 million | +$2.28 million | +$2.28 million | +$6.86 million |

# Gain deferral: Opportunity zones

## What are they?

- Investments into qualified opportunity zone funds allow taxpayers to defer the recognition of capital gains without an interest charge.
- Ten percent of the deferred gains can be permanently excluded if investment is held for five years.
- Appreciation in investment can be excluded if holding period requirements are satisfied.
- Specific rules must be satisfied regarding the nature of the investment and the timeline for such action (e.g., 180 days from the capital gain recognition).

## What to do now?

- Begin investigating potential investment opportunities in the event of a capital gain event in 2022 or 2021 (if retroactive changes are applied).
- Balance quality of opportunity zone investment with other alternatives.

# Entity-level state & local taxes

## Updated guidance in Notice 2020-75

- Guidance announced an intention to issue future proposed regulations.
- Allows entity-level deductions for state and local income taxes that are imposed on the entity.

## States continue to implement elective regimes that meet these requirements

- 13 states now have versions of these regimes.
- This has shifted from a future planning topic to a current one.
- Has the potential to reduce total sell-side tax cost.

## What to do now?

- Evaluate current states with operations to identify opportunities.
- Consider the costs and benefits of the entity-level taxes — there isn't a one-size-fits-all answer.

# Other structuring considerations?

## Alternative tax rules could still surface

- In 2017, the discussion around pass-through entities involved a proposed 25% tax rate until QBID was introduced in late November.
- It's possible that new rules that haven't been publicly discussed with advance in a final bill.

## What to do now?

- Move forward with deals as best as possible while accounting for the best information possible.
- Continuously monitor developments for legislative text and new proposals.

# Buy-side planning

*Impact of potentially rising taxes & available options*

# Direct impacts

## Increased benefit of asset basis step-up

- Increased tax burden on operations will simultaneously increase the value of tax deductions.
- Other tax changes currently taking effect outside of legislation magnify this result:
    - The business interest expense becomes more restrictive in 2022 (can no longer add-back depreciation, amortization, and depletion to get to adjusted taxable income).
    - Research and experimentation expenses must be capitalized and amortized beginning in 2022.

## Decreased tax differences for gross-up payments

- Outside of C corporation double taxation, the tax differential between asset and interest sales may be meaningfully reduced.
- The full Biden proposal would equalize taxes on ordinary income and long-term capital gains for taxpayers subject to the highest rates.

# Taxes on operations & distributions

| | C corporation | Pass-through | |
|---|---|---|---|
| | | With QBID | Without QBID |
| Current tax on operations | 21.00% | 29.60% | 37.00% |
| Proposed tax on operations | 28.00% | 34.72% | 43.40% |
| Change | +7.00% | +5.12% | +6.4% |
| | | | |
| Current tax on distributions | 23.80% | 0.00% | 0.00% |
| Proposed tax on distributions | 43.40% | 0.00% | 0.00% |
| Change | +19.60% | – | – |
| | | | |
| Current combined effective tax rate | 39.80% | 29.60% | 37.00% |
| Proposed combined effective tax rate | 59.25% | 34.72% | 43.40% |
| Change | +19.45% | +5.12% | +6.4% |

13.8% increase if QBID is eliminated

Assumptions:

- Shareholders and pass-through owners are all subject to the highest tax rates.
- Pass-through owners are active in the business operation.
- NIIT currently only applies to C corporation dividends, but will be imposed on all income for those in the highest tax brackets under the Biden proposals.
- Pass-through owners have sufficient tax basis to receive cash distributions without recognizing gain.
- Corporate distributions are characterized as dividends.

# Valuing asset basis step-ups

Key assumptions:

Purchase completed on 1/1/2022 | $10 million cost basis in intangible assets (§197) | Discount rate: 8.00%

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Totals |
|---|---|---|---|---|---|---|
| **Annual tax deductions** | **666,667** | **666,667** | **666,667** | **666,667** | **666,667** | **3,333,333** |
| **Corporations** | | | | | | |
| **21% Corporate rate** | | | | | | |
| Present value of deductions | 129,630 | 120,027 | 111,137 | 102,904 | 95,282 | **558,979** |
| **28% Corporate rate** | | | | | | |
| Present value of deductions | 172,840 | 160,037 | 148,182 | 137,206 | 127,042 | **745,306** |
| **Change** | **43,210** | **40,009** | **37,046** | **34,301** | **31,761** | **186,326** |
| **Passthrough Entities** | | | | | | |
| **37% with QBID (29.6% effective rate)** | | | | | | |
| Present value of deductions | 182,716 | 169,182 | 156,650 | 145,046 | 134,302 | **787,895** |
| **39.6% without QBID** | | | | | | |
| Present value of deductions | 244,444 | 226,337 | 209,572 | 194,048 | 179,674 | **1,054,075** |
| **Change** | **61,728** | **57,156** | **52,922** | **49,002** | **45,372** | **266,181** |
| **37% without QBID** | | | | | | |
| Present value of deductions | 228,395 | 211,477 | 195,812 | 181,307 | 167,877 | **984,868** |
| **39.6% without QBID** | | | | | | |
| Present value of deductions | 244,444 | 226,337 | 209,572 | 194,048 | 179,674 | **1,054,075** |
| **Change** | **16,049** | **14,861** | **13,760** | **12,741** | **11,797** | **69,207** |

