For the Technology and Life Sciences Industries

Key Provisions in the Tax Cuts and Jobs Act (the "Act") with the potential to impact Technology and Life Science Industries

NET OPERATING LOSS ("NOL")

Prior law: An NOL was permitted to be carried back two years and carried forward 20 years.

New law: NOL deductions cannot be carried back for use in prior taxable years, but may be carried forward indefinitely. Additionally, under the Act, NOL carryforwards can only offset 80% of taxable income, determined without regard to the NOL. This change is effective for tax years beginning after December 31, 2017.

Considerations:

- To the extent commercially practical, companies should consider the timing of receipt of taxable proceeds in order to utilize current year losses or NOL carryforwards (to mitigate the inability to carryback losses to prior periods). This is particularly critical for companies that receive significant taxable payments in one tax year that may not be expended until future years, such as, for example:
    - License and collaboration transactions that have large upfront payments or periodic payment terms,
    - Transactions in which companies raise large amounts of capital by selling digital tokens or other crypto-assets (such as through an initial coin offering), and
    - Sales of significant assets or lines of business.
- Companies may consider instead structuring such transactions, where feasible, in a manner that better matches the timing of taxable payments to future projected losses. Restructuring these types of transactions, however, may require alteration of business terms.

RESEARCH AND EXPERIMENTAL EXPENDITURES

Prior law: Certain research and experimental expenditures were not required to be capitalized and were allowed as a current deduction.

New law: The Act requires research and experimental expenditures paid or incurred in tax years beginning after December, 31, 2021 to be capitalized and amortized ratably over a five-year period (15 years for such expenditures attributable to research conducted outside of the United States).

Considerations:

- This change is not effective until tax years beginning after December 31, 2021.
- This change could exacerbate the inability to carryback NOLs (discussed above) (e.g., in connection with license and collaboration transactions) as income will now likely have to be recognized faster than deductions will be recognized from spending proceeds.

INTEREST DEDUCTIBILITY

Prior law: Generally, a deduction for interest expense paid to a related person was limited to 50% of earnings of a business before interest, taxes, depreciation and amortization (EBITDA) if the company's debt to equity ratio exceeded 1.5 to 1.

New law: Under the Act, the deduction for net business interest expense (which includes all interest expense paid to both related persons and third parties) generally is limited to 30% of EBITDA for taxable years before 2022. Beginning in 2022, deductions for depreciation and amortization must be taken into account, so the 30% limit will be applied against EBIT, which will result in many more businesses being subject to the limitation. These new rules, however, generally will not apply to a company for taxable years when the company's average gross receipts, calculated over a 3-year period, do not exceed $25 million.

Considerations:

- Any disallowed deductions may generally be carried forward indefinitely as part of a net operating loss carryforward.

SELF-CREATED INTELLECTUAL PROPERTY

Prior law: Self-created intellectual property was generally treated as a capital asset.

New law: The definition of a capital asset is narrowed and excludes a "patent, invention, model or design (whether or not patented), a secret formula or process" created by the taxpayer or held by a taxpayer that received the property from the taxpayer who created it in a carry-over basis transaction. This change is effective for tax years beginning after December 31, 2017.

Considerations:

- While certain self-created intellectual property is no longer considered a capital asset, the Act retains Section 1235 of the Internal Revenue Code, which treats the transfer of all substantial rights to a patent by an inventor to an unrelated party as a sale or exchange of a long-term capital asset.
- These changes may increase the desirability of corporate subsidiary structures for holding intellectual property, which may avoid these considerations because corporate stock is a capital asset.

CARRIED INTEREST

Prior law: Generally, gain from the sale of a carried interest was eligible for long term capital gain treatment if the interest was held for more than one year, and gain from the sale of a partnership investment was eligible for long term capital gain treatment if the investment was held by the partnership for more than one year.

New law: The Act imposes a special three-year holding period with respect to certain income realized from carried interests. More specifically, starting in 2018, a holder of carried interest will generally need to satisfy a three-year holding period requirement to obtain long-term capital gain rates in respect of:

- Gains from sales or dispositions of investments allocated by the partnership in respect of the carried interest. The holding period will be determined based on the partnership's holding period in the asset which gave rise to the gain.
- Gains from sales or dispositions of the carried interest. In this case, the holding period will be determined based on the holder's holding period in the carried interest.

Considerations:

- Although the new law is not intended to apply to interests issued in operating businesses that are not part of an investment fund, the new law could be relevant for certain companies that have been formed as LLCs.
- Importantly, it is unclear whether this new holding period requirement applies to profits interests issued to employees of certain operating subsidiaries of LLCs or other partnership holding companies in common structures utilized by investors to facilitate multiple liquidity transactions.

DEFERRED EQUITY

Prior law: Individuals who were granted stock options or restricted stock units (RSUs) from their employer generally were subject to income tax with respect to such equity awards when the award is exercised or settled.

