Responding to Regulatory and Organic Changes in the Middle-Market Landscape

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New York City's middle-market firms face challenges and opportunities as they respond to an ever-tightening labor market as well as new minimum wage laws and regulations that are forcing firms to find creative ways to protect their bottom lines. At the same time, organic market forces are driving changes in mid-sized companies' access to financing. And cybersecurity is a constantly evolving concern.

Macroeconomic factors including tariffs, rising interest rates and energy issues are also at play, as the larger economic environment continues to affect middle market firms' financial dynamics.

Meanwhile, the 2017 Tax Cuts and Jobs Act has been in force for more than a year, but not all of its provisions have been fully clarified. As a result, firms continue to re-evaluate their strategies. Several questions remain regarding the "Opportunity Zone" program; the sheer number of changes to the tax code has shifted the dynamics of capital investing and overseas operations in complex ways.

***Crain's* turned to these experts in the accounting and advisory world, who have experience working with middle-market firms, for their insight into changes to the middle-market landscape:**

- **Michael Clain, JD,** partner at Windels Marx Lane & Mittendorf, LLP
- **Ryszard Jania, CPA**, partner in the commercial business group at Marks Paneth
- **Lisa Knee, CPA, JD, LLM,** the co-leader of the national real estate practice and leader for the national real estate private equity group

***Crain's:* What tax incentives are available to middle-market companies with respect to business expansion and capital investing?**

Knee: The 2017 Tax Cuts and Jobs Act increased the special allowance for depreciation—also known as bonus depreciation—to 100 percent of any property with a class life of 20 years or less, which would include most equipment and furnishings. Also, the benefits of Opportunity Zones apply to most businesses that are located within the declared zones. Income from flow-through entities, other than certain service and entertainment businesses, is also eligible for the qualified business income deduction.

Jania: The Internal Revenue Code's Section 179 expensing threshold has been raised from $500,000 to $1 million. In addition, certain qualified improvement property—including HVAC units, new roofs, and fire and security systems—is now eligible for the Section 179 expense election. A lesser known incentive is the NYC REAP program, which provides a credit of up to $3,000 per employee to qualified businesses that relocate to designated revitalization areas within New York City and make capital improvements to their new business premises.

***Crain's:* What impact does the TCJA have on middle-market companies with overseas manufacturing or operations?**

Jania: The introduction of the GILTI (global intangible low-taxed income) in the TCJA is perhaps the most vexing issue when foreign operations are carried out through a controlled foreign corporation. GILTI essentially ends tax deferral of foreign income, which in the old law was allowed for certain types of income. As a result, middle-market companies have to deal with the seemingly unfair difference in treatment between a corporate owner of a CFC and a noncorporate (e.g., S corporation or individual) owner of a CFC. Tax breaks available to corporate shareholders in determining their GILTI liability (i.e., deductions and foreign tax credits) are not available to noncorporate owners of CFCs. Nevertheless, there are strategic planning opportunities that can be de-

vised to address this disparity.

***Crain's:* What special considerations should investors make if they incorporate Qualified Opportunity Funds into their portfolio versus a non-QOF investment?**

Clain: Investors should consider the potential tax benefits that an investment in a QOF provides and the benefits that may be lost if the specified holding-period requirements for such benefits are not met. The terms of the QOF agreements may provide limitations on the liquidity of such investments, and such agreements should be carefully reviewed with the investors' professional advisers. In addition, the terms of such agreements should be reviewed for the provisions regarding the assurances that the QOF will continue to meet the requirements for such status. Of course, the usual investment considerations apply to QOFs, and proper due diligence is required.

Knee: While a QOF offers tax deferral, potential reduction in tax, and a potential elimination of tax on appreciation on the sale of the QOF, investors should recognize that there are still inherent risks in making investments in these funds. Investors should still look for investments that offer a compelling return independent of the potential tax benefits. Also, make sure that your investment policies are aligned with the fund managers and they can execute and understand the guidelines outlined in the provision. Fund managers need to follow the guidelines closely in order to maintain QOF status so that investors can achieve the desired tax benefits and risk-adjusted returns.

Michael Clain, JD — Partner

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Jania: An investment into a QOF should be analyzed from a business perspective—if it wasn't a good investment before, it doesn't become one solely because of the Opportunity Zone benefits. Although there are tremendous tax benefits, investors should also keep in mind that in the year 2026, they will need to recognize 85 percent of the gain. The way the law is currently written, the investor won't receive the full tax benefit unless the partnership interest is disposed of. For that reason, investors should consider single-purpose entities, or else they will not be able to achieve their tax objectives until all the businesses within an entity are liquidated.

