BUSINESS TAX QUARTERLY

April 2018

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Important Dates

Business Law Section Spring Meeting
April 12-14, 2018
Orlando, FL

Editor

Michael Kliegman, Akin Gump Strauss Hauer & Feld LLP, New York City

Editorial Board

Message from the Chair

Your Taxation Committee continues to grow and the recently enacted Tax Cuts and Jobs Act has filled the plate of the Tax Committee this year. We have been busy preparing several webinars on various aspects of the bill including the effect on law firms, partnership audit rules, and international provisions. Our upcoming Orlando meetings will have an entire CLE session devoted to this topic, including both the domestic and international tax law changes for business lawyers.

In addition to our meeting events and webinars, the Tax Committee has been charged with writing a book for BLS on the Tax Cuts and Jobs Act. We are seeking submissions and volunteers to help with some of the chapters. If you feel like writing and would like to contribute to an important guide and resource, please contact me.

This year will be more active than most for our committee, and we are always seeking suggestions, content and speakers. As always, please encourage our younger lawyers to take an active role in this committee. We offer an opportunity for young lawyers to gain exposure and sharpen skills.

I am looking forward to seeing you in Orlando in April and online in our webinar series.

Roger Royse
Chair, Taxation Committee

Message from the Editor

We are pleased to bring you our Winter 2018 issue of Business Tax Quarterly. We ordinarily run a mix of topics, including important news from the IRS and Congress, as well as articles focusing on recurring issues confronting business lawyers. In this issue, for obvious reasons, we are running a number of articles on different aspects of the important and far-reaching tax reform legislation passed at the end of 2017. Our articles cover areas of interest to business lawyers including international tax, choice of entity, employment tax, estate planning, impact on M&A, and even impact on the entertainment industry.

If you want a break from tax reform, we have an article on the pending Supreme Court case reexamining the physical presence requirement for state taxation and an article focusing on the increasingly prominent role of transaction-related tax benefits as a negotiated item in M&A deals.

Finally, in addition to my regular solicitation of articles and suggestions for topics, please let me know if you would be interested in working with me to edit Business Tax Quarterly. It's interesting in a number of ways, and I could use the help.

Enjoy the articles, enjoy Spring and, of course, the Business Law Section's upcoming Spring Meeting.

Michael Kliegman

Feature Articles

Transaction-Related Tax Deductions and the Worst Words Ever Spoken by a Deal Professional
By Glenn West, Mark Schwed and Alex Farr

Contrary to popular belief, Raymond Burr's character in the famous TV series, *Perry Mason*, did not necessarily limit his practice to criminal defense. He was an old-fashioned sole practitioner that, at times, could be seen drafting contracts too (or at least dictating some instructions regarding their preparation to his trusted legal assistant, Della Street (played by Barbara Hale)). If memory serves, the show would sometimes open with the tail-end of a meeting between Perry and a regular client not accused of murder, discussing some business dealing of some kind, with Della carefully taking notes in shorthand. As the meeting wrapped up, and before the show turned to the meatier matters of some wrongly accused person desperately needing Perry's assistance, Perry would wave his hand and say something to the effect of "Della, please prepare the necessary papers."

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Breaking News: U.S. Supreme Court to Revisit Quill, Grants Cert in South Dakota v. Wayfair, et al.
By Jonathan Maddison and Sebastian Watt

Today the United States Supreme Court granted cert in South Dakota v. Wayfair, et al., the lead case challenging the Court's "physical presence" nexus rule reaffirmed in Quill Corp. v. North Dakota ("Quill"). The Court's eventual decision in South Dakota v. Wayfair will directly impact other states that have enacted "kill-Quill" legislation or regulations. But the impact of the Court's decision on other state efforts to increase sales and use tax collection on remote sales, without directly challenging Quill, either by enacting reporting regimes or by imposing sales tax collection obligations based on contacts with the jurisdiction that can be distinguished from the contacts presented by the taxpayer in Quill (for example, by enacting, "cookie nexus", or platform legislation), is unclear.

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Policy Points of the Tax Cuts and Jobs Act
By Annette Nellen

On December 22, 2017, President Trump signed into law significant tax reform legislation, commonly referred to as the Tax Cuts and Jobs Act (TCJA) (P.L. 115-97). While this legislation seems to have come into existence quickly, with legislative language first introduced in the House Ways and Means Committee on November 2, 2017, it had a longer history. That history included discussion of numerous tax policy matters and proposals, some of which are reflected in the TCJA, while others await future legislation. This article covers some of the tax policy changes in the TCJA and offers a rating on whether particular principles were met. An exhibit presents a timeline of key actions that led to the TCJA.

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Effect of 2017 Tax Reform on Choice of Business Entity
By Steven B. Gorin

Tax reform enacted at the end of 2017 made C corporations much more attractive from the standpoint of annual income taxes than S corporations, partnerships, or sole proprietorships (collectively, "passthroughs"). Or did it? And how about the consequences of transferring one's business by sale to third parties or through estate planning tools?

C corporations now have a flat 21% federal income tax rate. Even personal service corporations use the new low rate. This contrasts with the top federal income tax bracket of 37% for passthrough income, which may be reduced to 29.6% by way of a 20% deduction for qualified business income - if and to the extent that one's passthrough qualifies for the deduction. Partners and sole proprietors in lower income tax brackets face 15.3% self-employment tax, and those in the highest brackets may pay 3.8% self-employment tax or net investment income tax. S corporation owners who work in the business must report compensation income to the extent of the lesser of cash they receive or "reasonable compensation," and in 2017 the IRS explained to its agents how to keep taxpayers out of Tax Court when the IRS reclassifies distributions as compensation. Any amounts classified as wages are not eligible for the 20% deduction.

Read more....

Impact of US Tax Reform on Mergers and Acquisitions: New Opportunities and Pitfalls
By Stuart M. Finkelstein, Edward E. Gonzalez, Brian Krause, David F. Levy, David M. Rievman, Eric B. Sensenbrenner, Sally A. Thurston, David A. Schneider, Alec J. Jarvis

On December 22, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act (TCJA), which includes numerous changes that will significantly impact mergers and acquisitions (M&A). Although the TCJA has rightly been described as the most far-reaching piece of tax legislation enacted since the Tax Reform Act of 1986, the new provisions generally serve as an overlay to existing tax law, rather than a complete rewrite of the prior Internal Revenue Code (Code).1 Particularly as it relates to M&A, the old rules largely remain. That said, the TCJA's changes will have a significant impact on deal modeling, tax diligence and acquisition agreement negotiations. This memorandum discusses the changes to the Code most relevant to M&A and their potential impact. Overall, we expect that the reduction of the U.S. corporate tax rate to 21 percent will make the United States a more attractive jurisdiction for inbound M&A activity and also may increase the value of U.S. domiciled businesses. In addition, the changes to the international tax rules should allow many U.S. companies to access the cash of their foreign subsidiaries at a lower U.S. tax cost, which could provide them with liquidity to fund acquisitions.

Read more....

Tax Reform Advisory: International Provisions
By Abraham Leitner

On December 22, 2017, the President signed into law H.R. 1, informally known as the **"Tax Cuts and Jobs Act" (the "Act")**, implementing sweeping changes to the United States tax regimes generally applicable to businesses. Most provisions of the **Act will take effect as of January 1, 2018** and (except as noted below) generally will apply to tax years beginning after 2017. Certain highlights of the Act are discussed below.

Read more....

The Impact of Tax Reform on Employers
By Otto S. Shill, III

In the wake of the passage of the Tax Cuts and Jobs Act of 2017 (the "Act"), taxpayers and advisors have been evaluating its impact on their businesses. While one can debate whether the Act constitutes real, policy-based tax reform, it does generally reduce corporate and business tax rates, but it also eliminates some previously available tax deductions and credits. Thus, some classifications of income can no longer be offset by expenses that were historically deductible. Interpretive guidance is sparse and comes primarily from the Joint Explanatory Statement of the Conference Committee (the "Joint Committee Report"). Following is a summary of how the Act impacts a company that employs and manages a workforce.

Read more....

Dramatic Change to Federal Estate, Gift and Generation-Skipping Tax Exemptions
By Seth D. Slotkin, Timothy P. Tehan and Elizabeth E. Harris

The Tax Cuts and Jobs Act (the "Act"), which took effect on January 1, 2018, is the most comprehensive update to the Internal Revenue Code in decades. In addition to making sweeping changes to the federal income tax laws (addressed in this Akin Gump alert), the Act makes significant, albeit temporary, changes to the federal estate, gift and generation-skipping transfer (GST) tax laws.

Read more....

How the New Tax Law Impacts Hollywood: Lights, Camera, Accelerated Deduction
By Shane Nix

Costs for film and television productions generally are required to be capitalized and added to the tax basis of the resulting copyright. Absent a provision allowing for accelerated cost recovery, the tax basis of a copyright generally must be depreciated and recovered over a ten-year period, using the "income forecast method," which is intended to match the depreciation expense with the projected income from the film or television production. Generally, film and television productions produced overseas or productions otherwise not eligible for accelerated cost recovery will be recovered using the income forecast method. Historically, however, production costs for domestic productions have been eligible for deduction immediately as and when incurred, where a certain tax election was made (a "***Section 181 Election***"). The purpose of the Section 181 Election generally is to incentivize production companies to produce film and television productions in the United States. For a number of years, Section 181 was renewed retroactively as part of Congress's extenders package, which meant that production companies faced uncertainty during the year because they did not know whether the Section 181 Election would be available. Most recently, Congress extended the availability of the Section 181 Election retroactively through 2017 when Congress passed an extenders package on February 9, 2018. So much for incentivizing U.S. production prospectively!

Read more....

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Transaction-Related Tax Deductions and the Worst Words Ever Spoken by a Deal Professional

Glenn West, Mark Schwed and Alex Farr

January 31, 2018

Contrary to popular belief, Raymond Burr's character in the famous TV series, *Perry Mason*, did not necessarily limit his practice to criminal defense. He was an old-fashioned sole practitioner that, at times, could be seen drafting contracts too (or at least dictating some instructions regarding their preparation to his trusted legal assistant, Della Street (played by Barbara Hale)). If memory serves, the show would sometimes open with the tail-end of a meeting between Perry and a regular client not accused of murder, discussing some business dealing of some kind, with Della carefully taking notes in shorthand. As the meeting wrapped up, and before the show turned to the meatier matters of some wrongly accused person desperately needing Perry's assistance, Perry would wave his hand and say something to the effect of "Della, please prepare the necessary papers."

While Della was an amazing legal assistant, contract drafting is seldom a function of simply translating some notes from a meeting describing the supposed "deal" into a legally enforceable contract. The devil may well be in the details of the drafting and negotiation of the written agreement, and, as discussed in a prior Weil Private Equity *Insights*, it is that fully negotiated written contract that constitutes the deal, not what one of the parties may have *thought* was the deal based on pre-contract discussions. Nonetheless, some deal professionals persist in the mistaken belief that the deal was fully-made between the principals, and the lawyers just need to be Della and "prepare the necessary papers" to document that deal. Such a mistaken belief was very much in evidence in a recent Delaware Court of Chancery decision, *LSVC Holdings, LLC v. Vestcom Parent Holdings, Inc.*, C.A. No. 8424-VCMR, memo. op. (Del. Ch. Dec. 29, 2017), where the principals on both sides of the sale of a company supposedly agreed to share equally the benefits of the company's transaction-related tax deductions ("TTDs") and then left the lawyers to work out the details. As with any deal points, but particularly when it comes to TTDs, the worst words ever spoken by a deal professional are: "We have a deal, let's let the lawyers work out the details."