New law: Effective after December 31, 2017, employees of private companies are permitted to elect to defer the recognition of income, for up to five years, in connection with the exercise of stock options (including incentive stock options, nonstatutory stock options and shares transferred pursuant to an employee stock purchase plan) or the settlement of RSUs. Once an election is made, the deferred value is determined and will become includible in income (even if the stock value subsequently declines) for the taxable year that includes the earliest of the following events (1) the date five years after the employee's right to the stock became substantially vested; (2) the date the qualified stock becomes transferable, including to the employer (i.e., the date the employee has the ability to sell the stock to any person, including the employer); (3) the date the employee revokes the deferral election; (4) the first date that any stock of the employer becomes readily tradable on an established securities market; or (5) the date the employee becomes an excluded employee (generally, a one percent owner of the company, the CEO or CFO of the company (or a family member of the CEO or CFC) or among the top four highest compensated officers of the company).

Considerations:

- Certain conditions must be satisfied in order to qualify for the deferral election, including that the election is only available for grants made in a calendar year pursuant to a written plan under which at least 80% of the employees of the company who provide services in the United States are granted stock options or RSUs in such year and companies are required to provide notice of the ability to make a deferral election to each eligible employee and there will be penalties on companies that fail to provide the notice.
- Certain high-level employees are excluded from the deferral election.

The applicable conditions make it unclear how usable the deferral election may be in practice.

ACCOUNTING METHODS

New law: When taxable income is computed under an accrual method of accounting, the "all events" test will not be treated as met any later than when that item is taken into account as revenue in an applicable financial statement. Exceptions generally apply for any income item for which a special method of accounting is used. The Act also codifies the deferral method for advance payment of goods and services under Revenue Procedure 2004-34 for non-license transactions (although the implication from the Committee report is that this was not an intentional omission). Change is effective for tax years beginning after December 31, 2017.

Considerations:

- The change to the all events test may accelerate taxable income for companies under certain circumstances. However, the change applies only to taxpayers that have an applicable financial statement, which includes, among other things, a 10-K or other annual statement to shareholders required by the SEC or an audited financial statement used for credit purposes, reporting to shareholders or any other substantial non-tax purpose.
- The provision does not require recognition of income in situations in which income has not yet been realized for U.S. federal income tax purposes.
- This change does not generally apply if a special method of accounting is provided for elsewhere in the Internal Revenue Code. While not entirely clear, it does not seem that this change in income accounting should apply to the treatment of options, licenses or other items of income that are generally subject to deferral under U.S. federal income tax principles.

OTHER SIGNIFICANT CHANGES THAT IMPACT TAX PLANNING AND STRATEGY

New law: The Act includes various provisions that will require reconsideration of domestic tax planning and structuring strategies. Among the changes are provisions that will:

- Lower the corporate income tax rate to 21% (from 35%).
- Provide for more favorable tax rates for income from certain pass-through entities.
- Accelerate deductions for certain types of capital expenditures for property placed in service after September 27, 2017.

In addition, significant changes have been made to U.S. international tax rules, which may alter the considerations relating to various offshoring strategies. Among the changes are provisions that will:

- Impose a one-time mandatory tax on post-1986 accumulated foreign earnings of 15.5% on cash or cash-equivalents and 8% on non-cash assets. Taxpayers may generally elect to pay this tax in installments over eight years.
- Provide for a 100% deduction of foreign-source dividends received by U.S. corporate shareholders from specified 10% owned foreign corporations, which is intended to reduce the incentive to accumulate earnings offshore.
- Require U.S. shareholders of a controlled foreign corporation (a "CFC") to include in gross income on a current basis their share of the CFC's global intangible

low-taxed income ("GILTI").

- In 2018, GILTI is effectively taxed at a 10.5% tax rate for corporate shareholders. The rate increases to 13.125% for tax years beginning after December 31, 2025. These tax rates are higher for non-corporate shareholders of a CFC.

- Provide a preferential tax rate for foreign-derived intangible income ("FDII") of a domestic corporation, which relates to certain patent-box-like regimes.
    - In 2018, FDII is effectively taxed at a 13.125% tax rate for corporate shareholders. The rate increases to 16.406% for tax years beginning after December 31, 2025. These tax rates are higher for non-corporate shareholders of a CFC.

Except as noted above, the changes discussed in this section generally are effective for tax years beginning after December 31, 2017.

Considerations:

- As a result of these new rules, it may be advisable for certain companies to reevaluate their country of domicile and any offshoring strategies that they are contemplating or have in place.
- The GILTI and FDII rules can be expected to create a tax regime with patent box type preferential rates that require current inclusion of worldwide intangible income.
- The Act may also present planning opportunities with respect to operating as a corporation or pass-through entity. Considerations with respect to entity form include reduced corporate tax rates, lower pass-through tax rates, and qualified small business stock eligibility.

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