***Crain's:* The TCJA created the Opportunity Zone program to spur long-term growth and economic development in economically distressed neighborhoods. What is a Qualified Opportunity Zone and what are the investment opportunities within a QOZ?**

Knee: The secretary of the Treasury designated 8,762 census tracts as QOZs in all 50 states, five U.S. territories and Washington, D.C. (These designations will remain in effect until December 31, 2028.) The QOZs represent distressed areas that need an economic incentive to attract private capital. A QOZ business is an active trade or business organized as a corporation or partnership in which 70 percent of its assets are in QOZ business property, and at least 50 percent of the business gross income is derived from activities within a QOZ. In order to qualify as a QOZ business property, tangible property must be acquired by purchase after Dec. 31, 2017, and be used in a trade or business.

The original use of the property must commence with a Qualified Opportunity Fund or the QOF must substantially improve the property. In general, a QOF is an investment vehicle that is set up as either a partnership, a limited liability company taxed as a partnership, or a corporation for investing in eligible property that is located in a QOZ. Certain "sin businesses" are prohibited, such as golf courses, country clubs, massage parlors, hot tub facilities, race tracks, tanning facilities, gambling facilities and locations where the principal business is the sale of alcoholic beverages for consumption off-premises.

Clain: The TCJA provides substantial new tax benefits to taxpayers that have capital gains and invest in QOZs. These benefits include significant basis step-ups (which decrease taxable gain) on investments in a QOZ (up to 15 percent if the property is held for more than seven years), and deferral of the tax on the remaining gain. Further, if the investment is held for 10 years and an appropriate election is made, the capital gain may not be taxed at all upon the sale of the property. These benefits may apply not only to investments to purchase property in a QOZ, but also to investments in substantial improvements to property located in a QOZ.

Jania: In the simplest terms, if a taxpayer recognizes gain on the sale of certain assets—stocks, art, real estate, etc.—they can retain the original principal but roll the gain into a qualified investment in an opportunity zone within 180 days. Ten percent of the gain will be eliminated after five years, and another 7 percent after seven years. If the interest is sold prior to 2026, tax is due immediately. If the taxpayer still owns the business in 2026, tax is owed on only 85 percent of their gain. Amazingly, if the taxpayer owns it for at least 10 years, all gain from the date of the investment is tax-free.

***Crain's:* What are some of major issues that need to be resolved under the next set of regulatory guidance with respect to setting up a QOZ business in a Qualified Opportunity Zone?**

Knee: While the Treasury issued investor friendly, first-round proposed regulations and guidance in October 2018, there are still many areas of uncertainty with respect to these provisions. For an operating business, clarification is needed on the amount of revenue generated within the QOZ and if, under any circumstances, an existing business in a QOZ can qualify.

Another major issue revolves around the discussion of substantial improvement qualifications and whether tangible property has its original use in a QOZ. Rolling over gains recognized by a QOF on an interim sale and whether a reasonable time would be granted to allow a QOF to reinvest sales proceeds are other issues to be addressed. Further, if an entire interest is sold, the proposed regulations allow for reinvestment, but it is uncertain if any gain in excess of the original deferral must be recognized in the year of sale or whether the holding period is tacked from the original sale.

Clain: The U.S. Treasury Department is expected to issue additional guidance, possibly in the form of additional proposed regulations, regarding a number of topics concerning QOFs, including the federal income tax treatment of any gains that a QOF reinvests, what constitutes a "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty, the time period of a QOF to invest cash received from an investor-taxpayer and rules regarding conduct that may result in decertifying a QOF.

Ryszard Jania, CPA — Partner

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Jania: We expect additional guidance this month that will hopefully clarify some of the uncertainty and allow capital to flow freely into opportunity zones. We are anticipating answers to questions such as how the sourcing of sales will be counted by QOZ businesses, whether the investor can take out debt on the property, how the depreciation will be recaptured upon sale, how the original use requirement will be applied and whether or not taxpayers can preserve benefits if they sell a QOZ business before 2026 but reinvest the gain into another QOZ business.

***Crain's:* What do the new revenue recognition standards mean for middle-market companies?**

Jania: For some middle-market companies, the new revenue recognition standard, which is now in effect for nonpublic companies, will have minimal impact other than increased disclosure requirements on the company's financial statement. For others, particularly those with multiple performance obligations (contracts with multiple elements, sales of tangible property with service contracts, software arrangements, etc.), it will require careful analysis into when the performance obligation was satisfied and revenue can be recognized. We are strongly encouraging our clients to review all of their contracts to determine whether the terms and conditions as written are consistent with the anticipated revenue recognition in regard to the services or products sold. Companies may need to modify their accounting systems to capture the information required to make these determinations and recognize revenue properly under the new standard.