# Tax gross-ups

**Purchase completed on January 1, 2022**

**Key Assumptions:**
**Pass-through, unblocked, ownership**
**Ordinary income recapture (i.e., Section 1245, Section 751, etc.) is the only factor driving a tax gross-up**
**No iterative gross-up on the gross-up payment or QBID under Section 199A**

| | |
|---|---|
| Highest Ordinary Income Rate | 43.40% |
| Current LTCG Rate | 23.80% |
| Alternative LTCG Rate | 33.80% |
| Proposed Highest LTCG Rate | 43.40% |

| | |
|---|---|
| Current Character Rate Difference (Ordinary vs. Capital) | 19.60% |
| Proposed Other Character Difference (Ordinary vs. Capital) | 9.60% |
| Proposed Highest Character Difference (Ordinary vs. Capital) | 0.00% |

| Scenario 1: Tax Gross-up Calculation at Current Rates; $1M of Depreciation Recapture on Class V PP&E | | |
|---|---|---|
| Ordinary Income | 1,000,000 | [A] |
| Current Character Rate Difference (Ordinary vs. Capital) | 19.6% | [B] |
| Product: Incremental Cost | 196,000 | [A]*[B] = [C] |
| Tax Gross-Up | 243,781 | [C]/(1-[B]) |

| Scenario 2: Tax Gross-up Calculation at Alternative LTCG Rate; $1M of Depreciation Recapture on Class V PP&E | | |
|---|---|---|
| Ordinary income | 1,000,000 | [A] |
| Proposed Other Character Rate Difference (Ordinary vs. Capital) | 9.6% | [D] |
| Product: Incremental Cost | 96,000 | [A]*[D] = [E] |
| Tax Gross-Up | 106,195 | [E]/(1-[D]) |

| Scenario 3: Tax Gross-Up Calculation at Highest Proposed LTCG Rate; $1M of Depreciation Recapture on Class V PP&E | | |
|---|---|---|
| Ordinary income | 1,000,000 | [A] |
| Proposed Other Character Rate Difference (Ordinary vs. Capital) | 0.0% | [F] |
| Product: Incremental Cost | - | [A]*[F] = [G] |
| Tax Gross-Up | - | [G]/(1-[F]) |

# Post-COVID-19 due diligence

## *Approaching diligence with an eye toward recent changes*

# Diligence challenges: COVID-19 programs

## COVID-19-related stimulus included limited income tax changes

- Technical corrections to prior bills
- Limited acceleration of tax attributes (net operating loss (NOL) carrybacks and deferral of excess business loss rule)
- Enhanced short-term deductions: modifications to business interest expense limitation (temporary 50% limitation in place of 30%; special partnership rules)

## However, significant support was provided through loans, grants, and leveraging the payroll tax system

- Paycheck Protection Program (PPP) loans
- Industry-based grants and impact payments
- Employee retention credit, FFCRA credits, and payroll tax deferral program

## Primary issues:

- COVID-19-related programs may fall outside of normal diligence
- Potential exposure for programs, especially the employee retention credit, may be much larger than anticipated

# Income tax modifications by year

| | 2020 | 2021 | 2022 |
|---|---|---|---|
| Net operating losses | Current-year losses eligible for 5-year carryback | Restoration of NOL rules from TCJA; 80% limit on utilization, no carrybacks | Same as 2021 |
| Excess business losses: Sec. 461(l) | Current-year losses are also not subject to this limitation | Restoration of EBL rule, as modified by CARES Act | Restoration of EBL rule, as modified by CARES Act |
| Qualified improvement property | Corrected rules applicable | Corrected rules applicable | Corrected rules applicable |
| Business interest expense | Modified limitation to 50%, prior year ATI, special rule for partners | Return to rules as enacted in TCJA; final year of EBIDA calculation | Return to rules as enacted in TCJA; first year of EBI calculation |

