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2017 Tax Reform:
What Business Owners Need to Know

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Scott P. Greiner
J.D., LL.M. (Taxation)
Moye White LLP

16 Market Square, 6th Floor 1400 16th Street
Denver, CO 80202-1486
Direct dial: (303) 292-7942
Email: scott.greiner@moyewhite.com

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2017 TAX REFORM: WHAT BUSINESS OWNERS NEED TO KNOW

Congress has passed and President Trump has signed into law sweeping tax reform legislation commonly known as the Tax Cuts and Jobs Act ("TCJA"). TCJA took effect January 1, 2018. Business owners need to be acquainted with TCJA's far reaching impact to properly take advantage of its many benefits, especially when considering forming a business entity.

TCJA affects all businesses, whether operating as C corporations, sole proprietorships (including one-member LLCs) or pass-through business entities (e.g., S corporations, partnerships and LLCs taxed as partnerships). A C corporation's income is double taxed: first it is taxed at the corporate-level, then again at the shareholder-level when the corporation distributes dividends. By comparison, income of a pass-through entity is reported on the owners' or S corporation shareholders' individual income tax returns, whether or not distributed, effectively subjecting this income to one level of tax at individual income tax rates. For some perspective, according to the Joint Committee on Taxation, pass-through business owners in 2015 filed 35.3 million pass-through tax returns accounting for over 40% of net income reported by businesses overall.

Permanent Tax Reform for C Corporations.

Corporate Tax Rate. Under pre-TCJA law, a C corporation's taxable income was taxed at graduated rates reaching upwards to 35%. If a C corporation was a personal service corporation, its taxable income was taxed at a flat 35% rate. A personal service corporation is one where substantially all its activities involve services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts and consulting. Beginning 2018, the taxable income of all C corporations is permanently lowered to a flat 21% rate.

Corporate AMT Repealed. Furthermore, the prior law's 20% corporate alternative minimum tax on certain tax preference items is permanently repealed.

Planning Considerations. When forming a new entity, a business owner should consider the new lower C corporation rate and compare that to the tax treatment of pass-through entity income being taxed at an owner's or shareholder's individual tax rate. So long as the business owner is not in the trade or business of performing personal services, he should also be cognizant of the 50%/100% gain exclusion (up to $10,000,000 per year per issuer) from the sale or exchange of "qualified small business stock" of a domestic C corporation with aggregate gross assets of $50,000,000 or less, held for more than five years.

This choice of entity decision is further complicated by TCJA's new pass-through entity business deduction described below.

Temporary Tax Reform Affecting Business Owners of Pass-Through Entities.

Regular Individual Income Tax Rates. For the vast majority of Colorado businesses that conduct operations either as sole proprietorships or pass-through entities, for taxable years 2018 through 2025 TCJA temporarily reduces the top individual rate from 39.6% to 37% for married individuals filing jointly having taxable income in excess of $600,000, and for unmarried individuals with taxable income in excess of $500,000.

Individual AMT Exemption Amounts and Phase-Out Thresholds. Unlike C corporations, the alternative minimum tax for individuals remains in effect subject to the following modifications. For taxable years 2018 through 2025, Congress has temporarily increased the exemption amount for joint filers $19,900 from $89,500 to $109,400, and for unmarried individuals $16,000 from $54,300 to $70,300, with the exemption phase-out threshold being temporarily raised to $1,000,000 for joint filers and $500,000 for unmarried individuals, all as indexed for inflation starting 2019.

New 20% Pass-Through Entity Business Deduction. As a general rule for taxable years 2018 through 2025, certain pass-through business owners, S corporation shareholders and sole proprietors (including individuals, estates and trusts) may deduct the lesser of (i) the taxpayer's combined qualified business income amount, or (ii) an amount equal to 20% of the excess of the taxpayer's taxable income for the year less net capital gain. This deduction is available to both itemizers and non-itemizers alike. In short, the deduction is available on top of the taxpayer's newly raised standard deduction. Assuming full deductibility, which often may not be the case, the top rate on qualified business income would be 29.6%.

