Business Law Section Newsletter

Vol. 42, No. 1 — August 2018

Notes from the Editors

by Denise Walsh, Lori Mayer and Angelo Bolcato

Welcome to our new leadership team led by Brett Harris as chair and Steven Eisenstein as vice chair of the Business Law Section. A special thank-you to Jeff Shapiro regarding his time as the section's immediate past chair.

As summer flies by, it is time for the next installment of the *Business Law Section Newsletter*. This edition contains a number of informative articles we think will be helpful to business lawyers and their practices.

Two of the articles focus on the Tax Cuts and Jobs Act. One article looks at the act from the merger and acquisition side. The other summarizes three significant aspects of the act that may affect closely held businesses and their owners.

Keeping in line with recent changes in the law, this issue also includes an article reviewing six recently enacted statutory changes to the New Jersey Business Corporation Act.

Finally, contained in this edition are articles on confidentiality and franchise non-compete provisions, with the theme of both being how to protect a business and its brand, trade secrets and confidential information.

Is there an area of business law you want to learn more about? Are you looking for a summary of significant provisions of a new law and how they might affect your clients? We want to hear from you! As always, we also encourage you to submit an article for publication on a topic of interest to you and other members of the business law community. Please feel free to reach out to any of the editors to express your interest in submitting a piece, or with suggestions on future topics or how this newsletter can better benefit you and your practice. ■

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Business owners typically believe the information and data compiled throughout a company's history is a trade secret. Business lawyers are frequently consulted to review and draft nondisclosure agreements to protect such information. This article reviews the New Jersey Trade Secrets Act and recent case law on what businesses will need to demonstrate in order to protect their 'trade secrets.'

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The Tax Cuts and Jobs Act not only affects future business mergers and acquisitions, it also affects closely held businesses and their owners. In this informative piece, the author discusses three significant provisions of the act that will affect businesses and their owners: 1) reduction of corporation and individual tax rates; 2) introduction of Code Section 199A, which provides for a tax deduction of 20 percent of qualified business income, subject to limitations and exclusions; and 3) $10,000 annual limit on deduction of real estate taxes and state and local income taxes.

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It can be challenging to draft franchise non-compete provisions to broadly define the prohibited activity to protect the present franchise business and later changes to it, while not being so broad that the clause is vague regarding what is actually covered. This article reviews some pointers for drafting franchise non-compete clauses that protect the franchise system and help avoid or minimize litigation and other disputes, in-term and post-term, to the franchise agreement.

The opinions of the various authors contained within this issue do not reflect any legal advice on the part of any author or any author's law firm and should not be viewed as the opinions of the Business Law Section or the New Jersey State Bar Association.

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Call for Articles

We are seeking articles for the winter 2018 issue of the *Business Law Section Newsletter* on topics of interest to business lawyers in New Jersey and written by New Jersey State Bar Association members.

The deadline for submitting articles for the winter edition is **Nov. 15**.

Interested in submitting? Contact any of the editors:

Lori Mayer at 973-618-0400 ext. 127 or lmayer@nagelrice.com

Denise Walsh at 201-661-2436 or denise.walsh@epicbrokers.com

Angelo J. Bolcato at 973-729-1880 or abolcato@lcrlaw.com

We look forward to hearing from you.

Recent New Jersey Enactments on Corporate Governance

by Brett R. Harris

On the final day of Governor Chris Christie's term of office,[1] a series of laws were passed intending to modernize provisions of the New Jersey Business Corporation Act (BCA) and make the state more hospitable to corporations from a legislative perspective. The package was comprised of six bills that were developed based on recommendations by the New Jersey Corporate and Business Law Study Commission to update the BCA and generally benefit corporate boards.

By way of background, the commission was created in 1989 by the New Jersey Legislature[2] as a legislative commission responsible for studying and reviewing all aspects of statutes, legislation and decisions of New Jersey courts, as well as other states' relation to business entities and nonprofit corporations. Patrick J. Diegnan Jr., previously a state assemblyman and now a state senator, sits on the commission and sponsored the six bills that comprised the corporate reforms. The bills had all been introduced in previous legislative terms, one as early as 2010, but they languished for a number of years without activity, despite there being no apparent opposition to them. During 2017, Senator Diegnan continued to promote them as measures to streamline the state's corporate laws, making it easier for those already in the state to continue conducting activities and expand operations, and to attract new companies.

The state's business advocacy groups and transactional attorneys have long noted the lag in business incorporation activities in New Jersey as other jurisdictions have enacted more business-friendly corporate governance laws. Delaware touts itself as the preeminent jurisdiction for incorporation, which it attributes in part to its statute, the Delaware General Corporation Law, described on its website as "the most advanced and flexible business formation statute in the nation."[3] According to the website of the Delaware Division of Corporations, "More than two thirds of the Fortune 500 continue to call Delaware their corporate home, along with four out of every five new companies that go public in the United States."[4]

The New Jersey State Bar Association supported the package of corporate governance bills sponsored by Senator Diegnan "as amendments to New Jersey corporate law that will update current law."[5] The bar association also referred to several of the bills as "important measures to update the state's corporate governance laws and ease the burden on corporations to act in accordance with them."[6]

The New Jersey Business & Industry Association (NJBIA) also supported the bills while they were pending before the New Jersey Legislature: "This legislation would make New Jersey more business friendly and more competitive with states such as Delaware, Pennsylvania and New York, which have already incorporated changes regarding shareholder matters into their laws," said Mary Beaumont, NJBIA's vice president for health and legal affairs. She was quoted in several statements issued by the NJBIA in 2017 encouraging legislators to support the bills the association lauded as pro-business revisions to laws governing New Jersey corporations.

In the lame duck days of the 2016-2017 legislative term, the time was apparently finally right for some corporate governance reforms; thus, six new laws amending the BCA were enacted, as follows:

P.L.2017, c.299:[7] *An act concerning corporation proxy solicitation materials and supplementing Chapter 5 of Title 14A of the New Jersey Statutes*

This law allows certain materials to be included in a corporation's proxy solicitation materials. Specifically, it enables a corporation to establish in its bylaws procedures or conditions under which materials related to shareholder-nominated individuals will be included in the corporation's proxy solicitation materials. Codified as a new section of Chapter 5 of the BCA (Shareholders' Meetings and Elections; Rights and Liabilities of Shareholders in Certain Cases), Section 31[8] is entitled "Establishment of procedures, conditions relative to certain proxy solicitation materials."

The new section provides a non-exhaustive list of procedures or conditions that may apply to the inclusion of materials in a corporation's proxy solicitation materials for an upcoming election of directors. Six examples are set forth, including a condition requiring a minimum level of beneficial ownership of shares of the corporation's stock by the nominating shareholder, a provision limiting the number of shareholder-nominated directors for a particular shareholder meeting when directors will be elected, and a provision requiring that the nominating shareholder indemnify the corporation in respect of losses arising as a result of false or misleading statements submitted in connection with the nomination.