# Business support programs by year

| | 2020 | 2021 | 2022 |
|---|---|---|---|
| PPP loans | First-draw loan disbursement and deductions for expenditures | Second-draw loan disbursement and deductions for expenditures | Final filing of forgiveness applications |
| Provider Relief Fund (PRF) | Funds distributed and recipients attested to Terms and Conditions; funds utilized by recipients | Continued distribution and utilization of funds; initial deadlines to fully utilize funds | Continued use of funds and final deadlines for utilization |
| Restaurant Revitalization Fund (RRF) grants | N/A | Applications submitted and grants received; use of funds on eligible expenses and reporting by 12/31/21 to SBA on use of funds | Continued utilization of funds and additional reporting to SBA |
| Shuttered Venue Operator Grants (SVOG) | N/A | Applications submitted and grants received; deadline of 12/31/21 to use initial grants | Continued use of supplemental grants and deadline for use |
| Employee Retention Credit & FFCRA Credits | Qualifying wages paid and credits claimed (retroactive opportunities for ERC available to PPP borrowers) | Expanded credit programs take effect; includes time off for vaccination and recovery between 4/1/21 and 9/30/21 | Programs expire, but amended payroll tax returns can be filed to claim credits from 2020 and 2021 |
| Employer payroll tax deferral | Eligible deposits held by employer | First half of deferred amounts due 12/31/21 | Second half of deferred amounts due 12/31/22 |
| Employee payroll tax deferral | Eligible amounts retained by employees if employer opted in | Deferred payroll taxes are remitted through withholding between 1/1/21 and 12/31/21 | N/A |

# ERC in M&A

## Private equity

- Platform investments may not be precluded from claiming ERC.
- An analysis of higher-tier ownership must be performed to conclude.

## Tax due diligence

- Attitudes that a taxpayer who received a PPP loan may not also claim the ERC still exist in the marketplace.
- Smaller taxpayers that are targets may not have devoted the time or resources necessary to analyze the rules and claim the credits.
- As these credits are claimed, the scope of tax due diligence should include reading any supporting analyses/documentation.
- Employment tax exposures
  - Tax structuring generally will not shield a buyer from succeeding risks associated with pre-closing ERC claims.
  - Heightened focus on contractual protections, or tax insurance

## Purchase contract negotiation

- If ERC opportunities or costs are identified post-close, is the buyer or seller entitled to the refunds claimed or responsible for any taxes owed?
- Contract provisions should specifically state the party which is entitled to benefits.

# Due diligence: What to do now?

## Revisit COVID-19-related programs to identify exposure and potential opportunities

## Request detailed support and computations

- As the programs have evolved, so too have tax positions.
- Requests should move beyond basic inquiry and focus on validating the support for any material positions.
- Some programs are relatively small, but the ERC is likely material.

## Update agreements to address concerns

- Consider whether existing representations and indemnification provisions are sufficient.
- Evaluate escrow and insurance options.
- Identify situations where a buyer may be able to claim benefits based on prior periods.

# Fund-level planning

# Tax treatment of carried interests

## General trends

- Carried interest is the subject of continued public debate.
- Congress has struggled to create rules targeting the perceived disfavored interests while leaving alone favored interests.
- <u>Key issue</u>: Incentive equity, especially partnership profits interests, are widely used by all types of businesses.

## Sec. 1061

- Implemented by the TCJA
- Respects the general tax treatment of carried interest
- However, a three-year holding period was imposed in order to obtain long-term capital gain treatment
- The rules are relevant for taxpayers holding Applicable Partnership Interests (APIs)
- Includes several notable exceptions, including Sec. 1231 gains

# Carried interest proposals

## Biden administration

- Proposed the creation of another set of carried interest rules in addition to current Sec. 1061
  - Would apply to taxpayers with taxable income over $400,0000
  - Current Sec. 1061 would continue to apply to those below that income threshold
- Operates by recharacterizing as ordinary income any income attributable to an investment services partnership interest (ISPI)

## Sen. Wyden's proposal

- Would replace Sec. 1061 with a new set of tax rules (new Sec. 1299)
- Applies a modified mark-to-market concept that would subject some unrealized gains to annual taxation

# Integration of taxes into returns

## Impact of rising taxes

- Return on investment or internal rate of return may be calculated on a pretax or post-tax basis, depending on the situation.
- Any post-tax calculations will be negatively impacted by rising taxes.
- Limited options may exist for dealing with this in the short term.

## Planning options

- Consider what options exist to adjust computations to a pretax basis.
- Consider communications to address anticipated impact.
- Do we anticipate future fluctuations in tax rules?

# Thank you for attending!

# Visit www.plantemoran.com for additional resources.

# Contact your presenters

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