"Combined Qualified Business Income" Defined. Generally, the term "combined qualified business income" means the sum of the amounts determined for each of the taxpayer's qualified trades or businesses equal to the lesser of (i) 20% of the taxpayer's qualified business income with respect to a qualified trade or business, or (ii) the greater of (A) 50% of W-2 wages attributable to that trade or business or (B) the sum of 25% of such W-2 wages plus 2.5% of the unadjusted basis (determined immediately after acquisition) of all "qualified property." The latter term is defined generally as currently depreciable tangible property (including buildings) held or used in the production of qualified business income.

"Qualified Business Income" Defined. Generally, the term "qualified business income" means the net amount of items of income, gain, deduction and loss with respect to a business operating within the United States in pass-through form. Excluded from this calculation, however, is (i) any amount paid by an S corporation that is treated as reasonable compensation of the shareholder, (ii) any amount paid by a partnership as an IRC § 707(c) guaranteed payment for services rendered to the partnership by a partner acting in his or her partner capacity, (iii) any amount paid or incurred by a partnership as an IRC § 707(a) payment to a partner who is acting other than in his or her capacity as a partner for services to the extent provided in regulations, as well as (iv) specified investment-related income, deduction or losses (e.g., short-term and long-term capital gains and losses, dividends, or interest - unless the interest is allocable to a trade or business, etc.).

If a qualified trade or business is conducted through a partnership or S corporation, this provision is applied at the partner or shareholder level, not at the entity level. Consequently, each partner or shareholder must take into account his or her share of each item of qualified business income, W-2 wages, and unadjusted basis of acquired qualified property of the partnership or S corporation.

If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business to the next taxable year. As a result, any deduction allowed in a subsequent year is reduced by 20% of any carryover qualified business loss.

Phase-In of Deduction Limitation. For non-corporate taxpayers whose taxable incomes are below prescribed thresholds (i.e., $315,000 for joint filers and $157,500 for all others, both as index for inflation starting 2019), the pass-through entity business deduction is generally 20% of the taxpayer's qualified business income.

For joint filers with taxable incomes between the prescribed threshold plus $100,000 (i.e., $415,000), and for other taxpayers with taxable income between the prescribed threshold plus $50,000 (i.e., $207,500), the 20% qualified business income amount is reduced by an amount equal to a percentage (up to 100%) of the excess of 20% of the taxpayer's qualified business income less whichever of the two W-2 wage limitations described immediately below apply.

For taxpayers with taxable incomes in excess of the prescribed threshold plus $100,000/$50,000, the pass-through entity business deduction will be the lesser of (i) 20% of the taxpayer's qualified business income, or (ii) the greater of (A) 50% of W-2 wages or (B) the sum of 25% of such W-2 wages plus 2.5% of the unadjusted basis (determined immediately after acquisition) of all qualified property.

These limitations will result in the pass-through entity business deduction not applying to all pass-through income. Many pass-through business owners, S corporation shareholders and sole proprietors otherwise eligible, but conducting a business with few wage earners and/or with limited qualified property will be taxed on qualified business income at a rate higher than the 29.6% noted earlier.

"W-2 Wages" Defined. For purposes of the W-2 wage limitations, the term "W-2 wages" means (i) total employee wages subject to wage withholding, (ii) elective deferrals (e.g., any employer contribution under an IRC § 401(k) plan) and (iii) deferred compensation paid during the calendar year with respect to employment of employees of the qualified trade or business. While a shareholder of an S corporation can be a W-2 employee for tax purposes, a partner of a partnership and a member of an LLC taxed either as a partnership or as a sole proprietorship cannot. This wage cap can affect the choice of pass-through entity when initially organizing the business.

"Qualified Trade or Business" Defined. The term "qualified trade or business" is defined in the statute by exclusion. The term means any trade or business other than (i) a specified service trade or business or (ii) the trade or business of performing services as an employee. The statute does not define what a trade or business is, but by case law it generally means any activity conducted for income or profit on a regular and continuous basis.