P.L.2017, c.355:[9] *An act concerning corporate mergers and consolidations and amending N.J.S. 14A:10-3 and N.J.S. 14A:10-4.1*

This law clarifies that a corporation may agree to a 'force the vote' provision for a plan of merger or consolidation, and allows directors to amend a plan of merger or consolidation prior to effectiveness of the plan under certain circumstances. A force the vote provision allows shareholders to vote on a plan of merger or consolidation after approval by the corporation's board of directors, even if the board later determines that the plan is no longer advisable and recommends that the shareholders reject or vote against the plan. Force the vote provisions are used for deal protection purposes in the context of merger and acquisition (M&A) practice. When applied to a target of an acquisition, such a provision can protect a pending transaction by forcing a shareholder vote, even though the board continues to consider other offers.

The law also allows directors to amend a plan of merger or consolidation prior to effectiveness of the plan, as long as the amendment does not alter or change: 1) the consideration to be received by the shareholders; 2) the terms of the certificate of incorporation of the surviving corporation; or 3) any of the terms and conditions of the plan if such change would materially and adversely affect the shareholders of either corporation who have voted or are entitled to vote on the plan, unless the plan of merger or consolidation expressly provides otherwise. If such an amendment is adopted by the board, following the filing of a certificate of merger or consolidation but prior to the time when the merger or consolidation becomes effective, a certificate of amendment of merger or consolidation is to be filed with the Department of the Treasury.[10]

The law was modeled substantially on provisions of the Delaware Business Corporation Law.

P.L.2017, c.356:[11] *An act concerning corporate bylaws and amending N.J.S. 14A:2-9*

This law clarifies the scope of corporate bylaws and provides that bylaws may include a forum selection clause. Upon its enactment, several new clauses were added to Chapter 2 of the BCA, which addresses formation of corporations. One new clause[12] provides that "the by-laws may contain any provision, not inconsistent with law or the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or power or the rights or power of its shareholders, directors, officers or employees."

Another new clause[13] permits the bylaws to provide that the federal and state courts in New Jersey can be designated as the sole and exclusive forum for the following types of actions or proceedings: derivative actions brought on behalf of the corporation; actions by shareholders asserting a claim of a breach of fiduciary duty owed by a director or officer to the corporation or its shareholders, or a breach of the certificate of incorporation or bylaws; actions brought by shareholders asserting a claim against the corporation or its directors or officers arising under the certificate of incorporation or the BCA; any other state law claim, including a class action asserting a breach of a duty to disclose brought by shareholders against the corporation, its directors or officers; or any other claim brought by shareholders that is governed by the internal affairs or an analogous doctrine. If the bylaws include such a forum selection clause, the bylaws may also provide that shareholders who file an action without complying with the clause will be liable for all reasonable costs incurred in enforcing the requirement, including reasonable attorney's fees.

If a corporation's bylaws do include a forum selection clause, the BCA now provides that the corporation's directors and officers, and former directors and officers, are deemed to have consented to the personal jurisdiction of the forum, provided that the jurisdiction shall apply only to actions asserting claims arising after the date of the adoption of the bylaw provision designating the forum exclusivity.[14]

P.L.2017, c.362:[15] *An act concerning derivative proceedings and shareholder class actions and amending P.L.2013, c.42*

This law implements a technical change from an 'opt-in' to an 'opt-out' approach for the applicability of the existing provisions of the BCA on derivative proceedings. Several years ago, the BCA had been significantly updated in respect of derivative actions, which are generally proceedings brought by minority shareholders against the directors or majority shareholders of a corporation alleging failure by management. The 2013 legislation[16] had repealed the prior provision of the BCA, which governed actions by shareholders[17] and added nine new sections to the BCA to address derivative proceedings and shareholder class actions.[18] The 2013 provisions were intended to codify developments in this area of the law since the 1972 amendments to the repealed provision, and were drafted largely based on the Model Business Corporation Act, with substantial additions based on the Massachusetts Business Corporation Law.[19] However, the 2013 legislation stated its provisions would only apply if they were made applicable to a corporation by its certificate of incorporation.[20] "Consequently for those corporations, which through ignorance, disinterest, or purposeful choice, fail to adopt the new statute, the New Jersey Business Corporation Act has no provision dealing with the corporate requirements for derivative and class actions."[21]

The recent enactment changes the applicability by dividing the provisions into two categories: Some provisions will apply by default to corporations unless they affirmatively vary them in their certificate of incorporation, while other provisions will only apply if a corporation opts in by making them applicable in their certificate of incorporation. The following provisions will apply to a corporation unless that corporation chooses to vary the applicability or effect of the provisions in its certificate of incorporation: the conditions for commencing and maintaining a derivative proceeding; the actions that must be taken before a shareholder may commence a derivative proceeding; the conditions for a court to order a stay of a derivative proceeding; the conditions for dismissal of a derivative proceeding; and the requirement for court approval for the discontinuation or settlement of a derivative proceeding or shareholder class action.

There are two provisions of the BCA on derivative proceedings that will only apply if a corporation has expressly made them applicable in the corporation's certificate of incorporation: the rules governing how a court should allocate expenses following termination of a derivative proceeding or shareholder class action; and the allowance that a defendant corporation may require the plaintiff to provide security for reasonable expenses related to the derivative proceeding or shareholder class action.

P.L.2017, c.363:[22] *An act concerning actions of corporate directors and amending N.J.S. 14A:6-7.1*

This law clarifies that corporate directors may approve actions without a meeting, by electronic transmission. The provision of the BCA amended by this law had already provided that any action required or permitted to be taken pursuant to authorization voted at a meeting of the board, or a committee thereof, could be taken without a meeting if, prior to the action, all members of the board or committee consent to the action in writing. The law clarifies that this consent may also be by "electronic transmission," as defined elsewhere in the BCA as "any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved and reviewed by a recipient, and that may be directly reproduced in paper form by that recipient through an automated process."[23] The definition was added to the BCA by amendment in 2009[24] to permit certain notices to shareholders to be given electronically, and is a technology-neutral definition.

In recommending this legislation, the commission recognized that the law needed updating to reflect the reality of corporate practice: "The commission believes that, in addition to the historic practice of approving action by written consent, directors already approve action by electronic transmission. In light of changes in technology, the commission believes that it is appropriate to clarify that directors may use electronic transmissions to approve corporate actions."[25]

P.L.2017, c.364:[26] *An act concerning corporate books and records and amending N.J.S. 14A:5-28*

This law permits corporations to impose reasonable limitations or conditions on use or distribution of books and records by shareholders. In amending the existing section of the BCA which addresses inspection of corporate records, the type of limitations or conditions are

not set forth explicitly, but insight can be found in the legislative statement accompanying the underlying bill:

> Due to significant changes in technology that have occurred and the related ease by which materials may now be used and disseminated, the sponsor has proposed this bill to allow corporations to continue a common practice, which has developed, to condition the receipt of requested materials on, for example, the demanding shareholder agreeing to customary confidentiality obligations. However, the bill is not intended to provide a corporation with a right to deny access to a demanding shareholder of materials which the demanding shareholder is otherwise entitled.[27]

In closing, as a practice pointer, while all of the new public laws took effect immediately upon approval by the governor on Jan. 16, not all of the reforms will automatically benefit corporations. Rather, amendments to corporate governing documents are required to implement several changes. Bylaw revisions are necessary related to the corporation's proxy solicitation materials and forum selection matters, and the certificate of incorporation may need to be amended depending upon the corporation's desire for applicablilty of certain derivative action provisions (and whether or not they heeded Stuart Pachman's cautionary words[28] and previously amended their certificate of incorporation to address derivative actions).