Background on TTDs:

First, it is worth a brief detour to explain the mechanics of TTDs and the benefit of such deductions. TTDs are generally tax deductions generated by payments made by a target entity that become deductible in connection with the closing of the transaction, such as professional fees, compensatory payments, and deferred financing expenses, which generally result in ordinary deductions for the target entity. In a transaction that is consummated early in the year and causes the target's taxable year to close (resulting in a "stub" tax period), the TTDs arising from closing expenses incurred in the stub period may exceed the target's income during such period and generate a "net operating loss" ("NOL"). Historically, such deductions could first be claimed on the stub period tax return to reduce the pre-closing stub period taxable income (and, to the extent relevant, allow the target to claim a refund of estimated tax payments made in respect of such period). Any excess deduction would create an NOL that could then be carried back to the two taxable years preceding the taxable year in which the NOL was generated to produce refunds to the target for any taxes paid in such preceding years. Thereafter, the balance of the NOL could generally be carried forward and used to offset post-closing taxes of the buyer. Note, however, that as a result of the passing of the Tax Cuts and Jobs Act of 2017, newly-created NOLs are no longer eligible to be carried back to prior tax years (although they may still be carried forward).

There is no "right" or "wrong" way to allocate the value generated by the TTDs. Often, in a transaction where the seller is bearing the cost of the items giving rise to the deductions by a reduction to the purchase price, the seller may "expect" to receive the benefit of the TTDs via an offset of the pre-closing tax liabilities, as well as the benefit of any refunds generated as a result of the pre 2017-Tax Reform ability to carryback NOLs, and the benefit of the carryforward of the NOLs that are used to offset the company's post-closing tax liabilities. However, as can be expected in any negotiated transaction, the buyer may price in the value of some or all of these benefits and may negotiate to keep some or all of the benefit for itself. As there are numerous approaches to allocating the economic benefits of TTDs, and the mechanics for providing such benefits to the buyer or seller, as the case may be, can vary depending upon the facts of the specific transaction, and, in light of the court's analysis in *LSVC Holdings* discussed below, the specific mechanics should be explicitly spelled out in the final agreement.

<u>LSVC Holdings:</u>

LSVC Holdings involved a dispute over whether the final stock purchase agreement ("<u>SPA</u>") between the parties to a corporate acquisition contemplated a 50-50 split between Buyer and Seller of all TTDs in *all* respects, pre- and post-closing, or merely required Buyer to share 50% of the benefit of any TTDs utilized to offset post-closing taxes with the Seller. The executed letter of intent between the parties (the "<u>LOI</u>") merely provided that the Buyer "would pay over *to the seller* 50% of the benefit of any transaction tax deductions on an 'as and when realized' basis." (emphasis added). The final SPA only stated that the Buyer would be entitled "to retain 50% of" the post-closing TTD-related refunds or tax savings. Nevertheless, the Buyer filed suit alleging a breach of contract after learning that no TTDs would be available to it in the post-closing period because the Seller, anticipating the close of the transaction by year-end, accounted for the TTDs when making its fourth quarter tax payment to the IRS (i.e., claimed the deductions in the *pre*-closing period). The Buyer argued that doing so was both inconsistent with the deal and explicitly precluded by a provision in the SPA requiring the Buyer to include *all* TTDs on the post-closing tax returns. The court felt there was a "tension" between the provisions of the SPA necessitating an examination of extrinsic evidence:

> When a contract's plain meaning, in the context of the overall structure of the contract, is susceptible to more than one reasonable interpretation, courts may consider extrinsic evidence to resolve the ambiguity. Such extrinsic evidence may include the history of negotiations, earlier drafts of the contract, trade custom, or course of performance. After examining the relevant extrinsic evidence, a court may conclude that, given the extrinsic evidence, only one meaning is objectively reasonable in the circumstances of the negotiation. (citations omitted).

The court evaluated the history of the parties' negotiations leading up to the executed LOI, the drafting history of the SPA, and the post-closing actions of the parties, among other things. In each instance, the court concluded that the evidence favored the Seller's interpretation of the arrangement. For example, during initial negotiations each of the parties sought to capture 100% of the benefit of the TTDs, but ended up settling on a "middle ground" approach to split the TTDs 50-50; this was memorialized in the executed LOI which provided for payments from the Buyer to the Seller of 50% of any TTD value as and when realized. The court noted a lack of any explicit provision in the LOI or the final SPA providing for a payment *from the Seller* to the Buyer. Furthermore, over the course of exchanging drafts of the SPA, the Buyer's counsel proposed language that, if included in the final SPA, would have expressly precluded the Seller from claiming the TTDs pre-closing as it eventually did. Because the language was omitted in the final SPA, however, and, consistent with the LOI, the SPA contained no explicit provisions obligating the Seller to pay the Buyer for pre-closing benefits attributable to TTDs, the court declined to read into the SPA the interpretation that the Buyer sought to enforce:

> Under basic principles of Delaware contract law, and consistent with Delaware's pro-contractarian policy, a party may not come to court to enforce a contractual right that it did not obtain for itself at the negotiating table. This principle applies with particular force when the supposedly aggrieved party in fact sought the specific contractual right at issue in negotiations but failed to get it. This is because a court's role in interpreting contracts is 'to effectuate the parties' intent.' For a court to read into an agreement a contract term that was expressly considered and rejected by the parties in the course of negotiations would be to 'create new contract rights, liabilities and duties to which the parties had not assented' in contravention of that settled role. (citations omitted)

<u>Key Takeaways:</u>

LSVC Holdings reminds of the importance of clarity in all aspects of a transaction negotiation:

- *Clarify the Meeting of the Minds*

Make sure that you and your counsel have a clear and consistent understanding of the fundamental business deal. It is apparent that when the *LSVC Holdings* parties cut their "50-50" TTD deal, there was a disconnect in their respective interpretations of what that meant. Although the court upheld the plain drafting of the SPA, the parties could have potentially avoided the ambiguity debacle had they given due consideration to both the wording and conceptual meaning of their business deal with respect to TTDs.

- *Don't Leave Money on the (Drafting) Table*

Because the "deal" is typically reflected only in the four corners of the written agreement, deal professionals must stay involved and ask hard questions about the drafting—do not simply leave the details to the lawyers. As the *LSVC Holdings* court highlighted, the Buyer's counsel could have potentially foreclosed the issue had it pushed to include language explicitly proposed during the drafting process but omitted in the final SPA (i.e., explicitly prohibiting the target from accounting for TTDs in its pre-closing returns). And, of course, the Seller's counsel could have avoided a trial involving the introduction of extrinsic evidence if the written agreement did not contain language that created the need for such extrinsic evidence.

Deal professionals must stay involved with their counsel throughout the drafting process; and because the deal isn't done until the final agreement is fully negotiated and signed, they must make sure they have the right counsel familiar with the evolving caselaw regarding private equity deal documentation. Unfortunately a deal professional's job is not done just because they believe they have cut a deal.

Breaking News: U.S. Supreme Court to Revisit *Quill*, Grants Cert in *South Dakota v. Wayfair, et al.*

Authors: Jonathan Maddison, Sebastian Watt

Executive Summary:

Today the United States Supreme Court granted cert in South Dakota v. Wayfair, et al., the lead case challenging the Court's "physical presence" nexus rule reaffirmed in Quill Corp. v. North Dakota ("Quill").[1] The Court's eventual decision in South Dakota v. Wayfair will directly impact other states that have enacted "kill-Quill" legislation or regulations. But the impact of the Court's decision on other state efforts to increase sales and use tax collection on remote sales, without directly challenging Quill, either by enacting reporting regimes or by imposing sales tax collection obligations based on contacts with the jurisdiction that can be distinguished from the contacts presented by the taxpayer in Quill (for example, by enacting, "cookie nexus", or platform legislation), is unclear.

Body of Alert:

The United States Supreme Court granted *cert* in *South Dakota v. Wayfair, et al.*, the lead case challenging the Court's "physical presence" nexus rule announced in *National Bellas Hess v. Illinois*[2] and reaffirmed in *Quill Corp. v. North Dakota.*[3]

This case directly involves South Dakota S.B. 106, which imposes a sales tax collection obligation on an out-of-state seller if it:

1. makes over $100,000 in gross revenue from sales of tangible personal property or services delivered to South Dakota; or

2. completes 200 or more separate transactions for delivery to South Dakota.[4]

The case began when South Dakota brought an action seeking a judicial declaration that the requirements of S.B. 106 were valid and applicable to four out-of-state retailers: Overstock.com, Newegg, Systemax, and Wayfair (collectively, the "Retailers"). The Retailers filed a motion for summary judgment, arguing that there was no issue of material fact because the sales tax collection obligation of S.B. 106 directly contradicts the physical presence nexus rule of *National Bellas Hess* and *Quill*.[5] The Sixth Judicial Circuit of South Dakota and the Supreme Court of South Dakota agreed and granted the Retailers' motion.

The question immediately before the Court is whether the motion for summary judgment was properly granted and affirmed by South Dakota state courts. What is unclear, however, is whether the Court will take this case as an opportunity to revisit *Quill*'s physical presence rule,

[1] 504 U.S. 298 (1992).
[2] 386 U.S. 753 (1967).
[3] 504 U.S. 298 (1992).
[4] S.B. 106, § 1, 2016 Leg., 91st Sess. (S.D. 2016).
[5] South Dakota agreed there were no disputes of material fact. *South Dakota v. Wayfair, Inc., et al.*, No. 32CIV16-000092 (S.D. Cir. Mar. 6 2017)

as recommended by Justice Kennedy in his concurring opinion in *Direct Marketing Association v. Brohl*.[6]

What's next?

Regardless of the Court's eventual decision in South Dakota v. Wayfair, the decision will directly impact similar "kill-Quill" laws (for example, Indiana, Wyoming) and regulations (for example, Alabama). What is unclear, though, is what impact the Court's decision will have on other state efforts to distinguish Quill, rather than directly overruling it.

Colorado's reporting regime was upheld as constitutional by the U.S. Court of Appeals for the Tenth Circuit in *Direct Marketing Association v. Brohl*.[7] After the Court denied *cert* in that case, several states enacted similar reporting regimes. If the Court ultimately affirms *Quill*'s physical presence rule in South Dakota v. Wayfair, will more states follow Colorado's lead and enact similar reporting regimes?

Other states have attempted to limit *Quill* by taking a broad view of physical presence—and the Court's eventual decision in *South Dakota v. Wayfair* may not impact those efforts. For example, Massachusetts has promulgated a so-called "cookie nexus" regulation that is premised on the assertion that certain vendors have sufficient physical in-state presence through the use of software and complimentary text data files, known as "cookies," located on computers of their in-state customers, thus satisfying the requirement of *Quill*.[8]

Similarly, the Court's eventual decision may not immediately impact state attempts to impose sales tax collection or reporting obligations on "platforms." Minnesota, Pennsylvania, Rhode Island, and Washington have recently enacted regimes requiring companies that facilitate sales by providing an online marketplace to collect sales tax on sales certain remote sellers, or comply with burdensome reporting regimes.[9] These regimes raise issues under the Due Process Clause of the United States Constitution and the Internet Tax Freedom Act.

Taxpayers and state revenue departments may be hoping that the Court's decision in *South Dakota v. Wayfair* will provide much needed clarity regarding the constitutional limits on state taxing authority. But no such clarity is guaranteed. If the Court reaffirms *Quill's* physical presence rule, questions may remain on the scope and reach of the physical presence rule. And if the Court announces a new bright-line rule, there is no certainty that the rule will prove any easier to administer than *Quill*'s physical presence rule. Taxpayers should closely monitor this litigation and new state efforts to enforce their sales and use tax laws in the future.

About Reed Smith State Tax

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[6] 123 S. Ct. 1124, 1135 (Kennedy, J. concurring) (2015).
[7] 814 F.3d 1129 (10th Cir. 2015), *cert. denied*, 137 S.Ct. 591 (2016).
[8] A challenge to Massachusetts' regulation was filed in Virginia state court, and the Court's decision to grant *cert* may not halt that litigation. Through legislation, Ohio has adopted a similar "cookie nexus" standard for purposes of its sales tax.
[9] *See, e.g.* Jonathan Maddison, Walter Hellerstein & John Swain, *Platforms*, 86 STATE TAX NOTES 1165 (Dec. 18, 2017) .

Reed Smith's state and local tax practice is composed of more than 35 lawyers across seven offices nationwide. The practice focuses on state and local audit defense and refund appeals (from the administrative level through the appellate courts), as well as planning and transactional matters involving income, franchise, unclaimed property, sales and use, and property tax issues. Click here to view our State Tax team.