Deduction Phase-Out for Specified Service Trades or Businesses. Not all sole proprietors and pass-through business owners and S corporation shareholders can benefit by this new pass-through entity business deduction. For those who perform services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services, including investing and investment management, trading or dealing in securities, partnership interests or commodities, along with any trade or business where the principal asset is the reputation or skill of one or more of its employees, owners or shareholders, this deduction is available only if the specified service provider's taxable income does not exceeded the prescribed threshold plus $100,000/$50,000, depending on filing status.

For joint filers that upper limit is $315,000 (as indexed) plus $100,000 (i.e., $415,000); for all other filers it is $157,500 (as indexed) plus $50,000 (i.e., $207,500). If a specified service provider's taxable income exceeds the prescribed threshold plus $100,000/$50,000, no deduction is allowed. For joint filers with taxable incomes between the prescribed threshold plus $100,000, and for other taxpayers with taxable income between the prescribed threshold plus $50,000, only an "applicable percentage" of qualified items of income, gain, deduction, loss, W-2 wages and unadjusted basis of acquired qualified property are taken into account in computing qualified business income, W-2 wages and original basis of qualified property. For all filers with taxable income below the prescribed threshold, they are unaffected by this phase-out rule and can deduct 100% of their share of qualified items of income, gain, deduction, loss, W-2 wages and unadjusted basis of acquired qualified property.

Thanks to a last minute legislative change, architects and engineers are specifically excluded from the specified service trade or business limitation rule.

Separate 20% Qualified Deductions. In addition to the deduction stemming from qualified business income, in computing the combined qualified business income amount for a qualified trade or business you add 20% of the aggregate dividends received from real estate investment trusts (which dividends are not capital gain dividends or qualified dividend income) plus the net income from publicly traded partnerships. This 20% deduction is allowed without regard to the W-2 Wage limitation, but subject to the taxable income limitation described first above.

Which business owners are most likely to benefit by this new but temporary pass-through entity business deduction? Passive investors in businesses (other than specified service trades or businesses) that generate ordinary income should benefit the most. This would include investors in large real estate development partnerships. By contrast, partners of management companies of private equity funds will not benefit with respect to management fee income insofar as such income is from a specified service trade or business.

Bonus Depreciation Temporarily Extended. For both new and used qualifying property (generally, depreciable tangible property such as factory equipment, machinery and vehicles) acquired and placed in service after September 27, 2017 and before 2023 (before 2024 for "longer production period" property and certain aircraft), taxpayers can claim a 100% first-year bonus depreciation deduction. For taxable years 2023, 2024, 2025 and 2026, the first-year bonus depreciation is 80%, 60%, 40% and 20%, respectively.

Where bonus depreciation provides a real benefit is in the field of M&A deals structured as assets acquisitions. Over the next five years, a buyer purchasing depreciable tangible property receives a discount off the purchase price for such assets. For 2018, that discount equals the buyer's top marginal tax bracket. This discount lessens over time as the amount of bonus depreciation shrinks.

Limitation on Use of Excess Business Losses. Enthusiasm over increased business deductions is tempered by a new loss limitation rule applicable to non-corporate taxpayers. This new rule is applied after application of the "passive activity loss" rules introduced in 1986.

For taxable years 2018 through 2025, "excess business losses" of a taxpayer other than a corporation are disallowed for the taxable year in which they were incurred. The disallowed losses are treated as part of a taxpayer's net operating loss ("NOL") and carried forward to subsequent years. An excess business loss is a taxpayer's aggregate trade or business deductions, less the sum of aggregate trade or business gross income or gain plus $500,000 for joint filers or $250,000 for all others, both as indexed for inflation starting 2019. In the case of a pass-through entity, this loss limitation applies at the shareholder or owner level rather than at the entity level. This rule seems to have the effect of accelerating income into the first eight years of the tax bill.

Tax Reform Possibly of a More Permanent Nature.