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Endnotes

1. The legislation was signed by Governor Christie on Jan. 16, 2018.
2. P.L.1989, c.163, N.J.S.A. §1:14-12 *et seq*.
3. Response to FAQ: Why do so many companies incorporate in Delaware? https://corp.delaware.gov/faqs/. The Delaware Division of Corporation also boasts of the Delaware Court of Chancery, and its state government as being business-friendly and accessible and the division being a model of "state-of-the-art efficiency."
4. FY 2018 Annual Report Statistics Message from the Secretary of State, Jeffrey W. Bullock https://corp.delaware.gov/stats/.
5. NJSBA Capital Report dated Jan. 8, 2018.
6. NJSBA Capital Report dated Dec. 11, 2017.
7. Introduced in the 2010-2011 Legislative Session as bill number A-3252, identical bill number S-2495; reintroduced in the 2012-2013 Legislative Session as bill number A-2715, identical bill number S-550; reintroduced in the 2014-2015 Legislative Session as bill number A-2928, identical bill number S-3292 and reintroduced in the 2016-2017 Legislative Session as bill number A-2973, identical bill number S-2239.
8. N.J.S.A §14A:5-31.
9. Introduced in the 2012-2013 Legislative Session as bill number A-3839; reintroduced in the 2014-2015 Legislative Session as bill number A-2482, identical bill number S-3290 and reintroduced in the 2016-2017 Legislative Session as bill number A-2161, identical bill number S-2237.
10. N.J.S.A. §14A:10-4.1(3), the new provision added by this law, refers to filing with the secretary of state. However, the location for business entity filings was transferred from the Department of State to the Department of the Treasury per Executive Reorganization Plan 004-1998, at this time referred to as the Division of Commercial Recoding and now known as the Corporate Filing Unit of the Division of Revenue and Enterprise Services.
11. Introduced in the 2014-2015 Legislative Session as bill number A-2483, identical bill number S-3291 and reintroduced in the 2016-2017 Legislative Session as bill number A-2162, identical bill number S-2234.
12. N.J.S.A. §14A:2-9(4).

13. N.J.S.A. §14A:2-9(5).
14. N.J.S.A. §14A:2-9(5)(b).
15. Introduced in the 2014-2015 Legislative Session as bill number A-3614, identical bill number S-3294 and reintroduced in the 2016-2017 Legislative Session as bill number A-2970, identical bill number S-2236.
16. P.L. 2013, c.42 effective April 1, 2013.
17. N.J.S.A. §14A:3-6.
18. N.J.S.A. §14A:3-6.1 to 3-6.9.
19. *See* Senate Commerce Committee Statement to Assembly Bill No. 3123, dated Jan. 14, 2013.
20. N.J.S.A. §14A:3-6.9.
21. Stuart L. Pachman, The Derivative Action Statute That Isn't There, *NJSBA Business Law Section Newsletter*, Vol. 37, No. 2 (Sept. 2013).
22. Introduced in the 2014-2015 Legislative Session as bill number A-3612, identical bill number S-3293 and reintroduced in the 2016-2017 Legislative Session as bill number A-2971, identical bill number S-2235.
23. N.J.S.A. §14A:1-8.1.
24. P.L. 2009, c.176 effective Jan. 11, 2010.
25. Assembly Commerce and Economic Development Committee Statement to Assembly No. 2971 dated Nov. 30, 2017.
26. Introduced in the 2014-2015 Legislative Session as bill number A-3615, identical bill number S-3295 and reintroduced in the 2016-2017 Legislative Session as bill number A-2975, identical bill number S-2238.
27. Assembly Commerce and Economic Development Committee Statement to Assembly No. 2975 dated Jan. 12, 2017 and Senate Commerce Committee Statement to Assembly No. 2975 dated June 19, 2017.
28. *See* Pachman, *supra*.

Key Points for M&A Activity Under the New Tax Law

by Doug Collins

The Tax Cuts and Jobs Act (TCJA) brings both opportunities and concerns to the planning and execution of merger and acquisition (M&A) transactions. It can provide advantages to both sellers and buyers if deals are structured with a full understanding of these changes to the tax code.

The TCJA predominately impacts tax years beginning with 2018. A variety of changes, some of them temporary, affect due diligence, negotiations, pricing and how transactions are structured. These include:

- full capital expensing of qualifying assets, including 100 percent expensing of capital acquisitions
- a significant drop in the corporate tax rate to 21 percent from the previous level of 35 percent
- removal of the corporate alternative minimum tax (AMT); the individual AMT is retained with higher exemption amounts
- increase of long-term capital gains from carried interest to three years from one year
- a reduced deduction of 20 percent for qualifying pass-through income from partnerships and S corporations
- reduction in the value of a company's net operating losses (NOLs)

What do practitioners need to keep in mind as they review their clients' M&A plans and decisions under the TCJA?

Consider the Changes for Pass-Through Entities (PTEs) and Corporations

The TCJA now allows a deduction of up to 20 percent by non-corporate taxpayers of qualified business income (QBI) received from a pass-through business, such as S corporations, partnerships, limited liability companies (LLCs) and sole proprietorships.

The TCJA has placed many owners of pass-through entities at a similar level of deductions as owners of C corporations. If the client is on the buyer's side of the transaction, the client may benefit from having a pass-through entity purchase and own the business they are acquiring. When clients are looking at current acquisitions practitioners must consider the impact of the tax rate changes, especially the reduced tax rates on the acquisition, and how they apply based on whether it is a C corporation or a PTE. It is also critical to understand whether the acquisition will qualify for the Section 199A deduction. There is considerable uncertainty for many types of businesses regarding whether they will qualify for the 199A deduction.

In order to understand what is best for a specific M&A situation the buyers and their legal and accounting professionals need to know the long-term plans for the business, as well as the implications of dividends and distributions. In the past, a PTE was almost always a preferred choice, but now one has to consider whether a C corporation is a more advantageous choice. One caution about choosing a C corporation is if the tax rates increase a subsequent conversion to a PTE presents many challenges.

Take Advantage of Capital Expensing

One significant benefit under the TCJA is that businesses can now fully expense certain capital acquisitions. Bonus depreciation is set at 100 percent for properties, both new and used, placed in service after Sept. 27, 2017, and before Jan. 1, 2023. At that point, the depreciation rate begins to drop by 20 percent a year until being eliminated in 2027. Not all properties are eligible; they must have a depreciable life of 20 years or less and must meet the expanded definition of qualified improvement property.

