Tax Cuts and Jobs Act:
How Businesses and Business Owners Could Be Affected

The proposed "Tax Cuts and Jobs Act" (H.R. 1) (the "Act") includes a number of provisions that could significantly impact the taxation of businesses and their owners. We thought it would be useful to highlight some of the more significant possible changes to watch as the process unfolds on Capitol Hill. There has already been an amendment offered by House Ways and Means Committee Chairman Kevin Brady and this alert includes the provisions of that amendment. To the extent the Act, or some form of it, becomes law it could require a review of certain aspects of your organizational structure and compensation plans.

Below is a brief summary of the provisions of the Act most directly affecting businesses and their owners:

- **Corporate Tax Rate Lowered:** The Act would lower the tax on corporations to a flat 20% beginning in 2018 and personal service corporations would be taxed at 25%.

- **Limitations on Expenses and Deductions:** The Act limits deductions for business interest expense to 30% of the business's taxable income and also limits deductions and removes credit for entertainment expenses and employer provided child care among others.

- **Accelerated Expensing of Property:** The Act would allow complete expensing of qualified property, such as tangible personal property with a recovery period of 20 years or less; off the shelf computer software; qualified improvement property, by all first users and not just original users. However, qualified property will no longer include any property used by a regulated public utility company or any property used in a real property trade or business. The Act also increases the limitations on small businesses expensing Section 179 property from $500,000 to $5 million, with phase-out beginning at $20 million instead of $2 million. The new limitations would be indexed for inflation.

- **Net Operating Loss Carrybacks and Carry Forwards:** Under the bill, there will no longer be any carrybacks of NOLs (except for a limited one year carryback for small businesses and farms in the case of certain casualty and disaster losses), but carryforwards will be unlimited. NOLs can only be used to cover at most 90% of a taxpayer's taxable income.

- **Change in Treatment of "Pass Through" Businesses:** The Act would change the manner in which much of the income of limited liability companies,

partnerships and S-corporations is taxed. To the extent income from these businesses is allocated to passive owners, it would now be taxed at a maximum rate of 25% as opposed to the marginal rate applicable to the owner.

- For active owners, only a limited portion would be taxed at the 25% rate based on the portion of income that is related to a return on capital investment in the business. The Act would allow them to select 30% to be treated as a return on capital and so taxed at the 25% rate, or to apply a formula based on the facts and circumstances of the business and applying an assumed rate of return on capital investment.

- Whether or not an owner is passive would be determined under the current rules limiting passive activity losses.

- Personal services businesses (lawyers, accountants, architects, consultants, engineers, those in financial services, and performing arts) would generally not be eligible for any of the income from the business to be taxed at the 25% rate but they may apply a formula similar to that described above based on a return on capital investment so that a portion of it might be taxed at 25%.

- Investment income such as capital gains, dividends and interest would not be taxed at 25% and would continue to be taxed at current rates.

- Options and Deferred Compensation Taxed Upon Vesting: The Act would tax immediately upon vesting all "nonqualified deferred compensation" such as options and equity appreciation rights, whether or not they have been exercised.

  - This would mean the taxpayer would owe tax even though he/she may not yet have the cash from the compensation. This would likely have a dramatic effect on how executive compensation is structured.

  - Severance pay would also be taxed at termination of employment, regardless of when paid.

  - Under the Brady amendment, notwithstanding this general change to when deferred compensation is taxed, non-excluded employees of privately held companies which offer restricted stock or stock options to at least 80% of their employees may elect to defer recognition of income on restricted stock or stock purchased via a stock option from the time of vesting to the earliest of (i) when such stock becomes transferable (including transferable to the employer); (ii) when the employee becomes an excluded employee; (iii) when the company becomes public; (iv) 5

years from such vesting; or (v) if and when the employee revokes the election to defer. For this purpose, an excluded employee is someone who (i) has been at least a 1% owner at any time during the preceding 10 years; (ii) has been at any time the CEO or CFO; (iii) is related to a current or former CEO or CFO; or (iv) has been during any of the preceding 10 years one of the 4 highest compensated officers of the company.

- Extended Holding Period for Partnership Interests Received for Services: Under the Brady amendment, service providing partners (or related parties) in an investment or real estate business who due to such service are allocated a so-called carried interest in the underlying returns of the business will obtain long term gain treatment on such allocation only to the extent such allocation is attributable to gain realized on assets held for 3 years, instead of the standard 1 year. This provision thus appears to be more directed at hedge fund managers than at venture capital or private equity firms.

- Capital Contributions Potentially Taxable: New Section 76 by its terms would treat as taxable income to any entity the excess of the fair market value of property contributed by investors over the fair market value of any entity interest distributed to such investors in return for a contribution of capital. This provision likely will be amended to deal with unintended consequences, because as written, it would subject to tax the amount of any valuation discount applicable to valuing the entity interest distributed in return for any such contribution.

- Estate and Generation Skipping Tax Repeal: The Act would essentially double the estate tax exemption amount to $10 million (indexed for inflation) starting in 2018, and would repeal the estate and GST taxes entirely by 2024.

    - The Act would keep the gift tax in place even after 2023 but increase the exemption as well to $10 million (indexed for inflation) per donor and reduce the rate from 40% to 35%.

    - The Act would retain the "step up" in basis for assets owned by a person at his or her death.

Hemenway & Barnes will continue to monitor the Tax Cuts and Jobs Act and its potential effect on businesses and business owners.

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