Carried Interests and the New 3-Year Rule. Prior to TCJA, a partner who received a "profits interest" in a partnership in exchange for services, colloquially referred to as a carried interest, recognized long-term capital gains with respect to that interest upon the partnership selling a long-term capital gain asset[1] – an asset held for more than 1 year. This fact was most notable in the context of management companies of private equity funds. In exchange for services rendered by the managing general partner to the fund, the general partner (and in turn, its partners) were able to report a large portion of their compensation income as long-term capital gains.

With passage of TCJA, a service partner's share of long-term capital gains will now be re-characterized as short-term capital gains taxed at ordinary income rates where the amount of the service partner's share of net long-term capital gain "with respect to" an applicable partnership interest for a taxable year exceeds the amount of such gain calculated as if a 3-year (not 1-year) holding period applies.

Under this new rule, the preferential long-term capital gains rate applies to gain passed through to certain service partners if the partnership held the asset giving rise to the gain for more than 3 years. Use of the phrase "with respect to" also suggests that the service partner needs to hold his or her profits interest for more than 3 years in order to benefit by the preferential long-term capital gains rate. Thus, if the service partner held his or her profits interest for more than 3 years and the partnership held the partnership asset for more than 3 years, the service partner would be assured long-term capital gains treatment.

"Applicable Partnership Interest" Defined. The term "applicable partnership interest" is generally defined as any interest in a partnership, directly or indirectly, transferred to (or held by) a non-corporate taxpayer in connection with the performance of substantial services in any "applicable trade or business." This term does not include an interest in a partnership held directly or indirectly by a corporation, which the IRS has ruled refers solely to C corporations.[2] Nor does it include any capital interest, which pursuant to the partnership agreement, gives a

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[1] Rev. Rul. 68-79.
[2] See Notice 2018-18. The statute and the Committee Reports only refer to "corporations" without distinguishing been C and S corporations.

partner the right to share in partnership "capital"[3] (i) commensurate with the amount of capital he or she contributed, determined as of the time the partnership interest was received, or (ii) commensurate with the value of the partnership interest taxed under IRC § 83 on receipt or vesting.[4]

"Applicable Trade or Business" Defined. An "applicable trade or business" means any activity conducted on a regular, continuous and substantial basis, which consists to any extent of (i) raising or returning capital, <u>and</u> (ii) either (a) investing in (disposing of) specified assets (or identifying specified assets for investment or disposition) or (b) developing specified assets. Specified assets are developed if it is represented to investors, lenders, regulators or others that the value, price or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of the service provider.

"Specified Assets" Defined. For purposes of defining an applicable trade or business, the term "specified assets" includes securities (a defined term, including an interest in a partnership that is widely held or publicly traded), commodities (a defined term, including ones that are actively traded), real estate held for rental or investment (other than that on which the holder operates an active farm), cash or cash equivalents, and options or derivative contracts. This definition applies in tiered partnership structures to the extent of a partnership's interest in the foregoing, including, according to the Committee Reports[5], an interest in a partnership that is <u>not</u> widely held or publicly traded.

Related Party Transfers. If during the 3-year holding period a profits interest holder transfers any applicable partnership interest, directly or indirectly, to a person related to the holder, then so much of the holder's net long-term capital gain attributable to the sale or exchange of a partnership asset held for not more than 3 years as is allocable to the transferred interest is re-characterized as short-term capital gains taxed at ordinary income rates. A related person is a family member (e.g., spouse, parents, children and grandchildren) or a colleague (i.e., a person who performed a service within the current calendar year or the preceding 3 calendar years in any applicable trade or business in which or for which the holder performed a service).

Existing and Newly Granted Profits Interests. It is important to understand that this new 3-year carried interest limitation applies to both newly granted as well as existing profits interest awards since there is no grandfathering for profits interests received prior to enactment of TCJA. Additionally, pass-through items other than capital gains (e.g., qualified dividend income) are unaffected by this new rule and continue to be taxed at preferential rates.

Intended Targets. As the applicable trade or business definition suggests, this 3-year holding period requirement is primarily aimed at profit interests owned by investment managers. It does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third-party investors. Thus, profits interest awards to key management personnel of a non-investment services business only have to comply with a 1-year holding period requirement for long-term capital gain treatment on allocations from the partnership.