In addition, the limits for Section 179 of the TCJA increased to $1 million and includes qualifying improvement property, roofs, HVACs, alarm and fire protection systems, and security systems. A cost segregation study can help clients determine how they can benefit from these changes.

Consider Assets and Depreciation in Partnership Terminations

Previously, when a partnership interest of more than

50 percent was transferred it was considered a technical termination for tax purposes. The partnership, therefore, had to begin its depreciation again in terms of net book value of tangible assets. The TCJA removed the technical termination rules, including having to restart the depreciation. In addition, because it also made used property eligible for depreciation, business owners may be able to include this in their M&A transactions.

Therefore, buyers and sellers need to look carefully at the advantages of asset sales. It also puts more emphasis on purchase price allocations within the terms of the transaction. A practitioner may also wish to encourage clients to talk to their accountants about the timing of capital expenditures related to M&A transactions if they need to expand the business infrastructure.

Understand the Current Value of Net Operating Losses

The value of a company's NOLs has decreased under the TCJA. NOLs occurring in 2018 and future years can only offset up to 80 percent of taxable income, and can no longer be carried back to prior years. However, they can be carried forward indefinitely.

If clients have NOLs prior to 2018, those may be carried back two years or carried forward 20 years, and used to offset 100 percent of taxable income, just as they were before TCJA. This makes the NOLs incurred before 2018 more valuable than those arising today. This might increase the price of an M&A target. If a client is in the buyer position they will need to perform due diligence to make sure the NOLs exist, can be monetized as expected, and can be used by the buyer. In addition, the value of NOLs arising in 2018 and later has decreased because of the new 80 percent limitation.

However, the TCJA also eliminated the corporate AMT, which can potentially change the value of a business's NOLs to the buyer. Understanding the true value of any NOLs that are included in the purchase price of a business a client may be seeking to acquire is essential.

Watch Out for Short-Term Carried Interests

Investors wishing to take advantage of the carried interest provisions of the acquisition will now need to hold the investment for three years to get the long-term capital gains treatment. This is a change from one year under the previous tax code.

The three-year change of the TCJA applies to partnership interests in the fields of investing or in developing rental or investment real estate, cash or cash equivalents, securities, commodities and options or derivative contracts. It is possible this change could affect deals currently on the table, because they have not been specifically exempted. This means interest received in 2016 or 2017 and disposed of in 2018 is subject to the three-year rule rather than the previous one-year rule.

Make sure clients are paying attention to short-term capital gains versus long-term under the three-year requirement for any current M&A transactions.

Be Aware of Business Interest Deduction Limitations

When considering leveraged buy-out acquisitions, clients must also consider the new business interest deduction rules and limitations, and how they will impact the operations of the business. Under the TCJA, business interest deductions are limited to 30 percent of earnings before interest, taxes, depreciation and amortization, but additional amounts can be carried forward.

This applies to businesses with over $25 million in average annual gross revenue for the past three years, regardless of business structure (C corporation or PTE). Real property and trade or business may elect out of the limitation if they choose a less advantageous depreciation method. Because outstanding debt is included, highly leveraged companies may be hard hit by this limitation of deductions for existing debt. This makes M&A transactions involving those businesses less desirable than in the past.

Prepare for Limitations on 1031 Exchanges

Under the TCJA, 1031 exchanges no longer apply to personal property. This is particularly an issue when a taxpayer has real property that also includes personal property.

For example, if a client is selling a 200-unit complex and buying a 400-unit complex in a 1031 exchange, now all the personal property is taxable in that exchange. This can include office equipment, furniture, dishwashers, stoves, washers, dryers, drapes, tools and other equipment. Part of the transaction proceeds must now be allocated to personal property and reported accordingly, which can have a significant impact on real estate transactions.

Understand the Value of Asset Purchases

Asset purchases are likely to rise in 2018 and the

following years, for reasons described below. However, stock purchase buyers can also benefit through tax code sections 338(h)(10) or 336(e). Qualifying taxpayers can treat a stock sale as an asset sale for tax purposes. This gives buyers the tax benefits of the immediate deduction for equipment and depreciable assets.

The TCJA not only eliminates the corporate alternative minimum tax, but it also dropped the corporate tax rate from 35 to 21 percent. In addition, individual tax rates have been reduced in most brackets with a new maximum rate of 37 percent.

Because of the lower corporate and individual tax rates, sellers may be more open to selling assets, since they stand to gain more than in previous years. At the same time, buyers are also attracted to asset purchases due to the tax code changes that let them immediately deduct equipment costs and depreciable assets.

Conclusion

Last year, small business transactions hit record highs, and that momentum is expected to continue through 2018. The TCJA can give buyers greater cash flow at the same time that the Small Business Administration has lowered the down payment to 10 percent (from 25 percent) for business acquisitions. Despite recent increases, interest rates are historically low. As mentioned above, the corporate tax rate was dropped to 21 percent (from 35 percent), individual tax rates have been reduced, and for the next five years, companies can expense 100 percent of expenditures on qualified property.

If clients are considering selling, they may want to:

Clean up their financials. Consider removing nonessential items such as underperforming segments, non-operating assets, shareholder loans and minority investors. This allows buyers to focus on the core strengths of the business.

Focus on strengths. Private business owners nearing retirement may lose the drive to grow their businesses and operate their companies as a 'cash cow.' However, buyers are generally interested in a company's future potential. Achieving top dollar requires a tack-sharp sales team, a pipeline of research and development projects, well-maintained equipment and a marketing department that is strategically positioning the company to take advantage of market changes and opportunities.

Create a tax-aware offer package. With all the changes brought by the TCJA, sellers will want to make sure they offer potential buyers fixed asset registers and inventory lists, in addition to business plans and financial projections, working capital analyses, quality of earnings reports and more.

Keep confidentiality in place. Before clients give out any information or allow potential buyers to tour their facilities, remind them to require a confidentiality agreement to protect their proprietary information.

If clients are buying, be aware that 2017 was even more of a seller's market than 2016, with sellers realizing, on average, 99 percent of their asking price. If they are paying top dollar for an acquisition, make sure they have considered the tax changes above and are structuring the deal to put themselves in the most advantageous position for years to come.

The list above does not detail all of the changes brought by the TCJA that could pertain to M&A transactions. ■

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Recent Decisions Inform Conversations About Confidentiality Agreements

by Noel D. Humphreys

When one business party is about to reveal information to another business party, the parties often try to define in a confidentiality agreement what information the receiving party must treat as confidential. The disclosing party often wants everything it provides or discloses to be treated as confidential. However, a receiving party often wants the scope of confidential information to be limited to trade secrets.

It is important that business clients seeking to enforce nondisclosure agreements understand what constitutes a trade secret and what is necessary to protect its trade secrets.