Policy Points of the Tax Cuts and Jobs Act

Annette Nellen, CPA, CGMA, Esq.
San Jose State University
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On December 22, 2017, President Trump signed into law significant tax reform legislation, commonly referred to as the Tax Cuts and Jobs Act (TCJA) (P.L. 115-97). While this legislation seems to have come into existence quickly, with legislative language first introduced in the House Ways and Means Committee on November 2, 2017, it had a longer history. That history included discussion of numerous tax policy matters and proposals, some of which are reflected in the TCJA, while others await future legislation. This article covers some of the tax policy changes in the TCJA and offers a rating on whether particular principles were met. An exhibit presents a timeline of key actions that led to the TCJA.

Simplification

Rating: B-

The TCJA increases the standard deduction. It is estimated that this will result in a change from 30 percent of individuals claiming itemized deductions prior to the TCJA to only 13 percent in 2018.[1] The TCJA also removes some itemized deductions such as for interest expense on a home equity debt, miscellaneous deductions subject to the two percent of AGI limitation, and personal casualty and theft loss unless from a federal disaster. The new law limits the personal state and local tax deduction to $10,000 ($5,000 if married filing separately), but this was done more for revenue raising purposes than for simplification.

The TCJA also adds new complexities to the law including:

- IRC section 199A – the qualified business income deduction for owners of qualified trades or businesses. This is intended to provide some rate reduction parity for business owners operating out of the C corporation form, but adds numerous definitions and limitations.
- IRC section 163(j) – a new limitation on business interest of most businesses other than those with under $25 million of gross receipts.
- Various international provisions – the move to a territorial system with various backstops to prevent shifting income to tax havens, includes modifications to existing rules as well as a few new Code sections such as section 59A imposing a tax on base erosion payments, and section 951A on taxation of "global intangible low-taxed income" (GILTI).

Equity

Rating: C

[1] IRS Tax Stats at a Glance (https://www.irs.gov/statistics/soi-tax-stats-tax-stats-at-a-glance) report that for 2013, 29.6% of individuals claimed itemized deductions. The Joint Committee on Taxation estimates that for 2018, only 20.4 million taxpayers will itemize out of a total of 155.6 million filers. See JCT, *Overview of the Federal Tax System as in Effect for 2018*, JCX-3-18 (2/7/18), p. 4 (https://www.jct.gov/publications.html?func=startdown&id=5060).

Some new inequities show up in the TCJA. For example, the section 199A qualified business income deduction is not equally available to all types of businesses. For example, at certain high-income levels, some individuals in professional services, such as law and accounting, are denied the deduction although other types of businesses may claim the deduction even with similar income levels.

Cut back on some deductions, such as unreimbursed employee business expenses, treat employees different from independent contractors. Also, limitation on personal casualty losses result in treating differently, the tax treatment from, for example, a loss from a home fire, depending on whether the home is purely personal use (no deduction), rental (deduction allowed) or home office (deduction for the home office portion of the home).

Economic Growth

Rating: B-

A key driver of tax reform was to improve international competitiveness. To make the U.S. system more similar to those of other industrialized countries, the corporate rate was lowered to a flat 21 percent. In addition, for corporations, a territorial system was created, moving away from the worldwide system that few countries use today. Supporters of this approach project economic growth due to improved competitiveness for U.S. companies, as well as business expansion by U.S. and foreign businesses in the U.S. Possible changes by other countries, such as rate reductions, may limit the possible benefits.

The TCJA includes 100 percent bonus depreciation for qualified tangible business assets through 2022 (section 168(k)). Such favorable treatment is not allowed for acquired intangible assets although such assets are significant for today's businesses. In addition, after 2021, the R&D deduction is no longer allowed. Instead, R&D expenditures must be capitalized and amortized over five years (15 years for foreign R&D).

Business models have been changing including a growth in independent contractors, such as gig economy workers where such workers and service recipients and buyers are matched via a web-based platform. This new model warrants tax changes regarding information reporting, possible withholding on payments, retirement benefits and worker classification. None of these topics are part of the TCJA.

The TCJA only addressed income and estate tax changes. No changes were made to other taxes such as Social Security or gasoline excise taxes despite deficiency issues with the funds these taxes support. Should later tax increases be made to these or other taxes, tax savings and distributional effects of the TCJA would change significantly.

Permanence

Rating: C-

Due to the budget reconciliation approach to enacting tax reform, which only requires 51 votes in the Senate rather than 60, the bill cannot create deficits in the eleventh year and beyond from enactment date. Thus, almost all of the individual changes are temporary, lasting only from 2018 through 2025. In addition, the partisan approach to enactment of the TCJA might also means that change in the majority party, as well as bipartisan concerns over the deficit and debt, could result in changes to TCJA provisions. This makes long-term planning, including choice of entity considerations, difficult.

Preserving the Income Tax

Rating: B-

The Joint Committee on Taxation states: "the normal structure of the individual income tax includes the following major components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. Most other tax benefits for individual taxpayers are classified as exceptions to normal income tax law."[2]

The TCJA moves our income tax further away from the "normal structure." Personal and dependency exemptions are eliminated. A $2,000 child credit exists for children under age 17 and a $500 credit for other dependents, though. Also, elimination of all miscellaneous deductions that were subject to the two percent of AGI limitation removes deductions for unreimbursed employee business expenses and investment expenses from the tax base. Thus, the federal income tax does not follow the premise of a net income tax that expenses of generating income should be deductible or that a portion of the base reflecting family size should be exempt from tax.

Summary

The TCJA represents major reforms, particularly for corporations operating internationally. The budget reconciliation process for enactment presented many limitations that prevented the bill from fully addressing changes needed to ensure the tax system reflects today's ways of living and doing business. We'll see if additional changes will be made, perhaps after a few years of evaluating how the TCJA changes affect competitiveness of U.S. firms and budget projections.

For a list of changes included in the TCJA, in addition to the bill itself (P.L. 115-97), see the Joint Committee on Taxation list that includes cost estimates (JCX-67-17 (12/18/17)). And watch for an expected stream of much-needed guidance from the Treasury and IRS.

Exhibit – Brief History of the Tax Cuts and Jobs Act

January 2011 – Congressman Camp, chair of the House Ways and Means Committee launches the first in a series of hearings on tax reform.

February 2013 – House Ways and Means Committee forms 11 bipartisan working groups on tax reform.

Summer 2015 – Reports released of the Senate Finance Committee's five bipartisan working groups on tax reform created in January 2015.

June 2016 – House Republicans release a tax reform blueprint ("A Better Way").

April 2017 – President Trump releases a one-page tax reform plan.

[2] JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020*, JCX-3-17 (1/30/17), p. 3 (https://www.jct.gov/publications.html?func=startdown&id=4971).

September 2017 – The group of six (Speaker Paul Ryan, Congressman Brady, Senators Hatch and McConnell, Treasury Secretary Mnuchin, and White House economic adviser Cohn), release that tax reform "unified framework."

October 2017 – H.Con. Res. 17 enacted to allow up to $1.5 trillion cost for tax reform.

November 2, 2017 – H.R. 1 introduced in the House Ways and Means Committee.

November 9, 2017 – Senate Finance Committee releases proposal consisting of a summary from the Joint Committee on Taxation.

November 13, 2017 – House Ways and Means Committee passes H.R. 1, as amended.

November 14, 2017 – Senator Hatch, Chair of the Senate Finance Committee issues a mark-up to the earlier proposal.

November 16, 2017 – House passes H.R. 1 by vote of 227 to 205. Also, the Senate Finance Committee passes its version.

November 20, 2017 – Senate Finance Committee releases legislative text of what it passed earlier.

December 1, 2017 – Senate passes H.R. 1 as modified.

December 13, 2017 – Conference Committee created.

December 15, 2017 – Conference Committee bill and report released.

December 19, 2017 – House passes H.R. 1 by a vote of 227 to 203.

December 20, 2017 – Senate passes H.R. 1 by a vote of 51 to 48. The House has to revote on the bill due to amendments made to meet budget reconciliation requirements, by a vote of 224 to 201.

December 22, 2017 – President Trump signs H.R. 1 making it P.L. 115-97.

Effect of 2017 Tax Reform on Choice of Business Entity

By Steven B. Gorin*

Tax reform enacted at the end of 2017 made C corporations much more attractive from the standpoint of annual income taxes than S corporations, partnerships, or sole proprietorships (collectively, "passthroughs"). Or did it? And how about the consequences of transferring one's business by sale to third parties or through estate planning tools?

C corporations now have a flat 21% federal income tax rate. Even personal service corporations use the new low rate. This contrasts with the top federal income tax bracket of 37% for passthrough income, which may be reduced to 29.6% by way of a 20% deduction for qualified business income – if and to the extent that one's passthrough qualifies for the deduction. Partners and sole proprietors in lower income tax brackets face 15.3% self-employment tax, and those in the highest brackets may pay 3.8% self-employment tax or net investment income tax. S corporation owners who work in the business must report compensation income to the extent of the lesser of cash they receive or "reasonable compensation," and in 2017 the IRS explained to its agents how to keep taxpayers out of Tax Court when the IRS reclassifies distributions as compensation. Any amounts classified as wages are not eligible for the 20% deduction.

However, lower C corporation tax rates must be tempered by the taxation of distributions as dividends. A shareholder in the top bracket pays 23.8% federal income tax on qualified dividends, considering net investment income tax. Add state income tax, and the double taxation involved in declaring dividends each year can make C corporations unattractive.

If one lives in a state imposing 5% income tax, here is a comparison of effective annual tax burdens, considering all of the above factors:

	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship	34.6%-45.8%	27.4%-46.2%

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Although one can quibble over the assumptions used to generate the rates this chart uses, it demonstrates that a C corporation really produces superior annual income tax results only if it reinvests the lion's share of its income.

Suppose, seeing this, one says, "I don't care about taking annual distributions from the business. My goal is to build up the business by reinvesting earnings and selling it at some point." Reinvested earnings add to the basis of the one's partnership interest or S corporation stock, but they do not add to the basis of one's C corporation stock. Although that person will not incur the annual tax pain of taking distributions, he or she will feel it on the back end when selling. However, some C corporation owners will be able to avoid the gain – either by dying and getting a basis step-up or by the IRC § 1202 exclusion. Generally, the IRC § 1202 exclusion applies to stock that the corporation issued to the taxpayer (or was issued to the donor or decedent who transferred the stock to the taxpayer) if the corporation was never an S corporation and the corporations' activities were always among those approved by IRC § 1202 (which does not include professionals).

Suppose a passthrough converts to a C corporation. If the entity used the cash method of accounting for tax purposes and averages over $25 million in gross receipts, it may be required to convert to the accrual method and pick up income on its accounts receivable, unless it qualifies for an exception. Furthermore, if an S corporation converts to a C corporation, it must wait 5 years before making an S election.

An S corporation that converts might consider taking steps to preserve the ability to distribute its accumulated adjustment account (AAA) (its reinvested earnings taxed to its shareholders that can be distributed tax-free):

- Cash distributions made in the first C corporation taxable year after revoking the S election can use AAA instead of counting as dividends.

- After that first year, some AAA may be able to be used if the shareholders are the same as when the S election was revoked.

- If an S corporation converts to a C corporation, its AAA is wiped out and has to start over if it later makes an S election. Before revoking the S election, consider undergoing a Code § 368(a)(1)(F) tax-free reorganization, in which a new parent takes on the existing corporation's S status and AAA; then the existing corporation becomes a C corporation. If the old entity wants to revert to S corporation taxation, it can elect to be a qualified subchapter S subsidiary – an entity that is disregarding from its parent.

Suppose the political climate changes in Washington, D.C. the again and corporate tax rates increase. After 5 years, the C corporation could make an S election. However, the conversion may be taxable:

- Any assets with value in excess of basis that are sold within 5 years after making the S election are taxed at not only the shareholder level but also the corporate level. If the C corporation uses the cash method, any accounts receivable would get hit with this double tax, so it might want to change to accrual before making the S election. The corporation might consider selling other assets before the conversion.

- If the corporation uses LIFO inventory, recapture would be taxed.