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[3] Use of the word "capital" may represent a drafting error. It may/should mean "profits."
[4] IRC § 83 provides rules taxing the receipt of property in exchange for services rendered to an employer.
[5] Statements in Committee Reports are not law.

Likewise, limited partners holding capital interests in private equity funds are unaffected by this new carried interest rule and thus retain the 1-year holding period requirement.

Technical Terminations of Partnerships. TCJA repeals the IRC § 708(b)(1)(B) rule providing for technical terminations of partnerships whenever 50% or more of total interests in partnership capital and profits is sold or exchanged within a 12-month period. The repeal is permanent so those provisions in both partnership and operating agreements addressing the consequences of technical terminations are no longer needed.

Like-Kind Exchanges. Generally, the exchange of property, like a sale, is a taxable event. However, IRC § 1031 permits the tax-free exchange of relinquished property held for productive use in a trade or business or for investment, for replacement property of "like-kind" which is to be held for productive use in a trade or business or for investment. The determination of whether property is of a "like-kind" relates to the nature or character of the property and not to its grade or quality. To illustrate, improved real estate and unimproved real estate generally are considered to be property of a "like-kind" insofar as this distinction relates to the grade or quality of the real estate.

The non-recognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind. For example, IRC § 1031 does not apply to an exchange of real property for personal property.

If property received in the transaction consists not only of property that would be permitted to be exchanged on a tax-free basis, but also other non-qualifying property or money (i.e., "boot"), then the gain to the recipient of the boot is required to be recognized, but not in an amount exceeding the fair market value of the boot received. Additionally, any such gain recognized could constitute ordinary income to the extent the recapture provisions of IRC §§ 1245 and 1250 apply. No losses may be recognized.

Prior to TCJA, like-kind exchange treatment extended to both real and personal property alike. Under TCJA, like-kind exchange treatment will now be limited just to real property that is not held primarily for sale. This new rule applies to exchanges completed after 2017. However, an exception is provided for any exchange if the property disposed by the taxpayer in [a deferred] exchange is disposed on or before December 31, 2017, or the property received by the taxpayer in [a reverse] exchange is received on or before such date.

Because personal property is now excluded from IRC § 1031 treatment, it will be necessary to identify the personal property components of both relinquished and replacement properties, and the practicalities of having cash with which to pay the resulting tax liability. This issue will be most acute for clients who have had cost segregation studies performed for purposes of accelerating depreciation deductions. These studies have the effect of reclassifying components of nonresidential real property improvements as something other than nonresidential real property depreciable over a recovery period of less than 39 years.

IRC § 179 Expense Election. Business taxpayers of all types can now elect to currently expense (rather than capitalize and depreciate) in the year the property is placed in service the cost of acquiring up to $1,000,000 of (i) depreciable tangible personal property (now including property used predominantly to furnish lodging or in connection with furnishing lodging), (ii) off-the-shelf computer software, (iii) certain leasehold/retail improvements and restaurant property, and (iv) nonresidential real property improvements consisting of roofs, heating, ventilation and air-conditioning property, fire protection and alarm systems, and security systems. This expensing amount is not scheduled to sunset; however, it is reduced by the amount by which the cost of such property in any one year exceeds $2,500,000.

Interest Deduction Limitation. Under pre-TCJA law, interest paid or accrued by a business was generally deductible in the computation of taxable income, subject to a number of limitations. Beginning 2018, the net interest expense of every business, regardless of its form, is limited to the sum of (i) "business interest income," (ii) 30% of the business' "adjusted taxable income" and (iii) "floor plan financing interest." It applies to business interest on all existing indebtedness, as well as debt incurred after 2017. Any disallowed interest expense is carried forward indefinitely, subject to certain restrictions applicable to pass-through entities.

Business interest is any interest paid or accrued on indebtedness properly allocable to a trade or business, exclusive of investment interest. Business interest income is an amount of interest included in gross income properly allocable to a trade or business, exclusive of investment income.