New Jersey,[1] like many other states, has adopted (with certain variations) the Uniform Trade Secrets Act.[2] Under New Jersey's Trade Secret Act (NJTSA), a trade secret is defined as information, held by one or more people, without regard to form, including a formula, pattern, business data compilation, program, device, method, technique, design, diagram, drawing, invention, plan, procedure, prototype or process, that:

1. derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
2. is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[3]

A disclosing party seeking to protect its trade secrets can move for injunctive relief and/or monetary damages, depending on the circumstances.

Recent cases suggest that a company seeking to enforce restrictions on the use or disclosure of a trade secret (for example, through an injunction) must demonstrate that: 1) the information is, in fact, a trade secret, 2) the company derives economic value from the fact that competitors do not know the information at issue, and 3) the data has been misappropriated. If the moving party is unable to prove any one of these elements, it is unlikely to be successful in enforcing the restrictions on disclosure.

In a recent decision (the *K-Deer* decision), Bergen County Chancery Judge Edward A. Jerejian, on summary judgment, dismissed a NJTSA count due to the plaintiff's failure to prove the elements of the claim. In that case, the judge found the "[p]laintiff has not provided anything, other than its self-serving statements, to support that the information retained by [the defendant] constitute[s] trade secrets."[4]

In that case, the plaintiff company brought a claim under the NJTSA against a former employee (the chief financial officer) who it claims retained or misappropriated certain 'confidential' information of the company following termination of employment. As evidence of her wrongdoing, the plaintiff pointed to the defendant's LinkedIn page, where she claimed "that she '[m]anaged business from a loss in 2014 to over $300,000 in earnings before taxes.'" Judge Jerejian dismissed the plaintiff's contention that this constituted a trade secret, writing, "although plaintiff may not want its earnings to be publicly known, plaintiff has failed to demonstrate that such information [d]erives independent economic value, actual or potential, from not being generally known."[5] The court also did not treat the acquisition of the contested data as misappropriation under the statutory definition.[6] In doing so, the court focused on how the defendant came to possess the data.

On the other hand, in another recent New Jersey decision,[7] the plaintiff persuaded Judge Patrick DeAlmeida, of the New Jersey Tax Court, that a particular abandoned contract of sale of real property should be protected by a protective order. The argument was that a potential purchaser of the property would be advantaged by knowing the amount for which the seller had previously agreed to sell the property.

Recently, Nevada's Supreme Court starkly called attention to the requirement for a plaintiff to provide adequate proofs regarding misappropriation of a trade secret.[8] Like New Jersey, Nevada adopted the uniform

Trade Secrets Act[9] (with slight variations), and the elements of New Jersey's definition and Nevada's definition are similar.

In the Nevada case, a Peppermill Casinos employee took information about Grand Sierra Resorts' slot machine payouts in an unauthorized manner. In fact, the Nevada gaming commission fined Peppermill Casinos a million dollars for its employee's information thefts.

This stolen data, known as 'theoretical hold percentage information' or 'par values,' reveals how much the house keeps from its slot machines. Grand Sierra Resorts claimed the stolen data constituted a trade secret. The question for Nevada's Supreme Court arose in the context of contested jury instructions. Was the par value information a trade secret? The trial court jury found it was not.

In a 1974 decision, the U.S. Supreme Court wrote that maintenance of moral standards was a fundamental goal of trade secret law:

> The maintenance of standards of commercial ethics and the encouragement of invention are the broadly stated policies behind trade secret law. 'The necessity of good faith and honest, fair dealing, is the very life and spirit of the commercial world.'[10]

That case established that a state could enforce its trade secret law regardless of whether the underlying invention was patentable. Chief Justice Warren Burger filled the majority opinion with policy arguments about economic efficiency and incentives that trade secret law creates to benefit the public. He wrote:

> Trade secret law and patent law have co-existed in this country for over one hundred years. Each has its particular role to play, and the operation of one does not take away from the need for the other. Trade secret law encourages the development and exploitation of those items of lesser or different invention than might be accorded protection under the patent laws, but which items still have an important part to play in the technological and scientific advancement of the Nation. Trade secret law promotes the sharing of knowledge, and the efficient operation of industry; it permits the individual inventor to reap the rewards of his labor by contracting with a company large enough to develop and exploit it. Congress, by its silence over these many years, has seen the wisdom of allowing the States to enforce trade secret protection. Until Congress takes affirmative action to the contrary, States should be free to grant protection to trade secrets.[11]

The Nevada Supreme Court ignored the U.S. Supreme Court's approach emphasizing economic policy based on 'commercial ethics.' Instead, the Nevada Court focused on the plain language of the statute. The Court decided that Grand Sierra Resorts had "failed to prove by a preponderance of the evidence that its par information obtained by [Peppermill] was not readily ascertainable by proper means."[12]

For the par value information to constitute a trade secret, the plaintiff should have demonstrated that people in general (other than the defendant) could not have figured out the par value data for Grand Sierra Resorts' slot machines. Having failed to provide that evidence, Grand Sierra Resorts was not able to make out a trade secrets theft claim against its cross-town rival. The Nevada Supreme Court affirmed the lower court's denial of a motion for a new trial.

Unlike the defendant in the *K-Deer* case, the defendant in the *Grand Sierra Resorts* case possessed the contested data because its employee stole it. Theft does fit the definition of misappropriation. However, the decisions in both cases demonstrate that misappropriation is not enough. The contested secret has to fit the trade secret definition before the presence or absence of misappropriation comes into play. It's the plaintiff's job to make that case.

If a disclosing party wants to enforce a contract requiring confidential treatment of information that constitutes trade secrets, the disclosing party will probably need to provide proofs of what data constitute trade secrets. Business lawyers drafting and advising clients regarding nondisclosure agreements should advise them of the uphill battle they will face in trying to enforce these agreements. Business lawyers also should assist clients in establishing early on the bases for claiming a piece of information is, in fact, a trade secret. ■

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Endnotes

1. N.J.S.A. 56:15-2.
2. http://www.uniformlaws.org/shared/docs/trade%20secrets/utsa_final_85.pdf.
3. N.J.S.A. 56:15-2.
4. *Kristine Deer, Inc. v. Booth*, No. C-29-16, 2017 BL 314239 (N.J. Super. Ct. Ch. Div. July 28, 2017).
5. *Id.*
6. N.J.S.A. 56:15-2. "Misappropriation" means:
   (1) Acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or
   (2) Disclosure or use of a trade secret of another without express or implied consent of the trade secret owner by a person who:
      (a) used improper means to acquire knowledge of the trade secret; or
      (b) at the time of disclosure or use, knew or had reason to know that the knowledge of the trade secret was derived or acquired through improper means; or
      (c) before a material change of position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired through improper means.
7. *Merck Sharp & Dohme Corp. v. Twp. of Readington*, No. 004383-2016, 2016 BL 429257, 2016 WL 7429520 (N.J. Tax Ct. Dec. 22, 2016).
8. *MEI-GSR Holdings, LLC v. Peppermill Casinos, Inc.*, 416 P.3d 249 (2018).
9. http://www.uniformlaws.org/shared/docs/trade%20secrets/utsa_final_85.pdf.
10. *Kewanee Oil Company v. Bicron Corporation et al*., 416 U.S. 470, 481-482 (94 S. Ct. 1879, 40 L.Ed.2d 315)(1974).
11. 416 U.S. at 493.
12. 416 P.3d 249, 253.