Suppose the taxpayer decides to stay put as a passthrough. How does the new Code § 199A deduction for qualified business income (QBI) work?

It applies only to qualified income from a qualified trade or business. This has several components.

First, the business cannot be a specified service trade or business ("SSB"). An SSB is any trade or business other than (A) certain businesses that do not qualify for the IRC § 1202 exclusion from capital gain on the sale of C corporation stock, or (B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. The businesses mentioned in (A) are any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees; except that engineering, architecture are not blacklisted like the others are. The businesses mentioned in (A) are not blacklisted if the taxpayer's taxable income is below certain limits.

Second, income as an employee of the qualified business, guaranteed payments that a partner receives for services rendered to the partnership, and similar payments do not qualify. A partner who receives only a distributive share of profits benefits more than an employee-shareholder of an S corporation. Suppose, before considering the owner's compensation, a business has $300,000 of QBI, reasonable compensation would be $200,000, and distributions to the owner are at least $200,000. If the business is an S corporation, then the $200,000 wages the S corporation pays its owner will reduce the QBI from $300,000 down to $100,000. If the owner were a sole proprietor or a partner paid only though his or her share of profits, QBI would be $300,000.

Third, the deduction is the lesser of (a) 20% of QBI, or (b) the greater of (1) 50% of wages paid or (b) the sum of 25% of wages paid and 2.5% of the unadjusted basis of qualified property. The limitation in (b) does not apply if the taxpayer's taxable income is below certain limits. Also, although adding the qualified property was intended to benefit real estate, note that real activity must qualify as a trade or business. Taxpayers receiving rent through triple-net leases should consider whether their rental activity qualifies as a trade or business.

As mentioned above, having taxable income below certain levels helps one avoid certain limitations to the QBI deduction. For a married person filing jointly, taxable income (ignoring the QBI deduction) no more than $315,000 obtains the full benefits, which phase out over that level until fully phased out at $415,000. For other taxpayers, the amounts are $157,500 and $207,500, respectively.

Moving beyond the QBI deduction, any type of business can benefit from bonus depreciation, which allows most tangible personal property (equipment, etc.) to be 100% written off in the year of purchase if placed in service after September 27, 2017, and before January 1, 2023.

Businesses should also consider their debt equity structure. Suppose an owner loans to his or her business (other than a sole proprietorship). A taxpayer in the top bracket would be pay 40% federal tax (37% plus 3.8% net investment income tax) on interest income, whereas the business' federal benefit would be only 21% if a C corporation or 29.6% for a passthrough with a full 20% QBI deduction. IRC § 163(j) also may limit deductions for business interest and applies to more businesses due to 2017 tax reforms.

This article attempted to highlight some of the many issues raised by 2017 tax reform. Feel free to email the author for details supporting the statements made.

Impact of US Tax Reform on Mergers and Acquisitions: New Opportunities and Pitfalls

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On December 22, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act (TCJA), which includes numerous changes that will significantly impact mergers and acquisitions (M&A). Although the TCJA has rightly been described as the most far-reaching piece of tax legislation enacted since the Tax Reform Act of 1986, the new provisions generally serve as an overlay to existing tax law, rather than a complete rewrite of the prior Internal Revenue Code (Code).1 Particularly as it relates to M&A, the old rules largely remain. That said, the TCJA's changes will have a significant impact on deal modeling, tax diligence and acquisition agreement negotiations. This memorandum discusses the changes to the Code most relevant to M&A and their potential impact. Overall, we expect that the reduction of the U.S. corporate tax rate to 21 percent will make the United States a more attractive jurisdiction for inbound M&A activity and also may increase the value of U.S. domiciled businesses. In addition, the changes to the international tax rules should allow many U.S. companies to access the cash of their foreign subsidiaries at a lower U.S. tax cost, which could provide them with liquidity to fund acquisitions.

Reorganizations and Other Corporate Transactions. The TCJA generally does not change the tax-free reorganization rules or the rules related to other types of corporate transactions, including spin-offs, corporate liquidations and incorporation transactions. For example, the same rules that previously determined whether a particular acquisition would qualify as a tax-free reorganization, such as the relative mix of stock and cash consideration, continue to apply following the enactment of the TCJA. Similarly, the requirements for a spin-off or split-off to qualify as tax-free to both the distributing corporation and its shareholders are unchanged.

While it is possible that the new corporate income tax rate of 21 percent will reduce the corporate-level benefit of structuring a transaction to be tax-free, it should be noted that the top capital gains and qualified dividend federal income tax rate for individuals was left unchanged at 23.8 percent (including the 3.8 percent Medicare tax on net investment income). Accordingly, in situations where tax-free treatment of shareholders is an important consideration, we would expect that the motivation to structure a transaction in a manner that is tax-free will largely remain unchanged.

Reduced Value of Net Operating Losses. The TCJA changed a U.S. corporation's ability to offset taxable income with net operating losses (NOLs) arising in tax years beginning after December 31, 2017, and to carry such NOLs both forward and back to different tax years. Under pre-TCJA law and setting aside the special rules applicable to NOLs under the corporate alternative minimum tax (AMT),2 NOLs could offset 100 percent of taxable income, and unused NOLs could be carried back two years and forward 20 years. Under the TCJA, NOLs only can offset up to 80 percent of taxable income and cannot be carried back but can be carried forward indefinitely. Note, however, that NOLs arising in tax years that began on or before December 31, 2017 will continue to be available to offset 100 percent of taxable income and NOLs arising in tax years that ended on or before December 31, 2017 will remain subject to the two-year carryback and 20-year carryforward rule until their expiration. As a result, corporations with pre-TCJA NOLs may be viewed as more valuable than corporations with newer NOLs.3

100 Percent 'Bonus' Depreciation. "Bonus" depreciation (an immediate write-off of an applicable percentage of the cost of newly acquired or constructed tangible property) is a concept that has been in the Code for many years. Congress has periodically changed the applicable percentage, but the basic rules (including the types of property that qualify) have largely remained the same. The rules in effect immediately prior to the amendments by the TCJA allowed a depreciation deduction of 50 percent of the cost of qualified property for the tax year in which the property was placed in service by the taxpayer. Under prior law, only the taxpayer that originally placed the property into service (generally, the first owner) would be eligible for the bonus depreciation (the "original use" requirement).

Under the TCJA, qualified property acquired after September 27, 2017, and placed into service on or before December 31, 2022, generally will be eligible for 100 percent bonus depreciation (i.e., the purchase price for this property will be immediately deductible)4 with no "original use" requirement.5 The availability of 100 percent bonus depreciation to buyers, as well as the lower 21 percent tax rate now imposed on corporate sellers, may make asset sales or stock sales subject to a Section 338(h)(10) election more attractive.

Bonus depreciation is unavailable for goodwill and other intangible property, which remains amortizable under the straight-line method (i.e., pro rata) over 15 years.6 Accordingly, buyers generally will have an incentive to allocate as much purchase price as possible to tangible, depreciable property eligible for 100 percent bonus depreciation,7 whereas sellers will continue to have an incentive to allocate purchase price to whichever assets have the highest tax basis and therefore produce the lowest taxable gain.8 Given the potentially significant time value benefits of 100 percent bonus depreciation, it is likely that increased attention will be paid to establish a particular purchase price allocation (or at least guidelines for allocation) in asset purchase agreements in order to avoid purchase price allocation disputes after closing.

Limits on Interest Deductibility. In a sweeping change to prior law, the TCJA sharply limits the ability of businesses to deduct interest payments when calculating their taxable income, which could force a fundamental re-evaluation of the capital structure of every business that is subject to U.S. tax.

Under the new limitation, a taxpayer's allowable deduction for business interest expense in a particular tax year is limited to the sum of: (i) business interest income plus (ii) 30 percent of adjusted taxable income (which generally corresponds to earnings before interest, taxes, depreciation and amortization (EBITDA) for tax years beginning before January 1, 2022, and earnings before interest and taxes (EBIT) thereafter). Any disallowed business interest expense is carried forward indefinitely (by being treated as business interest paid or accrued in each succeeding tax year) and 100 percent of the carryforward is available in any tax year. However, such carryforwards are potentially subject to limitation under Section 382 if the corporation with such carryforwards experiences an ownership change.

We expect that the new interest deduction limitation could provide incentives for many businesses to raise capital through means other than debt, e.g., through leases, derivatives or equity issuances. It also could impact leveraged buyouts, both future deals and deals that already have closed. There is no rule that "grandfathers" existing debt incurred to fund consummated transactions or debt for pending acquisitions, even in situations where there is a binding acquisition agreement and lender commitment letter.

The New International Tax System

Dividend Exemption System. The TCJA introduced a dividend exemption system that, subject to a one-time transition tax described below and certain other limited exceptions, exempts from U.S. federal income tax dividends paid by foreign subsidiaries to their U.S. corporate parents. Under the new system, U.S. corporate shareholders that own 10 percent or more of a foreign corporation are entitled to a 100 percent dividends-received deduction for the foreign source portion of the dividends received from the foreign corporation, provided that a one-year holding period is met. Prior to the TCJA, the active business earnings of a foreign subsidiary generally were not subject to U.S. federal income tax until repatriated in the form of a dividend, at which point they would be subject to tax at the 35 percent corporate rate with a credit for any foreign taxes paid by the subsidiary on the income. The new dividend exemption system will allow U.S. corporations to access the cash on the balance sheets of their foreign subsidiaries at a significantly lower U.S. tax cost than under the previous worldwide tax system, which could provide fuel for additional acquisitions by U.S. corporations. As a practical matter, however, many U.S. corporations may find that very little of their foreign subsidiaries' income will be eligible for the 100 percent exemption due to the application of the "GILTI" tax, discussed below.

The dividend exemption system generally does not apply to sales of stock of foreign corporations, except to the extent the gain on such sales is treated as a dividend under Section 1248. Accordingly, U.S. tax advisers will still be required to provide input on how to structure efficiently sales of foreign subsidiary corporations.

U.S. corporate borrowers also should be aware that the TCJA did not include, as was widely anticipated, a repeal of Section 956 for U.S. corporations, which provides that a U.S. shareholder of a controlled foreign corporation (CFC) is treated as receiving a deemed dividend from the CFC if it provides a guarantee or pledge of the U.S. shareholder's debt, or if the U.S. shareholder pledges more than 66 2/3 percent of the stock of a first-tier CFC and provides certain negative covenants. As a result of retaining Section 956, such a "deemed" dividend from a CFC to a U.S. corporate shareholder may be subject to U.S. tax at the full 21 percent corporate rate, reduced by any available foreign tax credits, even in situations where an actual cash dividend of the same amount from the CFC would have been exempt under the dividend exemption system. Credit agreements entered into by U.S. borrowers thus will continue to need carve-outs for credit support arrangements from CFCs.

One-Time Transition Tax. Upon moving to the new dividend exemption system, the TCJA imposes a one-time mandatory transition tax on the previously untaxed deferred foreign earnings of certain foreign subsidiaries accrued since 1986 at a rate of 15.5 percent for cash and cash-equivalent profits and 8 percent on other reinvested foreign earnings.9 The tax is not imposed on the foreign subsidiary but is imposed instead on U.S. shareholders that own 10 percent or more of the foreign subsidiary on the last day of the foreign subsidiary's last tax year that began before January 1, 2018.10 The foreign subsidiaries of U.S.-parented multinationals often have a tax year that ends on November 30 or December 31 (though it is possible to have another fiscal year). U.S. shareholders that owned 10 percent or more of the stock of a foreign subsidiary with a December 31 tax year incurred the transition tax liability on December 31, 2017. With respect to a foreign corporation with a November 30 tax year, the 10 percent U.S. shareholders of that corporation will incur the transition tax liability on November 30, 2018. It is critical to note that the 10 percent U.S. shareholders on the last day of the foreign corporation's relevant tax year generally are responsible for their pro rata share, based on their percentage ownership on that date, of the transition tax liability, even if they recently purchased their shares and the deferred earnings of the foreign corporation accrued prior to their acquiring their shares.11

Taxpayers may elect to pay the transition tax over eight annual installments (without interest). Going forward, it is crucial that acquirers of both U.S. and foreign companies analyze and quantify the potential transition tax exposure as part of their standard list of tax structuring and diligence. Anyone acquiring U.S. corporations with foreign subsidiaries should be mindful of the target's potentially significant deferred U.S. tax liability, which may be accelerated in connection with post-acquisition integration transactions.