Adjusted taxable income is taxable income computed without regard to (i) any item of income, gain, deduction or loss not properly allocable to a trade or business, (ii) any business interest or business interest income, (iii) the amount of any net operating losses, (iv) the amount of any deduction for the new pass-through entity business deduction, and (v) for taxable years 2018 through 2021, any deductions allowable for depreciation, amortization or depletion. Since adjusted taxable income is not reduced by depreciation, amortization or depletion for taxable years beginning before 2022, adjusted taxable income will be higher; therefore, more business interest will be deductible.

Floor plan financing interest only applies to dealerships in cars, boats, and farm machinery and equipment. It is interest paid or accrued on floor plan financing indebtedness, which is indebtedness used to finance the acquisition of any (i) self-propelled vehicle designed for transporting persons or property on a public street, highway or road, (ii) boats and (iii) farm machinery and equipment, all held for sale or lease to retail customers that is secured by the acquired inventory.

Generally, the net interest expense disallowance is determined at the tax filer level. However, a special rule applies to pass-through entities requiring the determination to be made at the entity level rather than at the shareholder, partner or member level. This means the limitation is calculated separately for each pass-through entity.

Importantly, TCJA contains a number of exceptions. First, there is a small business interest expense exception. The interest disallowance rule does not apply to businesses with average annual gross receipts for the 3-year period ending with the prior taxable year that does not exceed $25,000,000 (the "$25 million gross receipts test").

Second, at the irrevocable election of a real property trade or business, the interest disallowance rule does not apply to any development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. However, to make this election, the real property trade or business must forgo the deduction for bonus depreciation, and must depreciate its real property using the straight-line alternative depreciation system ("ADS") rather the accelerated MARC system.

Third, at the irrevocable election of a farming trade or business, the interest disallowance rule does not apply, but the farm must forgo the deduction for bonus depreciation and use ADS to recovery its cost in depreciable property with a recovery period of 10 years or longer.

Fourth, at the irrevocable election of a cooperative, the interest disallowance rule does not apply to any business engaged in the trade or business of a specified agricultural or horticultural cooperative.

Finally, in the context of corporate acquisitions, in connection with complete liquidations of subsidiaries, or in connection with certain acquisitive reorganizations, the acquiring corporation succeeds to and takes into account any carryforward of disallowed business interest as of the day of distribution or transfer for use in taxable years ending after such date. Furthermore, any carryforward of disallowed business interest is also subject to the limitation on use of NOL carryforwards following certain ownership changes.

Expanded Cash Method of Accounting. Building on the $25 million gross receipts test, TCJA expands the universe of taxpayers who may use the cash (versus the accrual) method of accounting. Under TCJA, the cash method may be used by taxpayers (other than tax shelters) that satisfy the $25 million gross receipts test, regardless of whether or not the purchase, production or sale of merchandise is an income-producing factor. Included in this expanded universe are any farming C corporations or farming partnerships/LLCs with a C corporation partner/member that meets the $25 million gross receipts test.

Net Operating Losses. Prior to TCJA, NOLs could be carried back two years and carried forward 20 years offsetting 100% of taxable income. Starting 2018, except for certain losses incurred in the trade or business of farming, NOLs arising after 2017 can no longer be carried back but can be carried forward indefinitely, limited however, to 80% of taxable income. Farming NOLs can still be carried back two years. However, there are no new limitations placed on NOLs arising pre-TCJA.

Qualified Equity Grants. TCJA adds new subsection (i) to IRC § 83 entitled "Qualified Equity Grants." This new provision provides employees with an opportunity to defer from current income recognition an amount of income attributable to stock transferred to the employee upon exercise of stock options or settlement of restricted stock units ("RSUs")[6].

New IRC § 83(i) contains many defined terms, qualifiers and restrictions, and it only applies for income tax purposes, not for FICA or FUTA purposes. It grants a "qualified

[6] RSU is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. The arrangement may provide for the RSU settlement to be paid in cash or as a transfer of employer stock (or either).

employee" of an "eligible corporation" receiving "qualified stock" with respect to the exercise of stock options or settlement of RSUs, a 30-day election window to defer otherwise currently includible income from the exercise or settlement of the option or RSU for a maximum period of five years.

