LEGAL INSIGHTS
FOR SMALL BUSINESSES AND INDIVIDUALS

OTTOSEN BRITZ KELLY COOPER GILBERT & DiNOLFO, LTD.

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Tax Cuts and Jobs Act of 2017 - a mixed bag for LLCs, partnerships and other pass-through entities

by Ryan R. Morton

Late last year, the Tax Cuts and Jobs Act of 2017 (the "TCJA") dominated headlines. Most of the articles focused on how the tax reform legislation would affect individuals and large corporations. Other types of businesses, which include LLCs, partnerships, and S-corps, received less attention. As the year starts to wind down, those entities need to consider how the TCJA will affect their bottom lines.

New Deduction

The biggest business-related change included in the TCJA is giving pass-through entities (S-corporations, partnerships, sole proprietorships, and LLCs) a new deduction to lower their tax burden. Previously, the income from these businesses was taxed at the individual owner's personal tax rates. Now, however, the owners of these entities might be able to receive a deduction equal to 20% of their "qualified business income" ("QBI"). This new term refers to ordinary income attributable to the business, but it does not include capital gains, capital losses, dividends, interest, annuity payments, or payments made to the owners.

This QBI deduction does not lower the individual's adjusted gross income ("AGI"), but instead reduces the owner's taxable income, like an itemized deduction. If an individual's taxable income is below $157,500, or $315,000 for a married joint filer, that owner will likely qualify for the full 20% QBI deduction. If an owner's taxable income exceeds that number, though, the full deduction would not be available in certain service industries, including most professional services. The deduction would then phase out as the owner's income increases, disappearing at $207,000 (or $415,000 for joint filers).

Additionally, the QBI deduction will only be 20% if that is less than either 1) 50% of the W-2 wages paid to employees or 2) the sum of 25% of W-2 wages and 2.5% of the cost of qualified property (whichever is greater). Qualified property refers to depreciable property owned and used by the business during the tax year. Lastly, the QBI deduction cannot exceed 20% of the owner's taxable income after long-term capital gains and qualified dividends have been deducted.

Essentially, this tax deduction will especially benefit small businesses that have fewer employees and more capital investments (such as real estate, manufacturing, and construction).

Charitable Donations

The "loss limitation" rule prevents partners (and LLC members in a

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The pros and cons of alternative dispute resolution

by Joshua B. Rosenzweig

Since 2006, I have counseled numerous small businesses and individuals in various types of cases from simple contract disagreements to larger construction disputes to complicated trust matters. During my tenure as an attorney, I have tried to accomplish every client goal in a cost-effective, time-efficient manner. On many occasions, I will attempt settlement of a dispute prior to filing a lawsuit. Although settlements sometimes leave clients feeling as though they did not get the "pound of flesh" they desire for being wronged, clients often appreciate efforts at settlement because litigation can be time-consuming and very expensive.

If clients' goals include the avoidance of lengthy delays and the significant expenses that are often attached to going to court, alternative dispute resolution ("ADR") can be an effective substitute.

In most instances, ADR consists of mediation and arbitration. Mediation generally requires that parties to a dispute agree on a neutral third party to act as the intermediary between them, agree on a location to conduct the mediation, and sit in two separate conference rooms for a day or two, while the mediator runs back and forth between the rooms trying to bring the parties to an agreement. Arbitration requires that the parties agree

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partnership-like LLC) from deducting losses from their taxes, if those losses are greater than the tax basis of the partnership or LLC. The TCJA provides an exception to that rule for charitable donations. If the entity makes a charitable gift, the individual partner or LLC member can use that gift to reduce the entity's tax basis, thereby increasing the amount of loss the individual can deduct. This also applies to foreign taxes. If the donated property has appreciated though, the owner does not get that extra benefit deducted from the tax basis.

Partnership Termination

The TCJA also made some statutory changes without direct tax implications. For example, the Act eliminated the "technical termination" rule for partnerships. This rule provided that a partnership automatically ended as soon as 50% or more of a partnership's capital and profits were sold or exchanged. This created several tax-related headaches, if the partnership's tax year ended mid-calendar year, while tax attributes of the old partnership were lost, and a new depreciation period started. Now, a partnership automatically terminates only when the partners no longer carry on the business.