Acquisitions of foreign corporations by U.S. acquirers will require particularly careful attention for the remainder of 2018. If the foreign target has a November 30 tax year or if a U.S. target has significant foreign subsidiaries with a November 30 tax year , then, as previously discussed, the U.S. owner of the foreign corporation's shares on November 30, 2018, will be responsible for 100 percent of the transition tax, regardless of how recently it acquired the shares. U.S. acquirers that enter into acquisition agreements in 2018 should take into account the possibility of this tax exposure in the event their acquisition closes on or before November 30, 2018, because they would own the foreign target on the date the transition tax is incurred. This could be addressed in a few ways, including through an up-front purchase price reduction or a tax indemnity that allocates the economic responsibility for the transition tax to the target's shareholder(s).

In the case of an S corporation with foreign corporate subsidiaries, each of the S corporation's shareholders may elect to defer payment indefinitely until the occurrence of certain triggering events, at which point the S corporation's shareholders generally can elect to pay the tax over eight annual installments (without interest). Triggering events include the termination of S corporation status, the liquidation or sale of substantially all of the assets of the S corporation, the S corporation ceasing to exist or a transfer of any share of stock in the S corporation by the taxpayer (including upon death). Although the transition tax liability is imposed on the shareholders of the S corporation, the S corporation itself is jointly and severally liable for any transition tax liability for which a deferral election is made. Accordingly, an acquirer of such an S corporation could be forced to bear the selling shareholders' transition tax liability absent adequate contractual protection. In addition, the acceleration of the transition tax liability will create a disincentive for S corporation shareholders to sell unless they are compensated for the cost.

GILTI. The new "global intangible low-tax income" (GILTI) tax has been advertised as a global minimum tax on the income of CFCs derived from their use of intangibles, which, like the transition tax, is imposed on the 10 percent or greater U.S. shareholder(s) of the CFC and not the foreign corporation itself. In reality, the GILTI tax is significantly broader and is not limited to income derived from the use of intangible assets. Instead, a CFC's total net income, regardless of whether attributable to intangible or tangible property, over a 10 percent "routine" return on the CFCs' aggregate tax basis in its tangible, depreciable property, is subject to the GILTI tax. U.S. corporations are entitled to a deduction against their GILTI that is intended to result in their paying tax on this income at an effective rate of 10.5 percent for tax years prior to 2025 and 13.125 percent for tax years after 2025, and reduced by 80 percent of their foreign tax credits. Accordingly, any CFC with a low tax basis in its tangible, depreciable assets could attract a GILTI tax, regardless of whether the CFC's business utilizes intangible assets. In practice, this could mean that very little of the foreign earnings of many CFCs are eligible for the 100 percent dividend exemption because the earnings will instead be subject to the GILTI tax.12 For these CFCs, the GILTI tax, in effect, will result in an end to the deferral of U.S. tax on much of their foreign business income. Because a CFC's tax basis in its tangible, depreciable assets provides a "cushion" against the GILTI tax, offshore acquisitions treated as asset acquistions for U.S. tax purposes may become increasingly attractive to U.S. parented groups relative to stock acquisitions. Prospective U.S.

acquirers of foreign corporations holding meaningful tangible, depreciable property will want to consider structuring the acquisition as an asset purchase or stock purchase with a Section 338(g) election.

'Inverter' Penalties. A recurring theme of the TCJA is that so-called “inversions” (i.e., acquisitions by foreign corporations of U.S. corporations in which, following the acquisition, the former shareholders of the U.S. corporation own, or are treated as owning, at least 60 percent and less than 80 percent of the stock of the foreign acquiring corporation) are strongly discouraged, particularly for the next 10 years.

First, individual shareholders of foreign acquiring corporations that first complete an inversion after the enactment of the TCJA are permanently ineligible for the qualified dividend income rate of 23.8 percent (including the 3.8 percent Medicare tax on net investment income) on dividends received from such foreign corporation, which instead would be taxed at ordinary rates (currently, 40.8 percent taking into account the maximum 37 percent federal rate applicable through 2025, at which point it returns to 39.6 percent, and the 3.8 percent Medicare tax on net investment income).

Second, if the transition tax applies to a U.S. corporation that participates in an inversion within 10 years following the enactment of the TCJA, then the U.S. corporation's transition tax is recomputed at a 35 percent tax rate (the maximum marginal corporate income tax rate in effect prior to the enactment of the TCJA) and the U.S. corporation must pay as part of its income tax liability for the year it participates in the inversion transaction the difference between the recomputed transition tax at the 35 percent rate and the amount of transition tax it originally paid at the reduced 8 percent and 15.5 percent rates.

Finally, new rules apply under Subpart F that make it more difficult to engage in post-inversion tax planning (even with respect to U.S. corporations that inverted prior to the enactment of the TCJA), and certain disadvantageous rules apply to corporations that complete a tax inversion after November 9, 2017, under the new Base Erosion & Anti-Abuse Tax (BEAT), which is an alternative tax intended to mitigate erosion of the U.S. tax base by corporations that make deductible payments to related non-U.S. parties. The BEAT is the amount by which a U.S. corporation’s income tax liability, computed without taking into account certain deductible “base eroding” payments and using a 10 percent rate, exceeds the U.S. corporation’s regular income tax liability.

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1 All section references are to the Code.

2 The corporate AMT was repealed under the TCJA effective for tax years beginning after December 31, 2017.

3 It should be noted that Section 382, the complex provision that limits a loss corporation’s ability following a greater than 50 percent ownership change to offset post-change income with pre-change losses, survived the TCJA unchanged.

4 The bonus depreciation will be phased out 20 percentage points a year over five years beginning in 2023.

5 To be eligible for 100 percent bonus depreciation, the property generally must be acquired from an unrelated party by purchase.

6 As under prior law, qualified property continues to include: (i) tangible property that has a recovery period of 20 years or less, (ii) certain computer software and (iii) water utility property. Under the TCJA, qualified property now also includes certain qualified film, television and live theatrical productions.

7 There may be circumstances where 100 percent bonus depreciation would not be advantageous for a buyer. For example, if the immediate purchase price deduction put the buyer into a significant NOL position, the use of that NOL in future years would be subject to the 80 percent limitation previously described.

8 Non-corporate taxpayers and taxpayers with expiring capital losses should consider the consequences of depreciation recapture, which would treat gain as ordinary income to the extent of prior depreciation deductions.

9 For U.S. C corporations, the transition tax also can be reduced by the full amount of any pre-existing foreign tax credit carryforwards from prior tax years and by 80 percent of the foreign tax credits made available by the transition tax income inclusion.

10 S corporations, U.S. partners in U.S. partnerships and U.S. individuals who own 10 percent or more of a foreign corporation also are subject to the transition tax if the foreign corporation is a CFC or there is at least one U.S. C corporation that also is a 10 percent shareholder of the foreign corporation.

11 The earnings of the foreign corporation that accrued during periods when the foreign corporation was not a CFC and did not have a 10 percent or greater U.S. corporation as a shareholder are not subject to the transition tax. As a practical matter, it may be very difficult to track the precise ownership of a foreign corporation since 1986. In addition, a U.S. shareholder's transition tax liability is reduced by dividends paid by the foreign subsidiary during the foreign subsidiary's relevant tax year to other shareholders not subject to the transition tax.

12 Additionally, U.S. taxpayers are required to allocate their interest expense between their U.S. and foreign source income. Any interest expense allocated against GILTI could limit a U.S. corporation's ability to use foreign tax credits against this income.

Tax Reform Advisory: International Provisions by Abraham Leitner

On December 22, 2017, the President signed into law H.R. 1, informally known as the **"Tax Cuts and Jobs Act" (the "Act")**, implementing sweeping changes to the United States tax regimes generally applicable to businesses. Most provisions of the **Act will take effect as of January 1, 2018** and (except as noted below) generally will apply to tax years beginning after 2017. Certain highlights of the Act are discussed below.

Territorial Regime for Foreign Subsidiary Business Profits

New Dividends Received Deduction. The Act moves the United States to a so-called territorial system of international taxation, under which no US federal income tax is imposed on the operations of foreign corporate subsidiaries even when the profits are repatriated back to the United States in the form of dividends. But rather than simply excluding such dividends from gross income, the Act creates a new 100% dividends received deduction, contained in a new Code section 245A, for dividends received by a domestic corporation from a foreign subsidiary that is at least 10% owned by the domestic corporation. The deduction is not available to individuals or S corporations. As would be expected, no foreign tax credit is available for foreign taxes incurred with respect to any dividend that is eligible for the dividends received deduction. Moreover, the deduction-eligible dividends do not count as foreign source income for purposes of calculating the taxpayer's overall foreign tax credit limitation under section 904. A minimum one-year holding period is required to claim the deduction. The deduction does not apply to subpart F income. In addition, the deduction is not available to dividends received from a passive foreign investment company (PFIC).

Hybrid Dividend Exception. If a dividend is deductible by the foreign corporation paying the dividend (e.g., it is a hybrid dividend characterized as an interest payment for foreign tax purposes), then the dividend is not eligible for the dividends received deduction. If such a hybrid dividend is paid to a CFC by a lower-tier subsidiary, then it is treated as subpart F income and currently includible by the CFC's shareholders. In addition, no foreign tax credit is allowed for taxes incurred with respect to a hybrid dividend.

Transition Rule for Existing E&P. To transition existing offshore earnings into the new territorial regime, Section 965 is amended to provide for a mandatory immediate inclusion of all accumulated earnings and profits (E&P) of a "specified foreign corporation" into gross income. A specified foreign corporation includes for this purpose any CFC (regardless of whether its US shareholders are corporations or individuals) or any other foreign corporation (except for a PFIC) with respect to which a domestic corporation is a US shareholder. Such earnings and profits are required to be included in the income of US shareholders of the CFC by treating the earnings as subpart F income deemed to have been earned by the CFC in its last taxable year beginning before 2018 (i.e., 2017 for a calendar year CFC). A taxpayer who is a US shareholder of multiple CFCs one or more of which has an E&P deficit is permitted to reduce the section 965 inclusion by their pro rata share of such deficits. The amounts included by the US shareholder under section 965 are not includible in income as dividends a second time when they are distributed. A special dividends received deduction (not limited to domestic corporations) is allowed to the US shareholder who includes an amount under section 965. The amount of the deduction varies depending on whether the E&P of the relevant CFC is invested in a "cash position" (defined to include portfolio investments) or in business assets. In the case of a cash position, the deduction is an amount that would result in the section 965 inclusion being subject to an effective tax rate of 15.5% (determined by applying a hypothetical 35% tax rate to the net income after the allowable deduction). In the case of business assets, the deduction is an amount that would result in an effective tax rate of 8%, computed in a similar manner.

Foreign tax credits with respect to a section 965 inclusion are reduced by a percentage corresponding to the percentage of the dividends received deduction applicable to the inclusion (55.7% for cash position inclusions and 77.1% for other inclusions). It appears that this limitation on foreign tax credits may not apply to withholding tax paid with respect to a distribution of amounts previously included under section 965.

A number of special elections are available to US shareholders subject to a section 965 inclusion. A US shareholder is permitted to elect to pay the resulting tax liability on the section 965 inclusion in eight annual installments (8% in each of the first five years, 15% in the sixth year, 20% in the seventh year, and the remaining 25% in the eighth year. In the case of a REIT (which is subject distribution to requirements), an election is permitted to defer the section 965 inclusion (instead of the tax) over the same period. In the case of a subchapter S corporation, the shareholders of the corporation may elect to defer the tax on the section 965 inclusion indefinitely until the occurrence of one of the following triggering events: (1) the termination of the corporation's subchapter S election; (2) the liquidation or sale of substantially all of the assets of the corporation; or (3) a transfer of the corporation's stock by the shareholder. Significantly, a distribution of the income on which the tax was deferred appears not to be a triggering event. Upon the occurrence of a triggering event, the affected shareholder may then make the eight-year deferral election to pay the tax. **Individual shareholders may wish to consider transferring their stock in specified foreign corporations to a subchapter S corporation before the end of the year to benefit from this election.** Finally, a US shareholder who has NOL carryovers available may elect not to use the NOLs to offset the section 965 inclusion and to preserve the NOLs for use against future income (on which the tax would not have been eligible for the eight-year deferral election).