If an employee makes the election, the deferred income is not recognized until the taxable year which includes the earliest of (i) the first date the qualified stock becomes transferable, including the ability of the employee to sell the stock to the employer or any other person, (ii) the date the employee becomes an excluded employee (as defined below), (iii) the first date on which any employer stock becomes readily tradeable on an established securities market, as determined by the IRS, (iv) the fifth anniversary date after the first date the employee's right to the qualified stock first becomes transferable[7] or no longer subject to a substantial risk of forfeiture, or (v) the date the employee revokes (in such manner and at such time as the IRS provides) his or her inclusion deferral election. Income inclusion cannot be further delayed due to a lock-up period as a result of an initial public offering.

"Qualified Employee" Defined. A "qualified employee" is an individual who is <u>not</u> an excluded employee (as defined below), and who agrees to meet any necessary requirements set by the IRS to ensure the income tax withholding requirements of the employer corporation are met with respect to the qualified stock.

"Excluded Employee" Defined. An "excluded employee" is any individual (i) who was a 1% owner at any time during the current calendar year, or at any time during the preceding 10 calendar years, (ii) who is or has been at any prior time the CEO, the CFO or an individual acting in either such capacity, (iii) who is a family member[8] of an individual described in clauses (i) or (ii) above, or (iv) who has been one of the 4 highest compensated officers during the current calendar year, or at any time during the preceding 10 calendar years.

"Qualified Stock" Defined. "Qualified stock" includes any stock of a corporation if (i) a qualified employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and (ii)(a) the option or RSU was granted by the corporation to the employee in connection with the performance of services, and (b) in a calendar year in which the corporation was an eligible corporation (as defined below).

Excluded from this definition is any stock if, at the time the employee's rights to the stock first become transferable or no longer subject to a substantial risk of forfeiture, the employee may either (i) sell the stock to the corporation, or (ii) otherwise receive cash from the corporation in lieu of the stock. Stock can only be qualified stock if it relates to stock received in connection with options or RSUs. The term "qualified stock" does not include stock received in connection with other forms of equity compensation, such as stock appreciation rights or restricted stock.

"Eligible Corporation" Defined. A corporation is an "eligible corporation" with respect to a calendar year if two requirements are satisfied. First, no stock of the employer corporation

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[7] The rights of an employee in qualified stock are transferable only if the rights of a transferee of such stock are not subject to a substantial risk of forfeiture.

[8] Generally, an individual's parents, spouse, children and grandchildren.

(or any predecessor corporation) is readily tradeable on an established securities market during any preceding calendar year, and up to and including the time an inclusion deferral election is made. This means no election can be made if any stock of the corporation is readily tradeable at any time before the election is made.

Second, the corporation has a written plan under which, in the calendar year, not less than 80% of all U.S. employees (whether they are new hires or existing employees) are granted stock options or RSUs having the same rights and privileges to receive qualified stock (the "80% Requirement"). Excluded employees (as defined above) and part-time employees (i.e., employees who are customarily working fewer than 30 hours per week) are not taken into account. The 80% Requirement is seen as an anti-discrimination rule.

Importantly, the 80% Requirement cannot be satisfied in a taxable year by granting a combination of stock options and RSUs. Instead, all such employees must either be granted stock options or be granted RSUs for that year.

The corporation will not fail the 80% Requirement solely because the number of shares available to all employees is not equal in amount. The 80% Requirement will be satisfied so long as the number of shares available to each employee is more than a de minimis amount.

For purposes of this definition, corporations that are members of the same controlled group are treated as one corporation applying the definition under IRC § 414(b) rather than IRC § 1563(a).

Inclusion Deferral Election. An inclusion deferral election must be made no later than 30 days after the first time the employee's right to the qualified stock becomes transferable or no longer subject to a substantial risk of forfeiture, whichever occurs first. The election is made in a manner similar to the manner in which an IRC § 83(b) election is made. Thus, the employee must file the election with the IRS providing the employer with a copy.