Significant Provisions of the Tax Cuts and Jobs Act Affecting Closely Held Businesses and Their Owners

by Gerald A. Shanker

The Tax Cuts and Jobs Act[1] (TCJA) made significant changes to the Internal Revenue Code of 1986, affecting individuals, U.S. businesses, and international taxpayers. This article will discuss selected business provisions of the TCJA, and certain individual provisions affecting owners of pass-through entities.

Three significant TCJA provisions affecting closely held businesses and their owners are:

- Reduction of corporation and individual tax rates
- Introduction of Section 199A, which provides for a tax deduction of 20 percent of qualified business income, subject to limitations and exclusions
- $10,000 annual limit on deduction of real estate taxes and state and local income taxes

Corporate Tax Rates

Under pre-TCJA law, corporations were taxed at graduated rates of 15 percent on taxable income of $0 to $50,000, 25 percent for taxable income of $50,001 to $75,000, 34 percent for taxable income of $75,001 to $10,000,000, and 35 percent for taxable income over $10,000,000. Personal service corporations (defined in Section 448(d)(2)) did not have the advantage of graduated rates and were taxed at a flat 35 percent rate, on all income.

For tax years beginning after Dec. 31, 2017, the corporate tax rate now is a flat 21 percent rate.[2] This rate also applies to personal service corporations.

Because of this decrease in corporation tax rates, many S corporation owners and their advisors are considering revocation of the S election, and partners, limited liability company (LLC) members, and sole proprietors are considering changing their form of organization to a C corporation. However, to avoid potential pitfalls, the consequences of such a change must be analyzed.

In situations where the business may be sold in the future, the tax savings from the immediate rate reduction may be significantly less than the additional tax on the sale of the business assets and distribution of the after corporate tax sales proceeds to the shareholders. In a business sale transaction, purchasers typically favor structuring the transaction as an asset purchase rather than a stock purchase. When an S corporation or partnership sells its assets, the gain on the sale is passed through to the shareholders/partners, who pay a single tax (personal income tax) on the transaction. When assets are sold by a C corporation, the corporation pays tax on the gain and distributes remaining cash to its shareholders, who are then taxed on the distribution.

As shown in the following example, the total tax paid by a C corporation is almost double the tax paid by pass-through entities.

		C Corp	Pass Through
Selling price	$	100.00	100.00
Basis		–	–
Gain		100.00	100.00
Corporate tax at 21%		21.00	–
Available for distribution		79.00	100.00
Personal tax at 20%		15.80	20.00
Net to shareholders/partners		63.20	80.00
Total tax	**$**	**36.80**	**20.00**

As shown in this example, the total on a $100 gain is $36.80 for a C corporation and $20 for an S corporation or partnership. Although conversion from a pass-through entity to C corporation may result in immediate tax savings equal to the difference between the shareholders'/partners' personal tax rates and 21

percent, these saving will not offset the additional tax on a sale of the business. It should be noted that this example ignores the effect of Section 1411 net investment income tax and state income taxes, and assumes all assets qualify for long-term capital gain treatment.

Other factors to consider in determining whether to convert from a pass-through entity to a C corporation include, but are not limited to:

- **Distribution vs. Reinvestment—**Entities that reinvest income in the business rather than distribute to owners may find it advantageous to pay tax on such income at 21 percent rather than the owners' personal tax rate.
- **Debt Service—**Entities using taxable income to repay significant debt principal will benefit by paying 21 percent tax on this income, leaving more funds available for debt repayment and/or operations.
- **State Income Taxes—**As will be discussed later in this article, the TCJA has effectively eliminated the federal tax deduction for state income taxes paid. As pass-through entity owners are generally responsible for paying federal and state income tax on their share of taxable income, state taxes are paid on business income with no federal tax benefit. Since C corporations are subject to state income taxes, and there is no limitation on the deductibility of state income taxes by C corporations, the full tax benefit of paying state income taxes will be realized by the C corporation.
- **Other Nondeductible Expenses—**Entities that pay nondeductible expenses such as entertainment, life insurance, penalties and fines, and business meals (50 percent nondeductible) will pay 21 percent tax on these items rather than at the owners' personal tax rate.

Individual Tax Rates

Under pre-TCJA law, individual income tax rates ranged from 10 to 39.6 percent. The 39.6 percent rate was applicable to all taxable income in excess of $418,400 for single individuals and $470,700 for married filing jointly. The TCJA lowers the top rate to 37 percent and applies this rate to income over $500,000 for single individuals and $600,000 for married filing jointly.[3]

Section 199A Deduction

For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the TCJA adds Section 199A, under which a taxpayer that has qualified business income from a partnership, S corporation, or sole proprietorship may generally deduct, subject to limitations, 20 percent of the combined qualified business income for the tax year.[4] The effect of this provision is a tax rate reduction from 37 to 29.6 percent on qualified business income.

The 20 percent deduction is not allowed in computing adjusted gross income but is allowed as a deduction in reducing taxable income. For taxpayers with taxable income below the threshold amount of $315,000 for married filing jointly and $157,500 for others, the limitations and exclusions do not apply. The threshold amounts are phased out for taxable income between $315,000 and $415,000 for joint filers and $157,500 and $207,500 for others. For taxpayers with qualified business income and whose taxable income exceeds the threshold amount, the following limitations apply:

1. 50 percent of the W-2 wages with respect to the qualified trade or business, or
2. The sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all 'qualified property.' Qualified property is tangible, depreciable property that is held and available for use in the qualified trade or business at the close of the taxable year, which is used at any point during the tax year in the production of qualified business income, and the property's depreciable life has not ended before the close of the tax year.

The second limitation was added to benefit the real estate industry, where low wages and high-cost depreciable property are common.

The deduction does not apply to specified service trade or business. A specified service trade or business is a business involving the performance of services described in Section 1202(e)(3)(A), including health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. Although this code section includes engineering and architecture in the list of service professions, the TCJA excludes these professions from the definition of specified service trade or business.

When owner(s) of a specified service trade or business's taxable income exceeds the thresholds, the Section 199A deduction is reduced or eliminated.

Many such owners and their tax advisors are exploring ways to qualify for this deduction. For example, a law firm might bifurcate its activities into separate entities, consisting of an entity that performs non-qualifying specified services, and an entity that performs other functions. The following activities are some that may be structured to generate taxable income that may qualify for the 199A deduction:

- Office lease(s)
- Equipment leases
- Word processing
- Document printing and production
- Non-professional staffing
- Information technology
- Bookkeeping
- Firm management

The Internal Revenue Service (IRS) has yet to issue regulations or guidance on Section 199A. When issued, it is possible that regulations will render business restructuring ineffective in qualifying for the 199A deduction if the restructured businesses share direct or attributed ownership, or the commonly owned businesses provide the majority of their products or services to a specified service trade or business.