Built-In Losses

There was also some negative impact from the TCJA on certain entities. For example, the TCJA made it more difficult for partnerships (and LLCs that are treated as partnerships) to be sold. The "built-in loss" rule already requires a partnership to reduce its tax basis if an interest in the partnership is transferred with a substantial built-in loss, meaning the adjusted basis of assets exceeds the fair market value by more than $250,000. Under the new law, a substantial built-in loss also exists if immediately after the transfer, the new partner would lose $250,000 under a hypothetical sale.

The effect of these changes could be substantial for small businesses, forcing them to reevaluate their traditional tax planning strategies.

Converting from S-Corp to C-Corp

C-corporations, which are not pass-through entities, received a benefit from the TCJA, as all C-corps will now be taxed at a flat 21% federal income tax rate. Anticipating that this change could lead S-corps to convert to C-corps for the tax benefit, the TCJA also modified the tax implications of that process to discourage such conversions.

When an S-corp transitions to a C-corp, distributions are treated as taxable dividends, as long as they are part of the corporation's earnings and profits ("E&Ps"). However, dividends from accumulated adjustments accounts ("AAAs") generated during the company's life are tax-free. Under the old law, during the "post-termination transition period," the overall distribution of money by the corporation was first used to reduce the basis of the shareholders' stock, up to the AAA amount, thus maximizing tax-free dividends.

The TCJA changes that post-termination transition rule by treating distributions as paid pro-rata from AAAs and E&Ps. Consequently, more of the distributions will be taxable dividends. The previous rule is still in effect, but only for C-corps that: 1) operated as S-corps before December 22, 2017; 2) revoked their S-corp status within 2 years of that date; and 3) have the same owners on that date and the revocation date. Therefore, if the owners of an S-corporation are considering becoming a C-corporation, they should do so within the next year to take advantage of the old post-termination transition period rule.

The effect of these changes could be substantial for small businesses, forcing them to reevaluate their traditional tax planning strategies. Conventional wisdom may no longer be advisable. The TCJA includes several other changes affecting tax and business law for LLCs, partnerships, sole proprietorships, S-corps, and C-corps. Please contact an Ottosen Britz attorney to help you navigate these new rules before the year ends. ■

Alternative dispute resolution

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on an arbitrator (sometimes three depending on the rules agreed to by the parties) to act as a judge who will preside over a quasi-trial wherein the arbitrator considers the parties' evidence and arguments and eventually makes a ruling as to who wins and who loses.

ADR can be an effective means of resolving disputes for parties who seek to avoid going to court. And, depending on the nature of the dispute, such as in contract disputes where there can be a mandatory mediation and/or arbitration clause, the parties may be required to go to ADR before a lawsuit is filed.

There are several benefits to ADR that clients must consider. First, ADR can be a much more cost-effective means of resolving disputes. If mediation is agreed-upon or mandated, the parties, generally, have to prepare a single mediation binder to educate the mediator on their respective positions. Once that mediation binder is prepared and submitted, there are no additional court appearances to make, no depositions to take, and no oral arguments to prepare for leading up to the mediation. Instead, in mediation, the major event is the mediation itself.

If arbitration is agreed-upon or mandated, there are more formal guidelines than in mediation (i.e., there may be multiple telephone conferences with the arbitrator regarding the status of document exchanges, witness presentation, or evidentiary issues), but those events do not require an appearance in court (which generally would include travel time and time sitting in a courtroom waiting for a case to be called). Again, generally, the arbitration process provides a specified amount of time for the parties to produce their witnesses and evidence, and then a hearing takes place.

Second, because mediation and arbitration are more informal than a court proceeding and ultimate trial, the parties may be able to more freely identify for the mediators and/or arbitrators their respective positions without concerns of admissibility. For example, often times in mediation, mediators will attempt to appeal to the parties' sensitivities to get the parties to reach a resolution. The mediators might tell one party how much better it will be for that party to not have a dispute hanging over its head, while at the same time telling the adverse party that it needs to get this dispute resolved because the dispute is impeding growth in other areas of that party's business.

Moreover, the reasons for settling a case are not admissible in court and may often be found improper to discuss. However, the personalities, financial positions, and other events affecting the parties may be information that mediators can use to push parties to resolve a dispute, whereas none of those items would be considered by a judge in a court proceeding.

