

# Industry Insights



## What Every Business Can Learn from the New Tax Reform

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In today's business environment, every business faces unprecedented levels of complexity and uncertainty. Rather than changing this reality, the *Tax Cuts and Jobs Act* (TCJA) contributes to it. As a result, businesses that aren't analyzing the secondary effects on their operations and competition will be caught off guard.

Many are unaware of the multidimensional complexity of tax reform. Evaluating the economic effect of the changes to your business in a vacuum won't be enough to maintain competitive advantage. Instead, management must go beyond measuring the effect on its bottom line to understand the effect on its business strategy and that of competitors.

In this way, each business has something to learn from tax reform—both about itself and about the opportunities and competitive threats that await.

### **Assess Your Level of 'Strategic Flexibility'**

Before leadership offloads the responsibility of tax reform to the accountants, it would be wise to gain perspective on what a change like the TCJA can reveal about an organization and its business model.

The TCJA is an illustrative example of the tide of overwhelming turbulence and change sweeping across every industry. In the past, most businesses could operate on a fairly stable set of assumptions. A successful business might develop a business plan, set some short-term and long-term goals and then execute in a consistent manner over time. Thus, businesses were rewarded for their strategic stubbornness. However, those days are long gone.

Instead, change is occurring so rapidly that businesses unable to adapt their business models in seemingly real time are being swept out to sea in a rip current of irrelevancy. In this manner, change—regardless of whether it's technological, operational or regulatory, in the TCJA's case—can be enlightening, revealing the level of an organization's "strategic flexibility."

Strategic flexibility is an organization's ability to adapt to change to maintain competitive advantage. Companies with high strategic flexibility create competitive advantage, while companies with low strategic flexibility will lose what advantage they had because they can't adapt to changing market dynamics.

As the marketplace becomes increasingly more complex, savvy leadership will use change—regardless of type—to assess their business's strategic flexibility and embed processes and capabilities in their business models to recognize and optimize resulting strategic opportunities.

### **The Calculus of Tax Reform**

While change may bring self-awareness, the opportunities and competitive threats resulting from change aren't often apparent. As it relates to tax reform, each business must evaluate how certain tax law variables might be optimized and what effects these changes could have on its strategies and those of its competitors.

Consider a few variables and the calculus required to evaluate the potential effect.

### **Corporate Structure Affects Available Cash**

Tax reform provides for a permanent reduction for a C corporation from a top graduated rate of 35 percent to a flat 21 percent. However, for pass-through entities such as S corps, sole proprietorships and limited liability companies, which pay their taxes through individual returns, the top individual federal rate is 37 percent, reduced from 39.6 percent. While many

pass-through entities can deduct 20 percent of pass-through income—reducing the top effective rate to 29.6 percent—a sizeable difference between the tax rate for C corps and pass-through entities exists.

Before pass-through entities conclude it's more favorable to be a C corp, there are numerous factors to consider in determining the most appropriate structure. For example, businesses should determine the amount of shareholder earnings they plan to distribute. The overall tax paid will be less for those C corps planning to distribute less earnings to shareholders. However, as a C corp pays more in dividends, the overall tax paid will be greater than pass-through entities.

In addition, businesses that anticipate an upcoming sale might benefit from remaining a pass-through entity, because the seller can avoid the additional layer of tax resulting from selling a C corp. Furthermore, state income taxes, which are deductible by C corps but not individuals, also should be a conversion consideration.

Here's the point: Depending on how these variables are measured, available cash changes. The change in available cash in a particular business won't occur in isolation, but will have an effect in relationship to competitors with different corporate structures. This will create opportunities for companies willing to consider the effects of their corporate structures and other variables, such as distribution rates, the timing of a sale and state income taxes, on their business strategies.

### ***Bonus Depreciation Affects New Investment***

While corporate structure affects available cash, new bonus depreciation rules affect capital investment. The TCJA allows the deductibility of 100 percent of the cost of most tangible property (other than buildings and some building improvements). This is compared with 50 percent of the cost previously deductible in the first year. Property eligible for bonus depreciation can be new or used as long as it's "new" to the business and not purchased from related parties. The 100 percent deduction is decreased to 80 percent in calendar year 2023, 60 percent in 2024, 40 percent in 2025, 20 percent in 2026 and zero percent in 2027 and later.

Businesses that may have been delaying or planning to phase in capital expenditures over time are now incentivized to accelerate certain growth and maintenance capital expenditures receiving an immediate write-off. Many businesses will take advantage of the new bonus depreciation to upgrade facilities, enhance technology and streamline processes. This helps increase capacity and enhance productivity.

Therefore, the short-term and long-term effects of substantial new capital investment within this phased-out, 10-year window must be considered as management assesses current capabilities, competitors' capabilities and market positioning.

