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Alert | Tax

Dec. 21, 2017

Should Transactions be Delayed until 2018 because of the New Tax Law?

Those with an imminent sale of a business or real estate investment may be wondering whether they should delay closing until next year because of possible tax savings that might result from the Tax Cuts and Jobs Act. The answer will of course depend on the facts of the transaction but in many cases, there probably would not be a material tax savings in delaying the closing; in fact, a delay might even result in an increased tax liability due to the repeal of the deduction for state and local income taxes.

If the taxpayer expects to realize principally capital gain on the sale, there is little benefit (and perhaps a significant detriment) to waiting to sell until 2018. This is because the 20 percent capital gains tax and the 3.8 percent tax on net investment income are not reduced by either bill. This is true even if the business is sold pursuant to a sale of assets by a partnership (including an LLC that is treated as a partnership for tax purposes) or an S Corporation because even though the tax bill provides for a 20 percent deduction on "qualified business income" derived from a pass-through entity, capital gains are specifically excluded from the "qualified business income" that is eligible for the 20 percent dedication.

In the unusual situation in which a material portion of the income would be characterized as ordinary income (for example, from unrealized receivables or depreciation recapture) then there might be a benefit in delaying the closing until 2018, in order to take advantage of the lower tax rates on ordinary income. But this savings would have to be compared to the tax detriment (if any) of not being able to deduct all of the state and local income taxes on such income.

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The bill reduces the tax on "qualified business income" from pass-through entities (but not including service businesses such as law firms, medical practices, and finance firms) by allowing a deduction equal to 20 percent of the "qualified business income." If all of the "qualified business income" from the pass-through entity is ordinary income, then the benefit of this 20 percent deduction would translate to an effective tax rate of about 29.6 percent (down from the top tax rate of 37 percent under the bill). However, there is a critical limitation that would likely reduce the amount of the deduction if the closing occurs in early January for a business without significant payroll expense or material tangible assets. The deduction amount is limited to the greater of (1) 50 percent of the pass-through owner's proportionate share of W-2 wages paid by the pass-through entity, or (2) 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of its tangible depreciable assets. If the business does not own material tangible capital assets and the closing occurs in January, there would presumably not be much in the way of W-2 wages paid by the business so early in the year. Closing bonuses paid to rank and file employees would count toward this limitation, but not bonuses paid to partners in the entity (because partners do not generally have their bonuses reported on a W-2). As a result, there might not be a significant benefit in delaying a sale until early January 2018 even if there would be material ordinary income generated by the deal. There is an exception to this W-2 wage requirement for taxpayers with taxable income under a certain threshold - $315,000 for a married taxpayer filing jointly or $157,500 for a single taxpayer - but these thresholds would include the taxable income resulting from the sale of the business or real estate, and are phased out completely as taxable income exceeds $315,000 for a married joint filer or $157,500 for a single filer. As a result, this exception would not be of much help for more than a relatively modest sized transaction.

In addition, the tax benefit for pass-through entities would generally not apply to a business conducted outside of the United States. Consequently, if the business or investment real estate is located outside the U.S., there may be no advantage of delaying the sale until 2018.

However, even if the owners of a pass-through entity would benefit from a delay in the closing, there is an additional factor which would reduce any such potential savings if the closing is delayed until 2018. Under the new law, the owners would not be able to deduct more than $10,000 in state property and income taxes, while they would be able to deduct 2017 state income taxes paid on the gain from the sale, so long as they make an estimated payment of the 2017 state tax before the end of 2017. Any analysis to determine the potential benefit of delaying a sale should take into consideration the cost of the loss of the deduction for state income taxes from the sale. Even if an owner of the pass-through entity resides in a state without a personal income tax (like Florida), if the business is located in a state with a personal income tax, the investor may be required to pay state tax on the amount of gain apportioned to the gain on the assets located in the taxable state.

There are a lot of moving parts to consider. The facts and circumstances of each deal should be analyzed and modeled with the assistance of the business's accounting firm, taking into consideration the loss of the state income tax deduction on a 2018 sale in order to make a reasoned decision on whether the potential tax savings of delaying the sale of a business until 2018 is a beneficial move.

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