Third, mediation and/or arbitration can give the parties a sense of control over the process. Clients often do not feel as though they have any control over a dispute once a court case is filed. For instance, clients feel that if the judge rules against them once, the judge will always rule against them. In ADR, clients have a choice about who is the mediator and/or arbitrator.

Although there are significant benefits to ADR, some of which are outlined above, there are also factors weighing against ADR that parties must consider. As an initial point, most people do not know what ADR is, what mediation means, or how arbitration works. Clients also confuse mediation and arbitration. Therefore, simply not knowing what ADR involves can drive clients to file suit despite their counsel's best efforts to explain why ADR might make sense in a particular situation.

Additionally, ADR procedures generally require that parties agree - first, to go to ADR; then, to choose a mediator or arbitrator. The parties have not agreed on anything, which is why one of the parties is sitting in a lawyer's office, and now they are supposed to agree on multiple major factors relevant to resolving their dispute?

Finally, despite the parties' intent that the mediation and/or arbitration bring their particular dispute to a final resolution, it is possible that the mediation and/or arbitration may be non-binding. Therefore, despite the parties' initial intent that ADR bring the case to a final resolution, parties may change their minds, leading to an ADR proceeding being only one step in a longer resolution process.

ADR can be an effective means of resolving disputes between parties that seek to avoid the expenses and delay that come with a battle in court. However, there are drawbacks to ADR that clients must consider. Clients should speak to their attorneys about the pros and cons of ADR before filing suit. ■

The enforceability of "Evergreen" clauses

by Amanda McDonough

Contracts are part of our everyday lives. Big contracts that come to mind include homes and cars. Additionally, many of our smaller everyday services, such as newspaper subscriptions, television and internet services, and music streaming services, involve a contractual relationship. Contracts can be for a set period of time or until a condition is met, or a contract can contain a clause that automatically renews the contract on a regular basis.

An automatic contract renewal clause is often called an "evergreen" clause, named for the trees that are "ever green" year-round. Similarly, an automatic contract renewal clause makes a contract "ever green." Hence, a contract containing an evergreen clause will continue to be valid, unless affirmative steps are taken to terminate the contract.

Any person, firm, partnership, association, or corporation is permitted to include an automatic contract renewal clause in a contract for the sale of products or services. Many contracts containing an evergreen clause can be canceled only during a specific window of time. These contracts can be deceiving and can leave consumers feeling as though an evergreen clause is an unfair trap. As a result, in 2005, Illinois enacted the "Automatic Contract Renewal Act" ("Act"), which sets out requirements for the enforceability of evergreen clauses.

First, the Act requires that an automatic contract renewal clause be clearly and conspicuously stated in the contract. The Act provides that the procedure for cancellation of the contract be conspicuously identified as well. Typically, this means that the clause should be either bolded, capitalized, or underlined to alert the signer to an important piece of information. Additionally, the consumer must be notified, in writing, of the automatic contract renewal clause if the contract term is 12 months or more, and if the contract renews for a specified term of more than one month.

Second, the Act mandates that consumers be given written notice, not fewer than 30 days and no more than 60 days before the cancellation deadline, that their contracts will be renewed pursuant to the evergreen clause. The notice must clearly and conspicuously state that the contract will renew unless the consumer cancels the contract, and how the consumer can access details of the specific clause, along with information regarding the cancellation procedure.

Terminating a contract containing an automatic contract renewal clause can be tricky because, generally, there is a designated window of time to cancel a contract before it renews for another term. The contract term could be months or even years. As a result, an automatic contract renewal clause could force a party to stay in an agreement longer than intended. Since an evergreen clause binds a party to a contract until the consumer cancels the agreement, precautions must be taken to ensure the terms and conditions are made clear to the consumer.

Failure to meet any of the requirements noted above can result in the contract being unenforceable. Questions tend to arise when a party wants to terminate a contract containing an evergreen clause. However, an evergreen clause can be a great benefit to both parties, especially when there is an intent to form a long term contract.

There are a variety of ways in which an automatic contract renewal clause can be drafted to effectuate the ultimate goal of a continuous contract. If you are preparing such a contract or have questions about the enforcement of an evergreen clause, make sure you consult with your attorney to determine the best possible way to achieve your desired result. ■

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