### ***Interest Deductibility & Net Operating Losses (NOL) Affect Leverage***

The amount of capital investment management chooses to make will depend on a number of choices, including financing. Given the changes in interest deductibility and carryforwards in NOLs, this could create an interesting dynamic as businesses look to fuel growth and lower taxable income.

Under the TCJA, net interest deduction is limited to 30 percent of adjustable taxable income, generally defined as earnings before interest, taxes, depreciation and amortization (EBITDA). NOLs are limited to 80 percent of taxable income, determined without regard to the NOL deduction itself, and there's no longer the carryback of any NOL.

Consequently, businesses wanting to capitalize on the new bonus depreciation changes by aggressively pursuing capital investment through leverage, while limited when it comes to the deductibility of interest in a given year, will be able to carry forward any excess interest expense. This could create scenarios where businesses could highly leverage now, creating interest deductibility and NOLs to be used well into the future.

These certainly aren't all the TCJA's changes, but they touch on some of the major issues. The point is that tax reform adds to economic complexity and uncertainty by introducing a unique combination of change in key tax variables. If evaluating the tax effect on business strategy in the past required only basic algebra, now it requires calculus. Savvy businesses will attempt to optimize these variables in light of their business strategies. But in doing so, businesses will need to be aware of a few of the many strategic implications.

## Three Strategic Implications

Consider three strategic implications that come as a result of the TCJA.

### 1. **Capital Budgeting**

The new bonus depreciation, which allows the deductibility of 100 percent of the cost of most tangible property in the first year, along with lower effective tax rates, affects the capital budgeting process for each business and favors businesses with lower capital costs.

For example, when evaluating any number of possible investment options, management will often perform some type of free cash flow analysis to determine whether the project will generate a positive return. This requires projecting future cash flows and discounting them back at the required rate of return for the business, called the weighted average cost of capital (WACC).

Since 100 percent of the cost of a new asset placed in service in the first year can now be deducted, this generates higher depreciation tax savings earlier. In addition, the new lower effective tax rates (for some businesses) will increase the after-tax operating cash flows anticipated on projects. Assuming all other variables are constant, this can result in more projects generating a positive return. Therefore, capital allocation decisions will require greater discernment by management, since projects that may not have looked to generate a positive return in the past now may do so.

However, the resulting effects from changes to capital budgeting are more complex when compared across competitors with different corporate tax rates. In general, lower effective tax rates increase the after-tax cost of debt. This, in turn, increases the WACC, which also could be thought of as the rate of return that must be generated for a business to maintain its current value. Therefore, as the after-tax cost of debt increases, businesses with higher leverage will need to generate higher returns, assuming no change to the cost of debt.

Therefore, increases in after-tax operating cash flows will be need to be measured against potential changes in the company's required return to determine the effect. But, in general, the cost of capital will increase for businesses with more leverage. Therefore, as it relates to the ability to take on new projects and allocate capital, businesses with less leverage receive greater benefit from tax reform than their highly leveraged competitors.

### 2. **Mergers & Acquisitions**

The increase in available cash resulting from the TCJA is expected to lead some large corporations to more aggressively pursue new deals. While this could raise valuation multiples of privately held businesses in an already hot market, there are a couple of strategic considerations to keep in mind.

First, for privately held businesses looking to acquire, potential acquisition targets once on the radar screen may now be too pricey. With more cash on hand, larger corporations may come down market looking to purchase middle-market companies that add niche capabilities or provide accelerated tax benefit. This will place some deals out of reach for privately held businesses, causing them to rethink their growth strategy and potentially acquire riskier businesses.

Second, for privately held businesses looking to sell, special attention should be paid to deal structures that could affect valuation. The bonus depreciation increase allows buyers to take advantage of assets purchased from a different taxpayer. Sellers should be aware of these additional depreciation benefits and negotiate with them in mind.

### 3. **Employee Compensation**

Finally, the current labor market is tight. As a result, most privately held businesses can't find enough skilled labor. Some businesses with more available cash are using the extra savings to increase hourly wage rates and other compensation incentives. The purpose isn't only to reward existing employees but, more strategically, to secure

hard-to-find workers. In some cases, hourly employees are leaving for competitors and even switching from one industry to another.

Businesses that increase wage rates will need to produce corresponding productivity gains in the long term. But from a short-term perspective, this strategic move may leave some privately held businesses, which are slow to respond, scratching their heads and re-evaluating their long-term growth strategies in light of an inability to hire and retain a motivated and skilled workforce.

## **Conclusion**

Change can be a great teacher, but not all businesses learn at the same rate. When it comes to tax reform, businesses with the greatest amount of strategic flexibility will benefit most. Savvy leadership will not only embrace the increased economic complexity, but will evaluate its secondary effects and figure out how to use them wisely.

For more information, contact [Patrick](#) or your trusted BKD advisor.