Repeal of Indirect Foreign Tax Credit. The section 902 indirect foreign tax credit (for dividends from foreign subsidiaries, which dividends are now exempt from tax) is repealed. However, the section 960 foreign tax credit for subpart F income inclusions (which remain taxable) and distributions of previously taxed subpart F income remains in place. There is a new separate limitation for foreign branch income (that is, income attributable to a foreign qualified business unit of the taxpayer) which will prevent foreign taxes imposed on a QBU from offsetting non-branch income.

CFC Changes

Expansion of CFC and US Shareholder Status. The ownership attribution rules relevant for determining whether a corporation is a controlled foreign corporation or whether a shareholder is a 10% "US shareholder" are expanded to treat a US entity as owning stock owned by an owner of the entity. This change is a very significant one, and will result in many foreign corporations becoming CFCs. A common example is a situation where a US individual owns a minority (but greater than 10% interest) in a foreign corporation and the balance of the shares are owned by a foreign parent of the individual. The ownership attribution rules do not attribute stock owned by a nonresident alien individual to a US family member. However, under the new rule, if the foreign parent owns an unrelated domestic corporation, then the parent's shares are attributed to that corporation and cause the foreign corporation to become a CFC. Surprisingly, this rule is effective retroactively for the last taxable year of the foreign corporation that begins before January 1, 2018 (e.g., for calendar year taxpayer, calendar year 2017) and any taxable year of a shareholder that ends during such year.

Another significant expansion to the definition of a US shareholder is the inclusion of a 10% shareholder by value rather than merely voting power (as was the case until now). However, the news is not all bad. Historically, being classified as a US shareholder under section 958 was generally something to be avoided, but for a domestic corporation under the new participation exemption regime, being a US shareholder entitles the taxpayer to the dividends received deduction. Unlike the preceding rule, this rule is effective only for taxable years of a CFC beginning on or after December 31, 2018.

For individual US shareholders of a CFC, there is no 50% deduction available and no foreign tax credit is allowed. As a result, the GILTI tax rate is the ordinary income tax rate, or 37%. Notwithstanding the “intangible” moniker, GILTI can include income from manufacturing, sales and services activities where the CFC does not have a sufficient amount of tangible depreciable property or does not have sufficient basis (or remaining basis) in that property. For many CFCs with individual shareholders, the GILTI tax will apply to virtually all of the CFCs’ active business income, effectively ending future income deferral. Direct ownership of foreign corporations by US individuals may become a thing of the past, as such shareholders will in most cases be better off holding their CFC shares through a domestic corporation.

Elimination of the 30-Day Rule. The Act eliminates the 30-day rule in section 951(a) which currently protects shareholders from subpart F inclusions if the corporation was a CFC for an uninterrupted period of less than 30 days. This exception, often used by cross-border estate planners, provided taxpayers with a very useful planning technique in which a CFC with appreciated property could be liquidated within the first 29 days of the year (or sometimes within 29 days following the death of a foreign shareholder from whom a US beneficiary inherited the shares of the CFC) without triggering subpart F income. This provision applies to taxable years of a foreign corporation beginning after December 31, 2017, and to taxable years of a US shareholder with or within which such taxable year of the corporation ends.

New Tax on Low-Taxed Income of CFCs. The Act adds a new tax on "global intangible low-taxed income" (GILTI). The GILTI tax operates in a manner similar to subpart F requiring US shareholders of a CFC with GILTI income to include their proportionate shares of such income on a current basis. GILTI income is any low-taxed income of a CFC (that would not otherwise be subpart F income) that exceeds a 10% annual return on the amount of capital (i.e., the average quarterly adjusted tax basis) the corporation has invested into tangible depreciable property used in a trade or business. The GILTI tax has a unique feature that differentiates it from the rest of subpart F. Namely, a US shareholder's GILTI inclusion is determined at the shareholder level by aggregating the shareholder's proportionate share of the income in all of the shareholder's CFCs. This fiendishly complicated rule is actually taxpayer favorable, as it allows potential GILTI from a highly profitable CFC to be offset by losses from another CFC and to be blended with income from other CFCs with less profits or a higher cost of capital in their tangible assets.

The GILTI inclusion of a US shareholder that is a domestic corporation is accompanied by a deduction [contained in new Code section 250] that is equal to 50% of the amount of the inclusion. Given the new corporate tax rate under the Act of 21%, this results in the GILTI being subject to an effective tax rate of 10.5%. In addition, a shareholder that is subject to a GILTI inclusion is allowed a foreign tax credit under section 960 for 80% of the foreign tax paid by the shareholder's CFCs that is determined to be allocable to the GILTI income (even though only 50% of the GILTI is effectively taxable in the US). The effect of the modified foreign tax credit is that a foreign tax rate of 13.125% is sufficient to entirely eliminate the US corporate tax on the GILTI. Hence, the inclusion of the "low-taxed" moniker in the GILTI acronym. As the foreign tax credit declines below 13.125%, the US tax increases from zero to a maximum of 10.5% if no foreign tax is paid at all.

Export Incentives

Section 199 Repeal. The Act repeals the section 199 deduction for domestic production activities.

New Deduction for Foreign Derived Income of Domestic Corporations. The Act add a new deduction equal to 37.5% of a domestic corporation's foreign derived intangible income (FDII) which effectively reduces the tax rate on such income to 13.125%. Broadly speaking, FDII is income from the sale, lease or license of property to foreign purchasers for use outside the United States or from services provided to persons located outside the United States. However, FDII does not include any income derived through a CFC or through a foreign branch of the taxpayer. Thus, this provision effectively replaces the repealed section 199 deduction for domestic production activities. FDII is reduced by a 10% annual return deemed to be attributable to the taxpayer's capital invested in tangible property and calculated in a manner similar to the tangible property return taken into account for GILTI inclusions from a CFC, described above.

Pass-thru Deduction. The new 20% deduction for qualified business income from pass-thru entities is not available for income from a trade or business that is not conducted in the United States.

Rules Targeting Base Erosion

Base Erosion Minimum Tax. The Act imposes a new base erosion minimum tax (BEAT) of 10% (5% for 2018) on the modified taxable income of an applicable taxpayer which is calculated by adding back to the taxpayers income any deductions for payments made to related foreign parties and any depreciation claimed for assets purchased from such persons (as well as NOL carryovers attributable to such payments made in prior years). Applicable taxpayers to whom the BEAT applies are domestic corporations (other than RICs, REITs or S corporations) the average annual gross receipts of which for the preceding taxable years are at least $500 million and whose base erosion payments would otherwise result in a 3% (2% in the case of a bank or registered securities dealer) reduction in taxable income. The BEAT does not apply to the extent the payment to the related foreign person is effectively connected to a US trade or business of the foreign person or is subject to US withholding tax. The BEAT tax rate will increase to 12.5% after 2025. The BEAT tax rate on a bank or registered securities dealer is 1% higher than it is for other taxpayers.

Hybrid Payments. The Act provides for the disallowance of any deduction for hybrid payments made to a foreign related party where, due to a difference in the tax characterization of the payment (e.g., as an interest or a dividend payment) or the entity making or receiving the payment (e.g., where the paying or receiving entity is a hybrid entity) the recipient is not subject to tax on the payment in its country of residence or is entitled to an offsetting deduction with respect to the payment. This disallowance rule targets "double dips" and similar structures involving, for example, repos or Canadian “tower” financing structures.

Outbound Transfers. The Act repeals the foreign active trade or business exception to the gain recognition rule for outbound transfers to a foreign corporation under Code section 367(a). The Act codifies the authority of the Treasury Department (which has been the subject of much controversy) to more expansively tax outbound transfers of foreign goodwill and going concern value and to value intangible property transfers for purposes of section 367 and 482 on an aggregation basis and by considering the realistic alternatives to the transfer.

Partnership Aggregate Treatment

The Act reverses the result in the recent pro-taxpayer Tax Court case, Grecian Magnesite Mining v. Comm’r (and codifies the controversial position taken by the IRS in Revenue Ruling 91-32), and treats gain or loss recognized by a foreign partner on a sale of an interest in a partnership that is engaged in a US trade or business as effectively connected to the US trade or business and thus as taxable. There is also a new withholding tax requirement that requires the buyer of a partnership interest to withhold 10% of the amount realized unless the seller provides an affidavit that the seller is not a foreign person. If the buyer fails to withhold, then the withholding obligation shifts to the partnership itself. Until regulations are issued, the withholding tax apparently applies even to non-recognition transactions. The new rule does not apply to the extent the underlying assets of the partnership consist of US real property the gain on which is taxable under FIRPTA. The new characterization rule is effective for transfers occurring on or after November 27, 2017. The withholding tax on such transfers is effective for transfers after December 31, 2017.

PFICs

The Act would tighten the PFIC insurance company exception to limit the availability of the exception to entities that would be taxed as in insurance company if they were US corporations and whose applicable insurance liabilities exceed 25% of the foreign corporation's total assets. Elective relief is provided in certain cases where the foregoing percentage is below 25%, but over 10%, and the shortfall is due to run-off related circumstances (resulting from the winding down of the business) or ratings related circumstances (e.g., where required by a regulator as a condition of obtaining a rating to write new insurance business for the current year) involving the company's insurance business.

For updates to this advisory and to read our additional advisories on the corporate and general business or the real estate provisions of the Act, please visit: https://www.goulstonstorrs.com/NewsEvents/Advisories.

THE IMPACT OF TAX REFORM ON EMPLOYERS

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In the wake of the passage of the Tax Cuts and Jobs Act of 2017 (the "Act"), taxpayers and advisors have been evaluating its impact on their businesses. While one can debate whether the Act constitutes real, policy-based tax reform, it does generally reduce corporate and business tax rates, but it also eliminates some previously available tax deductions and credits. Thus, some classifications of income can no longer be offset by expenses that were historically deductible. Interpretive guidance is sparse and comes primarily from the Joint Explanatory Statement of the Conference Committee (the "Joint Committee Report"). Following is a summary of how the Act impacts a company that employs and manages a workforce.

Changes in Deductions and Exclusions:

Health Insurance: The Act has repealed the individual requirements of the "shared responsibility" provisions under the Affordable Care Act. Both prior to and under the Act, employers were and are required to provide health insurance coverage to 95 % of their employees that (i) is affordable (costing no more than 9.5% of an employee's income) and (ii) meets minimum coverage standards. Prior law required individuals to maintain personal coverage, whether through an employer or otherwise, and to pay a penalty for failing to comply. The Act eliminates this individual mandate. This is not likely to affect the majority of the workforce as most people still acquire health insurance through their employers. However, if too many employees elect not to be covered, the lack of an individual mandate could present employers with challenges in acquiring and maintaining compliant group plans. In addition, while the employer obligation is to *offer* minimum affordable coverage, allowing employees to "opt-out" of coverage can affect the determination of whether a plan meets affordability requirements. Where an employer makes payments to employees who chose to forgo coverage under the employer's plan, these "opt-out" payments can be conditioned on the employee taking other coverage, or can be unconditional. With the repeal of the individual mandate for insurance, some employees may choose to take the "opt-out" payment but not purchase alternative coverage. At least in that case, the employer will have to consider the "opt-out" payment in determining whether or not its offered coverage meets the affordability standards. (See IRS Notice 2015-87). If enforced or finalized, proposed regulations under the affordable care act would be even more expansive.