An employee may make an inclusion deferral election not only with respect to qualified stock received upon exercise of a non-qualified stock option granted under Reg. § 1.83-7, but also with respect to qualified stock attributable to an incentive stock option granted under IRC § 422, as well as qualified stock attributable to an option granted under an employee stock purchase plan per IRC § 423. In the latter two instances, the options are not treated as statutory options but rather as non-qualified stock options for FICA purposes, and the rules relating to statutory options and related stock do not apply for income tax purposes.

Limitations on Making Inclusion Deferral Election. New IRC §83(i) does not apply to income with respect to non-vested stock that has previously been included in income as a result of an IRC § 83(b) election. Nor does IRC §83 (other than new IRC §83(i)) apply to RSUs, so RSUs are not eligible for an IRC § 83(b) election.

Further, as a general rule, an employee may not make an inclusion deferral election for a year with respect to qualified stock if, in the preceding calendar year, the corporation redeemed any of its outstanding stock. This limitation does not apply, so an election can be made, where at least 25% of the total dollar amount paid for redeemed stock is for stock with respect to which an inclusion deferral election is in effect ("deferral stock") and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis. In order for this exception to apply, stock redeemed from an individual is not treated as deferral stock (and the redemption is not treated as a purchase of deferral stock) if, immediately after the redemption, the individual holds any deferral stock for which an election has been in effect for a longer period than the election with respect to the redeemed stock. Thus, an individual's deferral stock with respect to which the election has been in effect the longest must be redeemed first.

The corporation has an obligation to report the redemption of any of its outstanding stock on its income tax return for the year of the redemption if any deferral stock is outstanding as of the beginning of any calendar year. The corporation has to report the total dollar amount of outstanding stock it redeemed during the year, as well as such other information as the IRS may require.

Corresponding Employer Deduction. If an employee makes an inclusion deferral election, the corporation's deduction is deferred until the corporation's taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee's income.

Notice Requirement. The corporation must provide written notice to the qualified employee at the time, or a reasonable period before the time, the employee's right to the qualified stock first becomes transferable or no longer subject to a substantial risk of forfeiture (the "Notice Requirement"). A corporation's failure to comply with the Notice Requirement could result in a penalty of $100 for each failure, up to a maximum penalty of $50,000 for any one calendar year.

The notice must (i) certify that the stock is qualified stock, and (ii) notify the employee (a) that the employee may elect to defer income inclusion with respect to receipt of the qualified stock, (b) that, if the employee makes such election, the amount of income required to be included at the end of the deferral period will equal the value of the stock at the time the employee's right to the stock first becomes transferable or no longer subject to a substantial risk of forfeiture, and (c) the amount of income to be included at the end of the deferral period will be subject to income tax withholding, as well as the employee's responsibilities regarding same. Importantly, the notice must inform the employee that even if the value of the stock declines between the election date and the end of the deferral period, even if it declines below the employee's income tax liability with respect to the qualified stock, the employee must include as income the value of the stock at the time the employee's right to the stock first becomes transferable or no longer subject to a substantial risk of forfeiture.

Withholding Requirement. For the year in which the deferral period ends, the amount required to be include as income is treated as wages with respect to which the corporation is required to withhold income tax at the highest marginal rate applicable to individuals.

Reporting Requirement. The corporation must report on Form W-2 the amount of income covered by an inclusion deferral election, first for the year of deferral, and then for the year in which the deferral period ends. Additionally, for any calendar year, the corporation must report on Form W-2 the aggregate amount of income being deferred, determined at the close of the calendar year.

Transitional Rule. Until the U.S. Treasury promulgates regulations or the IRS issues other guidance implementing the 80% Requirement and the Notice Requirement, a corporation will be treated as complying with the two requirements if it complies with a reasonable good faith interpretation of those requirements.

Conclusion.

TCJA introduces significant changes to the tax laws. This article describes only a sampling of those changes. Business owners of all types, especially those forming new entities or considering converting to a different entity, should consult with their tax advisors for a more in-depth explanation of this sweeping tax reform legislation.