***Crain's:* Are there any new sources of financing that have recently become available to middle-market companies?**

Clain: Middle-market financing is constantly evolving to keep up with technology and more closely match the needs of the market. For instance, supply-chain finance programs, through which large buyers provide financial support to their vendors, are moving downstream and growing rapidly; competition among merchant cash-advance companies, which provide financing to restaurants and other hard-to-finance cash businesses, is bringing down rates; and fintechs are teaming up with banks to provide faster and more automated services to small and midsized businesses to provide a customer experience that feels more like consumer lending.

Jania: Over the past year, I have noticed considerably more private equity activity in the tristate area involving middle-market companies. The private equity firms are looking for market-leading companies in high-growth industries where these companies can use the cash infusion from the private equity firm to aggressively grow their sales. The owners are equally interested in working with the private equity firms because they provide an exit strategy that creates a significant liquidity event. In addition, traditional financial institutions have definitely been signing more loans than they were in the past several years.

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***Crain's:* How can middle-market companies protect their data and their customers' data from cybersecurity threats?**

Clain: Middle-market companies simply don't have the capital necessary to build and maintain appropriate firewalls around their servers. Fortunately, more and more technology companies now offer software and platforms available online as a service, which are built on top of secure and reliable infrastructure—like AWS or Azure—and offer enhanced security measures such as two-factor authentication, strong encryption and tokenized access. Companies still have to protect the ramps to those platforms (make sure employees use strong passwords and don't share them, for instance), but those are procedural safeguards that don't have material costs attached.

Jania: Contrary to popular belief, most cyberattacks are caused by deficiencies in a company's most basic protections. Organizations need to focus on the fundamentals first, such as adequate password security and dual authentication for remote access. While more advanced cyber tools are helpful, the best cybersecurity is rooted in consistently assessing the company's vulnerabilities to evolving threats and creating a company-wide awareness of security best practices. Having these basic security measures in place not only greatly reduces the likelihood of an incident, but also diminishes the impact of an attack if and when it occurs.

Lisa Knee, CPA, JD, LLM — Partner

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***Crain's:* How are midsized companies handling HR issues such as the new minimum wage laws and a tight labor market?**

Jania: In today's very tight labor market, middle-market companies need to offer a work environment that attracts today's workforce. Soft benefits such as flexible work schedules, remote work locations, paid backup care and others can be competitive differentiators, particularly since these are some of the things that millennials look for in an employer.

Clain: We have seen companies modify their HR practices in response to the tightening of the labor market and increase in hourly wages in different ways.

To attract and retain desirable employees, some companies have begun offering signing bonuses, student loan repayment programs and payments for continuing educational expenses. Companies are also providing executive coaching more frequently to enable their most successful employees to advance their careers internally. In addition, many companies are providing additional paid time off and are showing greater flexibility on work hours and on allowing employees to work remotely.

As a result of the increase in minimum hourly wages, some companies are converting full-time employees into part-time employees, and thereby eliminating entitlement to benefits, as part of an attempt to offset the increase in wages with a decrease in the cost of benefits.

***Crain's:* Do you see any particular signs of danger—or optimism—for midsized businesses in the year ahead?**

Jania: As minimum wages continue to increase, middle-market companies are facing the challenge of how to recover additional wage costs without affecting their bottom line. In particular, I see this change affecting our franchisee clients in the quick service restaurant space. They do not have the ability to increase prices to cover higher wage costs, and it is very difficult for them to trim expenses that increase every year. Ideally, increased wages should attract better talent, and companies need to capitalize on the improved operational efficiencies created by a higher functioning workforce. If middle-market companies do not think creatively and plan strategically to address this issue, they could risk significant danger.

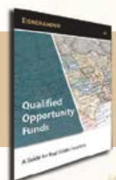
Clain: Midsized businesses have two major concerns as they look at the rest of this year: tariffs and rising interest rates. The imposition of tariffs impacts the overseas markets for exporters and increases the price of imported materials and components. Even talk of imposing tariffs makes it harder for businesses to plan for the rest of the year and project revenues and expenses. Rising interest rates makes it harder to finance operations and puts pressure on companies that are overleveraged.

Another significant concern is energy. Although we have plenty of oil and gas, our ability to transport it has been constrained as public pressure and regulatory oversight have limited pipeline construction. Some utilities have already announced moratoriums on new gas connections in parts of their territories. This will impact new construction and have a ripple effect on supporting industries. It remains to be seen whether it also encourages the development of alternative energy, as some hope.

Looking to invest in opportunity zones?

The Qualified Opportunity Zone Program, a new incentive in the Tax Cuts and Jobs Act of 2017, provides significant tax benefits to investors, business owners and real estate developers. By investing in qualified opportunity funds, you could temporarily defer capital gains taxes, eliminate up to 15 percent of the tax on the deferred gains, and eliminate the capital gain on the appreciation of your investment in the qualified opportunity fund.

EisnerAmper tax specialists can help you navigate the complex rules of this new investment strategy.



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