Unreimbursed Business Expenses of Employees: Employees no longer have the ability to deduct moving expenses under section 217 of the Internal Revenue Code (the "Code"). The Act also eliminates a prior exclusion for moving expense reimbursements under section 132 of the Code. Thus, if an employer does not reimburse those expenses, the added tax cost to employees of losing the moving expense deduction could affect the employer's competitiveness in the job market. Even if an employer does offer a partial or complete reimbursement of moving expenses, the tax cost to a new employee will increase because the reimbursement will be taxable income without an offsetting deduction. A similar problem results from the repeal of an individual's ability to deduct miscellaneous itemized deductions. As a result, employers will find themselves under more pressure to provide reimbursement that employees cannot deduct. This in turn can diminish already tight profit margins.

Business Entertainment: The Act repeals an employer's deduction under Code section 274 with respect to entertainment, amusement, or recreation expenses that were directly related to or associated with the active conduct of the employer's trade or business. This change clearly prevents employers from deducting the cost of tickets to sporting events or other entertainment-related expenses, which includes club dues. However, certain expenses remain at least partially deductible such as meal facilities and certain employee meal expenses. The Joint Committee Report provides that, "Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel). This language hardly clarifies matters. For example, whether or not normal business meals involving employees remain deductible is ambiguous and is a matter of debate between experts. The Code as revised retains at least partial deductibility for food and beverages provided for employees on the employer's premises, expenses for social activities for the benefit of employees who are not highly compensated, and expenses directly related to business meetings. Regulatory guidance is expected to clarify these issues. Also, under the Act, employers cannot deduct transportation-related fringe benefits provided to employees. In the case of tax-exempt entities, such disallowed expenses are added to unrelated business taxable income. The likely result of these changes is that employers will spend less on customer entertainment and fringe benefits than employees have enjoyed in the past.

Social Engineering Through Tax Reform.

Employment-Related Litigation: Employers have generally been permitted to deduct the costs associated with resolving employment-related disputes. Perhaps in response to the renewed focus on sexual harassment and assault in the workplace, the Act now denies a deduction to an employer for any settlement payment or attorneys' fees related to the settlement if the settlement is subject to a non-disclosure agreement. Non-disclosure clauses have been a standard part of most employment dispute settlements, and their elimination could become a significant factor in an employer's decision to settle. In the past, such settlements were reached largely based on litigation risk. Now, employers may be reluctant to pay significant sums only to risk having misinformation concerning the dispute disseminated by the other party. Employers will now have to add the cost of the lost deductions to the other costs of settlement when determining whether the expense of a confidential settlement is preferable to the risks of litigation.

Paid Medical Leave: Currently, employers with 50 or more employees are required to provide to employees up to 12 weeks per year of unpaid family and medical leave. In an effort to encourage employers to provide paid leave, new Code section 45S provides a new tax credit for employers who pay employees who are on family or medical leave. Employers must have a written policy pursuant to which they provide paid leave, and must pay for leave at a rate that is at least 50% of the rate at which they normally compensate the employee. The credit is equal to 12.5 percent of a qualifying employees wages, increased (but not above 25 per-cent) by 0.25 percentage points for each percentage point by which the rate of payment for leave time exceeds 50 percent. Leave that is paid by reason of a state or local law mandate is not eligible for the credit.

Compensation-Related Tax Changes.

Changes in Executive Compensation: Supplemental taxation of amounts designated as excessive compensation has long been a part of our tax structure. In particular, prior to the Act, the Code denied a deduction to a public company paying either (i) guaranteed base compensation of specified highly compensated employees of public companies in excess of one million dollars and (ii) compensation received by executives of public companies because of a change in control of the company that exceeded three time the average of the executive's 5 prior years compensation. In addition, excessive compensation received due to a change in control could also be subject to an excise tax. The Act has retained the rules described above, has broadened the categories of public company executives subject to them, and added Code section 164(m)(4) making performance-based compensation subject to the one million dollar deductible limit. In addition, the Act also adds new Code section 4960, which extends one million dollar limit and the "golden parachute" restrictions on compensation related to a change of control, to highly compensated employees of applicable tax-exempt entities by imposing an excise tax on the excess compensation.

Non-qualified Deferred Compensation: Generally, compensation is taxable to an employee and deductible by an employer when it is both paid and not subject to a substantial risk of forfeiture. Section 83(b) of the code allows employees to accelerate the taxation of any property they receive as compensation in order to minimize the tax consequences of the compensation by including it in income when received, before the property appreciates in value. The timing of the employer's deduction coincides with the time the employee includes the compensation in his or her income. The challenge with making an election to accelerate income under section 83(b) of the Code is that while the tax cost is likely less expensive, the non-cash compensation cannot be used to pay the associated income and payroll tax costs that become due immediately because of the election. As a result, both employees and employers have to cover these tax costs out of their own pockets.

For privately held companies, the Act has added an additional option. New section 83(i) of the Code allows employees who are covered by a written plan that benefits at least 80% of the employer's workforce to defer the calculation and payment of tax for up to 5 years following the lapse of the substantial risk of forfeiture. The deferral ends upon the earlier of the stock received becoming tradeable on a public exchange or otherwise transferrable, the electing employee becoming ineligible to make, or revoking, the election, or the date that is 5 years after the lapse of the risk of. Tax is determined and payable at the time deferral ends. An employee making an election under Code section 83(i) may not make an election under Code section 83(b). Similarly, an option subject to Section 83(i) cannot be an incentive stock option under section 422 of the code. Employers can be penalized for failing to notify employees of a transfer of stock that qualifies for the election under Code section 83(i).

Conclusion.

The current iteration of tax reform is somewhat of a hodgepodge. The primary objective was lowering corporate tax rates, and the Act accomplishes that. It also provides a deduction for pass-through entities that is measured, in part by wages paid. Thus, more employees can equate to increased tax benefits. However, only time will tell whether the rate decrease is worth the trade-offs. For employers, the increased operational costs could be higher because they can provide less in benefits to employees as some employer deductions have been limited, they may be subject to increased excise taxes, and they now have fewer options when resolving employment disputes.

Dramatic Change to Federal Estate, Gift and Generation-Skipping Tax Exemptions

by Seth D. Slotkin, Timothy P. Tehan and Elizabeth E. Harris*

February 8, 2018

Individuals Have New, Exciting Opportunity to Make Large Gifts to Benefit Their Families and Reduce Estate Tax

The Tax Cuts and Jobs Act (the "Act"), which took effect on January 1, 2018, is the most comprehensive update to the Internal Revenue Code in decades. In addition to making sweeping changes to the federal income tax laws (addressed in this Akin Gump alert), the Act makes significant, albeit temporary, changes to the federal estate, gift and generation-skipping transfer (GST) tax laws.

Federal Estate, Gift and GST Tax Exemption Amounts Double

Under the Act, each individual's exemptions from federal estate, gift and GST taxes have roughly doubled, from $5,490,000 ($10,980,000 for a married couple) in 2017 to approximately $11,200,000 ($22,400,000 for a married couple) in 2018. The exemptions are scheduled to further increase with inflation for each year through 2025.

Absent further changes to the tax law, the increased exemptions are available only temporarily, through 2025. On January 1, 2026, the exemptions are scheduled to revert to 2017 levels, indexed for inflation. (Some practitioners have asked whether lifetime gifts in the amount of the increased exemptions made prior to 2026 will be subject to tax if the exemptions are subsequently reduced. While this seems unlikely, it remains an open question.)

Wealthy individuals can take advantage of the increased exemption currently by making lifetime gifts to their children and more remote descendants (or other family and friends), or to trusts for their benefit. Selecting the optimal property to transfer is critically important. Factors, such as whether valuation discounts can be taken, the prospects for appreciation in the property and the income tax basis in the property, should all be considered. Techniques, such as gifts and sales to intentionally defective grantor trusts, as well as grantor-retained annuity trusts, which preserve the use of the valuable gift and estate tax exemptions, remain viable. Forgiving family indebtedness may also be attractive in light of the increased exemption amounts.

Impact on Individuals and Families

The increased federal estate, gift and GST tax exemptions will have an important impact on many individuals and families:

- In light of the dramatic increase in the estate and GST tax exemptions, we strongly recommend that you review the terms of your existing estate plan to ensure that the provisions in your documents are still in line with your current wishes. For instance, your will, lifetime trusts or even beneficiary designations may provide for disposition of an amount based on the estate or GST tax exemption in effect at your death, and you may wish to consider whether such a provision would result in "overfunding" the disposition in the event of death prior to 2026. In some cases, it may be possible to simplify your plan as a result of the increased exemption. In all cases, flexibility should be built into your estate-planning documents to anticipate both the expiration and the extension of the federal tax law changes, as well as the possible enactment of related state tax law changes.

- As a result of the increased exemptions, fewer estates will be subject to federal estate tax, at least until 2025. Income tax planning—specifically, planning to ensure that appreciated assets will benefit from having income tax basis stepped up to fair market value at death—will likely become the highest priority for individuals with nontaxable estates. If this is your situation, you may wish to review, and possibly unwind, certain estate-planning transactions that you have undertaken in the past.

- As discussed above, given the temporary increase in the gift and GST tax exemptions, you now have a window of opportunity to make large, tax-free gifts to your children and more remote descendants (or other family and friends), or to trusts for their benefit.

Tax Rates Unchanged and Step-Up in Basis on Death Preserved

The highest marginal federal estate and gift tax rates remain unchanged at 40 percent, and the GST tax rate remains unchanged at a flat 40 percent. The new law also preserves the step-up in income tax basis for assets owned at death.

Gift Tax Annual Exclusion Increases

In addition to the higher lifetime exemptions, the amount that can be given tax-free pursuant to the so-called "annual exclusion" has increased from $14,000 in 2017 to $15,000 in 2018 as a result of inflation adjustments. In other words, individuals can now give $15,000 per year, and married couples can give $30,000 per year, to all of their children and grandchildren or anyone else without using any part of their valuable gift tax exemption.

State Tax Law

In reviewing your existing estate plan and evaluating gifting options, you should bear in mind any applicable state estate and gift tax laws. As an example, for a New York resident, the state estate tax exemption is currently $5,250,000 and is scheduled to increase in 2019, but only to the pre-Act federal exemption amount. The benefit of the New York estate tax exemption phases out abruptly once the value of the taxable estate exceeds the amount of the exemption. As a result of this estate tax "cliff," the entire taxable estate is subject to New York estate tax at graduated rates up to a maximum of 16 percent. Since the federal estate tax exemption is now much higher than the New York exemption, many New York estates that are not subject to federal estate tax will be subject to substantial New York estate tax. Steps that can be taken to minimize this result may include lifetime gifting (New York imposes no gift or GST tax) to reduce the taxable estate. Impending changes in state tax laws should certainly be monitored.

Conclusion

This is a high-level summary of the federal estate, gift and GST tax changes brought about by the new law. Individual circumstances will determine what kind of planning is warranted as a result of these changes. We encourage you to contact us to discuss how these changes impact your estate planning.

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How the New Tax Law Impacts Hollywood: Lights, Camera, Accelerated Deduction![1]

Shane Nix, Esq.

Costs for film and television productions generally are required to be capitalized and added to the tax basis of the resulting copyright. Absent a provision allowing for accelerated cost recovery, the tax basis of a copyright generally must be depreciated and recovered over a ten-year period, using the "income forecast method," which is intended to match the depreciation expense with the projected income from the film or television production. Generally, film and television productions produced overseas or productions otherwise not eligible for accelerated cost recovery will be recovered using the income forecast method. Historically, however, production costs for domestic productions have been eligible for deduction immediately as and when incurred, where a certain tax election was made (a "***Section 181 Election***"). The purpose of the Section 181 Election generally is to incentivize production companies to produce film and television productions in the United States. For a number of years, Section 181 was renewed retroactively as part of Congress's extenders package, which meant that production companies faced uncertainty during the year because they did not know whether the Section 181 Election would be available. Most recently, Congress extended the availability of the Section 181 Election retroactively through 2017 when Congress passed an extenders package on February 9, 2018.[2] So much for incentivizing U.S. production prospectively!