Limitation on Tax Deductions by Individuals

The TCJA imposes a new $10,000 annual limitation on the deduction of real estate and state and local income taxes by individual taxpayers, regardless of the source of the income giving rise to the taxes.[5] Since the majority of closely held businesses are operated as pass-through entities, this limitation effectively eliminates the federal tax deduction for state and local income taxes paid on business income.

The Connecticut General Assembly has enacted, and Governor Dannel Malloy is expected to sign (and New York and New Jersey have proposed), legislation to impose entity-level taxes on the income of pass-through entities, with an accompanying credit for these taxes to be utilized by the owners of the pass-through entities on their state personal income tax returns. Since entity-level taxes are legal obligations of the business, they should be deductible expenses on the entity's federal tax return, just as they would be if the entity were a C corporation.

In addition to the significant provisions identified at the beginning of this article, the following other TCJA provisions may affect closely held businesses and their owners.

New Limitations on Excess Business Loss

For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, a noncorporate taxpayer's 'excess business loss' is disallowed.[6] Under the new rule, excess business losses are not allowed for the tax year but are carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent tax years. The effect of this provision is that business losses in exceeding threshold amounts may no longer be used to offset interest, dividend and capital gain income. This limitation applies after the application of the passive activity loss rules set forth by Internal Revenue Code Section 469.[7]

An excess business loss for the year is the excess of aggregate deductions of the taxpayer attributable to the taxpayer's trades and businesses, over the aggregate gross income or gain of the taxpayer, plus a threshold amount. The threshold amount for a tax year is $500,000 for married taxpayers filing jointly and $250,000 for other individuals, with both amounts indexed for inflation.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's or shareholder's share of items of income, gain, deduction, or loss of the pass-through entity is taken into account in applying the limitation for the tax year of the partner or shareholder.

New Holding Period Required for 'Carried Interest'

In general, the receipt of a capital interest for services provided to a partnership results in taxable compensation to the recipient. However, under a safe harbor rule the receipt of a profits interest in exchange for services provided is not a taxable event to the recipient if the profits interest entitles the holder to share only in gains and profits generated after the date of issuance. This provision was effectively employed by hedge fund managers, who receive performance fees as compensation for their services. These performance fees typically consist of a percentage of total fund assets and a percentage of the fund's earnings. The earnings component is often carried over from year to year, until a cash payment is made, usually following the closing out of an investment. This is known as a carried interest. Under pre-TCJA law, carried interests were taxed at favorable capital gains rates instead of as ordinary income.

Effective for years beginning after Dec. 31, 2017, the

TCJA imposes a three-year holding period requirement for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain.[8] If the three-year holding period is not met, the gain will be treated as short-term gain taxed at ordinary income rates.[9]

Certain Self-Created Property Not Treated as Capital Asset

Under prior TCJA-law, Section 1221 specifically excluded certain assets from the definition of capital asset, including inventory, depreciable property, and certain self-created intangibles such as copyrights and musical compositions.

Effective for dispositions after Dec. 31, 2017, the TCJA expands this capital asset exclusion to include patents, inventions, models or designs, and secret formulas, which are held either by the taxpayer who created the property or by a taxpayer with a substituted or transferred basis from the taxpayer who created the property.[10]

Dividends Received Deduction Percentages Reduced

Under pre-TCJA law, corporations that receive dividends from other corporations were entitled to a deduction for dividends received. If the corporation owns at least 20 percent of the stock of the payor corporation, an 80 percent deduction was allowed. Otherwise, a 70 percent deduction was allowed.

For tax years beginning after Dec. 31, 2017, the 80 percent dividends received deduction is reduced to 65 percent, and the 70 percent dividends received deduction is reduced to 50 percent.[11]

Corporate Alternative Minimum Tax Repealed

For years beginning after Dec. 31, 2017, the corporate alternative minimum tax (AMT) is repealed. For taxpayers with AMT credits, the credits may be used to offset regular tax liability and is partially refundable for years 2018 through 2020 and fully refundable beginning in 2021 for AMT credits exceeding regular tax liability.[12]

Expensing, Depreciation, and Capitalization

Section 179 Expense

Under Section 179, a taxpayer may elect to deduct the cost of qualifying property, rather than recover the cost through depreciation deductions. Under pre-TCJA law, the maximum amount a taxpayer could expense was $500,000 of the cost of qualifying property. The $500,000 was reduced by the amount by which the cost of qualifying property placed in service during the year exceeds $2 million.

For property placed in service in tax years beginning after Dec. 31, 2017, the maximum amount a taxpayer may expense under Section 179 is increased to $1 million and the phase-out threshold amount is increased to $2.5 million.[13]

The definition of Section 179 property has been expanded to include certain depreciable personal property used to furnish lodging or in connection with furnishing lodging. The definition of qualified real property eligible for Section 179 expensing is also expanded to include the following improvements to nonresidential real property: roofs; heating, ventilation and air conditioning; fire protection and alarm systems; and security systems.

It is important to note that New Jersey law limits the annual Section 179 expense deduction to $25,000. For New Jersey tax purposes, the cost of property placed in service exceeding this $25,000 limitation is recovered through depreciation deductions.

Bonus Depreciation

Under pre-TCJA law, an additional first-year bonus depreciation deduction was allowed equal to 50 percent of the adjusted basis of qualified property, the original use of which began with the taxpayer. Under the new law, a 100 percent first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023.[14] The additional first-year deduction is allowed for new and used property. This deduction is phased out at the rate of 20 percent per year, starting with property placed in service after Dec. 31, 2022, and will be eliminated after 2026.

New Jersey does not allow any deduction for bonus depreciation.

Cash Method of Accounting

Under pre-TCJA law, a corporation, or a partnership with a corporate partner, was not permitted to use the cash method of accounting if its three-year average annual gross receipts exceeded $5 million. For years beginning after Dec. 31, 2017, the $5 million average annual gross receipts test has been increased to $25 million, regardless of whether the purchase,

production, or sale of merchandise is an income-producing factor.[15]

The exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations are retained, allowing these entities to use the cash method of accounting without regard to the $25 million gross receipts test, so long as the use of the method clearly reflects income.

Business Deductions, Exclusions and Credits

Limits on Deduction of Business Interest

Under pre-TCJA law, interest paid or accrued by a business is generally deductible in the computation of taxable income.

For tax years beginning after Dec. 31, 2017, every business is generally subject to a disallowance of a deduction for net interest expense in excess of 30 percent of the business's adjusted taxable income.[16] The net interest expense disallowance is determined at the tax filer level. However, a special rule applies to pass-through entities, which requires the determination to be made at the entity level.

For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2022, adjusted taxable income is computed without regard to deductions for depreciation, amortization, or depletion. After Dec. 31, 2021, these deductions are included in the computation, effectively lowering the interest deduction limitation.

The amount of interest not allowed as a deduction for any taxable year is treated as interest paid or accrued on the succeeding taxable year, and may be carried forward indefinitely.