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law; this is now referred to as "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution of the Budget for the Fiscal Year 2018" (the "***Act***").[3] Prior to the Act, certain qualified property was eligible for "bonus depreciation," which allowed taxpayers to depreciate such qualified property on a more accelerated basis than the applicable default method for such property. The Act expanded "qualified property" eligible for bonus depreciation to include qualified (domestic) film and television productions and qualified (domestic) live theatrical performances. The bonus depreciation rules effectively replace Section 181 going forward for qualified U.S. film, television, and live theatrical productions. The important distinctions between Section 181 and bonus depreciation are noted below.

1. Qualified Film/Television and Live Theatrical Performances

Generally, a qualified film or television production[4] is any such production where 75 percent of the total compensation (excluding participations and residuals) is for services in connection with the production which were performed in the U.S. by actors, production personnel, directors, and producers

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[1] Portions of this article are reprinted with the permission of Juris Publishing, Inc., Huntington, New York, www.jurispub.com, from the following publication written by Shane Nix, A Guide to Structuring and Taxation in the Entertainment Industry, in *The Essential Guide to Entertainment Law: Dealmaking*, pp. 663-744 (Jay Shanker and Kirk Schroder, eds.). © 2018 Juris Publishing. More on this publication can be found at www.eg2el.com.

[2] The Bipartisan Budget Act of 2018, Pub. L. No. 115-123 (2018).

[3] The Act initially was given the short title "The Tax Cuts and Jobs Act." However, the Senate Parliamentarian rule that the inclusion of a short title violated the applicable procedural rules that allowed the Senate to pass the legislation with a simple majority. Therefore, the short title was stricken from the final version of the legislation.

[4] Except for certain sexually explicit productions, the term "production" means any motion picture, film, or video tape (including digital video) production, the production costs of which are subject to capitalization under IRC § 263A, or would be subject to capitalization if IRC § 263A applied to the owner of the production. IRC § 181(d)(2); Treas. Reg. § 1.181-3(b)(1).

("***Qualified Compensation***").[5] In the case of a television series, each episode of such a series is treated as a separate production, and only the first 44 episodes of such a series are taken into account for purposes of the Section 181 Election.[6]

A qualified live theatrical performance is any production that meets the Qualified Compensation test and is a live staged production of a play (with or without music) which is derived from a written book or script and is produced or presented by a taxable entity in (i) any venue which has an audience capacity of not more than 3,000, or (ii) a series of venues, the majority of which have an audience capacity of not more than 3,000.[7] In the case of touring companies (or multiple live staged productions), each live stage production generally is treated as a separate production if (i) a Section 181 Election would be allowable to the same taxpayer, and (ii) the multiple live stage productions are separate phases of a production or separate simultaneous stagings of the same production in different geographical locations (not including multiple performance locations of any one touring production).[8] Special rules apply for seasonal productions.[9]

2. Tax Years Prior to 2018: Section 181 Election

For qualified film and television productions commencing after December 31, 2007 and before January 1, 2018, and for qualified live theatrical productions commencing after December 31, 2015 and before January 1, 2018, a taxpayer could elect to expense the first $15 million of production costs ($20 million for productions in low-income communities or distressed areas) (the "***Production Cost Expense Limit***").[10] During such tax years applicable to qualified film and television productions, if the owner of a production reasonably expected that such production would be, upon completion, a qualified film or television production, the owner could elect to treat production costs paid or incurred by that owner as a deductible expense for the taxable year in which the costs were paid or incurred (rather than

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5 IRC § 181(d)(3). A service is considered performed in the U.S. if the principal photography to which the compensated service relates occurs within the U.S. and the person performing the service is physically present in the U.S. Treas. Reg. § 1.181-3(d). For purposes of an animated film or animated television production, the location where production activities such as keyframe animation, in-between animation, animation photography, and the recording of voice acting performances are performed is considered in lieu of the location of principal photography. *Id*. For purposes of a production incorporating both live action and animation, the location where production activities such as keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production is considered in addition to the location of principal photography. *Id*. The term "actors" means players, newscasters, or any other person who are compensated for their performance or appearance in a production. Treas. Reg. § 1.181-3(f)(1). The term "production personnel" means persons who are compensated for providing services directly related to the production, such as writers, choreographers, composers, casting agents, camera operators, set designers, lighting technicians, and make-up artists. Treas. Reg. § 1.181-3(f)(2).

6 IRC § 181(d)(2)(B). For this purpose, an episode includes pilot episodes. Treas. Reg. § 1.181-3(b)(2). A television series may include more than one season of programming. *Id*.

7 IRC § 181(e).

8 IRC § 181(e)(2)(B). For this purpose, "phase" generally refers to each of the following, but only if each of the following is treated by the taxpayer as a separate activity for income tax purposes: (i) the initial staging of a live theatrical production, and (ii) subsequent additional stagings or touring of such production which are produced by the same producer as the initial staging. IRC § 181(e)(2)(C).

9 *See* IRC § 181(e)(2)(D).

10 IRC § 181(a)(2); Treas. Reg. § 1.181-1(b).

recover the cost over time under the income forecast method).[11] The Section 181 Election generally must have been made by the due date (including any extension) for filing the owner's federal income tax return for the first taxable year in which (i) any aggregate production costs were paid or incurred, and (ii) the owner reasonably expected (based on all facts and circumstances) that the production would be set for production and would, upon completion, be a qualified film or television production.[12]

Some states did not adopt Code Section 181. In California, for example, in calculating a taxpayer's California income tax liability, a California resident would not get the benefit of recognizing an immediate deduction by making a Section 181 Election. Instead, the production costs generally would be recovered using the income forecast method for California income tax purposes.

3. Tax Years 2018 and Beyond: Bonus Depreciation

The Act and subsequent extenders package did not extend Section 181 for taxable years commencing after December 31, 2017, but, instead, qualified film and television productions and qualified live theatrical productions (in each case with the same meaning as under Code Section 181) are now eligible for certain "bonus depreciation" to the extent such property is (i) acquired after September 27, 2017, and (ii) placed in service after such date, but before January 1, 2027.[13] To qualify as property eligible for bonus depreciation, (i) the original use of the qualified production must begin with the taxpayer, or (ii) the use of the production by the taxpayer may be by acquisition if the taxpayer never used the property at any time prior to the acquisition and generally acquired the production in a taxable transaction from an unrelated party.[14]

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11 Treas. Reg. § 1.181-1(a)(1)(i). The term "owner" for this purpose means any person that is required to capitalize the costs of producing the production into the tax basis of the production, or that would be required to do so if Code Section 263A applied to that person. Treas. Reg. § 1.181-3(a)(2)(i).

12 Treas. Reg. § 1.181-2(b)(1). An owner generally must make a Section 181 Election for each production. Treas. Reg. § 1.181-2(c)(1). For a production owned by an entity, the election must be made by the entity (for example, if the production is owned by a partnership or an S-corporation, the partnership or S-corporation must make the Section 181 Election. *Id*. For each applicable production, the owner of the production is required to attach a statement to the owner's federal income tax return for the taxable year of the election stating that the owner is making a Section 181 Election and provide certain information set forth in the Treasury Regulations. Treas. Reg. § 1.181-2(c)(2). For qualified film and television productions commencing after October 22, 2004 and before January 1, 2008, the owner must not, based on all facts and circumstances, expected that the aggregate production costs paid or incurred for such production would, at no time, exceed the Production Cost Expense Limit). Treas. Reg. § 1.181-2(b)(1).

13 IRC § 168(k)(2)(A)(iii); § 13201(h)(1) of the Act.

14 *See* IRC § 168(k)(2)(A)(ii) (stating that one of the requirements to constitute qualified property for purposes of bonus depreciation is that the property's original use must begin with the taxpayer or the taxpayer must have acquired the property and met the requirements of Code Section 168(k)(2)(E)(ii)). Property satisfies the acquisition requirement under Code Section 168(k)(2)(E)(ii) if (i) the acquisition is not from a related party (within the meaning of Code Section 267 or 707(b), with modifications for family relationships to include only his spouse, ancestors, and lineal descendants), (ii) the property is not acquired by one component member of a controlled group from another component member of the same controlled group, (iii) the property does not receive a carryover basis and the basis is not determined under Code Section 1014(a) (relating to property acquired from a decedent), and (iv) the cost of property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the person acquiring such property.

A taxpayer that owns qualified property eligible for bonus depreciation may take a depreciation deduction for the tax year in which such property is placed in service equal to such property's tax basis, multiplied by the following applicable percentage:

- 100% in the case of qualified property placed in service after September 27, 2017, and before January 1, 2023;
- 80% in the case of qualified property placed in service after December 31, 2022, and before January 1, 2024;
- 60% in the case of qualified property placed in service after December 31, 2023, and before January 1, 2025;
- 40% in the case of qualified property placed in service after December 31, 2024, and before January 1, 2026; and
- 20% in the case of property placed in service after December 31, 2025, and before January 1, 2027.[15]

Notably, a taxpayer does not recognize the qualified production cost deduction until the production is *placed in service* when taking bonus depreciation, whereas the qualified production costs were deducted *when paid or incurred* when a Section 181 Election was made. Importantly, however, qualified film, television, or live theatrical productions for purposes of bonus depreciation each have the same definitions as under Code Section 181, except that the Production Cost Expense Limit does not apply.[16] In other words, a taxpayer may now deduct the full amount of qualified production costs for productions placed in service after September 27, 2017 and before January 1, 2023 (followed by the phase-out summarized above), whereas qualified production costs could only be immediately deducted up to $15 million (or $20 million if the production was produced in certain designated low-income communities) under Code Section 181. For purposes of bonus depreciation for qualified production costs, (i) a qualified film or television production is considered to be placed in service at the time of initial release or broadcast, and (ii) a qualified live theatrical production is considered to be placed in service at the time of the initial live staged performance.[17]

Notwithstanding the extension of the applicability of bonus depreciation to acquired qualified property, any interest in a copyright to a qualified film or television production that is acquired as part of a trade or business generally must be amortized over a 15-year period under other rules that apply to such intangible assets.[18] Conversely, any such copyright that is acquired separately (and not as part of the acquisition of all or a substantial portion of a trade or business) may be eligible for bonus depreciation.[19]

The following is a summary of the key differences between deducting qualified production costs as bonus depreciation or under Code Section 181:

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15 IRC §§ 168(k)(1)(A); 168(k)(6).

16 *See* IRC § 168(k)(2)(A)(i).

17 IRC § 168(k)(2)(H).

18 *See* IRC §§ 197(a) (requiring any section 197 intangible to be amortized over a 15-year period beginning with the month in which the intangible was acquired); 197(d)(1) (defining a "section 197 intangible" to include any copyright); 197(e)(4) (providing that the definition of "section 197 intangible" does not include any interest in a copyright, film, sound recording, video tape, book, or similar property, that is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof).

19 IRC §§ 167(f)(2); 168(k); 197(e)(4).

Code Section 181	**Bonus Depreciation**
Deduction is in the tax year in which in which the costs are paid or incurred.	Deduction is in the tax year in which the production is placed in service.
Production Cost Expense Limit imposes limitation on amount deductible at $15 million (or $20 million in certain cases).	Production Cost Expense Limit does not apply.
An acquired production (finished or partially finished) may be eligible for deduction if the production was acquired prior to its initial release or broadcast.[20]	An acquired production may be eligible for deduction if the production was (i) never used by the acquiring taxpayer, and (ii) generally acquired in a taxable transaction from an unrelated party.

4. Additional Considerations

Although production companies continue to get an accelerated deduction for production costs with respect to qualified (domestic) productions as compared to the income forecast method, the acceleration may come later in time than with a Section 181 Election, since the cost recovery does not occur until the qualified production is placed in service. Depending on the circumstances, this deferred recovery potentially can lead to timing differences as a result of other limitations on losses passed under the Act, including a new limitation on “excess business losses” (generally limiting the use of current year losses to $250k if single and $500k if married filing jointly) and the inability to carry back net operating losses.[21] Limitations on losses related to passive activities and certain “at-risk” rules continue to apply.[22] A discussion of these provisions is beyond the scope of this article, and taxpayers should consult with a tax advisor to plan carefully for these potential issues.

[20] Treas. Reg. § 1.181-1(a)(2)(ii).

[21] *See generally* IRC §§ 461(l); 172.

[22] *See generally* IRC §§ 465; 469.