Taxpayers with average annual gross receipts for the three-year tax period ending with the prior tax year that do not exceed $25 million are exempt from this interest deduction limitation. Real property businesses can elect out of this provision if they use the alternative depreciation system to depreciate applicable real property used in the trade or business.

Partnerships are subject to an increased limitation, the computation of which is beyond the scope of this article. Any business interest that is not allowed as a deduction to the partnership is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership. The partner may deduct its share of the excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership, the activities of which gave rise to the excess business interest carryforward.

When excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced by the amount of the allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest.

In the event the partner disposes of a partnership interest, the basis of which has been reduced, the partner's basis is increased, immediately before such disposition, by the amount of interest carryforward allocated to the partner, and not deducted.

Modification of Net Operating Loss Deduction

Under prior law, a net operating loss (NOL) could be carried back two years and carried forward 20 years, to offset taxable income in those years. For NOLs arising in tax years ending after Dec. 31, 2017, the two-year carryback provision is repealed and the NOL deduction is limited to 80 percent of taxable income.[17]

Domestic Production Activities Deduction Repealed

Under prior law and subject to certain limitations, a taxpayer could claim a domestic production activities deduction equal to nine percent (six percent for oil and gas) of the lesser of the taxpayer's qualified production activities income or taxable income for the year. For tax years beginning after Dec. 31, 2017, the domestic production activities deduction is repealed.[18]

Like Kind Exchange Treatment Limited

Under prior tax law, like kind exchange nonrecognition treatment was available for a wide range of property, including real estate and tangible personal property held for productive use in the taxpayer's trade or business, or property held for investment purposes.

Effective for transfers after Dec. 31, 2017, the rule allowing deferral of gain on like kind exchanges is modified to allow for like kind exchanges only for real property that is not held primarily for sale.[19]

Employer's Deduction for Fringe Benefit Expenses Limited

For expenses incurred after Dec. 31, 2017, deduction

for entertainment expenses is disallowed and the current 50 percent limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer. For years beginning after 2025, the TCJA disallows the employer's deduction for expenses incurred for meals provided for the convenience of the employer on the employer's business premises. Deductions for employee transportation fringe benefits, such as parking and mass transit, are denied, but the exclusion from income for those benefits received by an employee is retained. No deduction is allowed for transportation expenses that are the equivalent of commuting for the employee, except as provided for the safety of the employee.[20]

Credit for Employer-Paid Family and Medical Leave

For wages paid in tax years beginning after Dec. 31, 2017, and before Jan. 1, 2020, the TCJA allows businesses to claim a general business credit equal to 12.5 percent of wages paid to qualifying employees during any period in which those employees are on family and medical leave, if the rate of payment is at least 50 percent of the wages normally paid to an employee. The credit is increased to as much as 25 percent for wages where the rate of payment exceeds 50 percent. To qualify for the credit, all qualifying full-time employees must be given at least two weeks of annual paid family and medical leave.[21]

Hastily enacted, the TCJA contains many provisions requiring clarification. This article was intended to provide a general overview of its significant provisions. Before taking any action, a tax advisor should be consulted to determine the best course of action based on the taxpayer's specific fact pattern and the applicability of the TCJA. ■

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Endnotes

1. Public Law 115-97 (12/22/2017).
2. §11(b)
3. §1(i).
4. §199A(a).
5. §164(b)6.
6. §461(l)(3).
7. §461(l).
8. §1061(a).
9. §1061.
10. §1221(a)(3).
11. §243.
12. §55.
13. §179.
14. §168(k)
15. §448.
16. §163(j).
17. §172.
18. §199.
19. §1031
20. §274.
21. §45S.

Franchise Agreement Restrictive Covenants: A Brief Overview

by Beth R. Stearns

"I do not want to be arguing over what is in a tuna sandwich."

"It is not as if your products are McDonald's special sauce or KFC's 11 herbs and spices."

"Your non-compete provision does not cover the current location."

These are all similar to statements from judges in actual lawsuits that any franchisor could easily hear from a judge if its franchise agreement did not include a well-drafted non-compete clause.

A franchise agreement memorializes an arrangement between a franchisor and a franchisee wherein the franchisor grants the franchisee a license to operate a business using the franchisee's system. The arrangement typically includes a right on the part of the franchisee to operate under, or to sell or distribute goods or services associated with, the franchisor's trademark or service mark, and involves substantial oversight by the franchisor over, and restrictions on, the way the franchisee operates the business. Franchise agreements typically contain in-term and post-term non-compete provisions, as well as confidentiality and non-disclosure provisions.

From the franchisor's perspective, the prohibited activity in non-compete clauses should be described broadly enough to encompass the entire business/system, including future modifications to the system. For instance, for a restaurant franchise, it should be clear that the franchisee cannot sell the main franchise menu items in its other businesses, including menu items that are added after the commencement of the franchise term. The agreement between the franchisor and franchisee should also forbid the use of the franchisor's trade secrets and intellectual property in the franchisee's other businesses during the term of the franchise relationship and after its termination.

A franchisee will often try to negotiate the non-compete clauses of the franchise agreement, including the right to operate its existing businesses even if those businesses might in some way be competitive with the franchisor's system or certain aspects of the system. For example, a restaurant franchisee may have existing restaurants that sell some of the same menu items as the franchisor's franchised restaurants. Franchisors may want to agree to those limits or exceptions for experienced and desirable franchisees as long as the limits are clear and not overly broad.

The prohibitions on the types of activity a franchisee may engage in usually continue for one to three years after the franchise relationship ends, but the prohibitions on the use of trade secrets and intellectual property post-term should be, and usually are, absolute and forever.

The radius or geographic limits included within franchise agreement non-compete provisions depend upon, of course, the nature of the franchise business system and the locations of the other franchisor- and franchisee-owned locations. Franchise agreements usually prohibit operation of a competing business within a radius of five to 10 miles of franchisor- and franchisee-owned locations. Also, the clause should probably specify that the radius restriction applies both to locations that exist at the date of the franchise agreement and to future locations. One obvious but potentially overlooked radius restriction is the franchisee's location or locations.

The venue of the franchisee's business may impact how the radius or geographic restrictions are defined. For instance, although geographic restrictions are often stated in miles, a franchise agreement for a location in New York City would probably contain a radius restriction based upon city blocks. Similarly, a franchise agreement for a location in an airport would probably have a radius restriction based upon airport terminals.

As is alluded to at the outset of this article, one of the most challenging things about drafting franchise non-compete provisions is to define the prohibited activity broadly enough to cover both the franchise business at the time of execution and later changes to both the franchise system and the type of business operated by the franchise system, but not so broadly that the clause

is vague regarding what is actually covered. A franchisor needs to ensure that its franchisee will not be able to cease operating its franchised business, make a few modifications, and then resume operations as a competitor of the franchisor.

Well-drafted franchise non-compete clauses should protect the franchise system and help avoid or minimize litigation and other disputes in-term and post-term to the franchise agreement. ■

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