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New Choices & Challenges

Working Through Key Issues in the 2017 Tax Act

Introduction

2017 Tax Act

- Signed into law on December 22, 2017
- Provisions generally apply now – to taxable years beginning after December 31, 2017
- Corporate and International changes are "permanent;" almost all individual changes (including the new 20% deduction for qualified business income from passthrough entities) expire Dec. 31, 2025 (there are efforts in Congress to make individual tax changes permanent)
- The volume of new rules coupled with the speed with which the Act went through the legislative process has left practitioners and taxpayers (clients) scrambling to learn, understand and PLAN
- Will likely need corrections but enacting any corrective legislation will be very difficult with the current Congress (would either need 60 votes or would have to use budget reconciliation process (again) – using budget reconciliation will come with challenges (e.g., will likely not be a budget resolution before Spring, 2018 at the earliest; provisions have to have a "revenue effect"))
- No JCT Bluebook yet – only have House, Senate and Conference Committee Reports

Choice of Entity

Rate Differentials

- Corporate rate = 21% plus 18.8% (79%* 23.8% (Qualified Dividend rate of 20% plus NIIT of 3.8%)) for a top marginal rate of 39.8% on dividend distributions to individuals; impact of double taxation is significantly reduced; C corps may be able to use other provisions to lower effective tax rate (e.g., full expensing)
- Top individual rate (37%) plus 3.8% on wages or NIIT, if applicable
- Passive Investor in a Partnership/S Corp (no wage/qualified property limitation) = 32.64% ((100% -20%)*40.8% (37% + 3.8% NIIT)) if you can take advantage of the 20% deduction; 40.8% if you can't
- Active owner of a Partnership or an S corp = rate varies between 30.72% to 40.8% depending upon a number of complicating factors

Use of C Corp?

- Using C corporation as a shelter: to the extent that earnings can be re-invested instead of distributed, the second level of tax can be avoided; important to note that the Act did not eliminate the basis step-up upon death – so if assets remain in the corporation, the second level of tax could be permanently avoided through basis step-up in stock
- In cases in which the owners of a business have no intent to sell (no foreseeable plan to dispose of assets), and are willing to re-invest profits into the business (in lieu of distributing profits), forming (or converting to) a C corporation should be considered
- If a corporation holds investment assets, the corporation can pay much lower rates on the investment income during the investor's lifetime and upon that investor's death, there will be a basis step-up in the stock.
  - Fixed income investments – interest is taxed at up to 40.8% to an individual but at 21% in a corporation
  - Equity investment (stock in another corporation) – dividends taxed at 23.8% to an individual but 10.5% to a corporation (because of the 50% dividends received deduction (50% x 21%))
  - Need to get around the personal holding company rules (20% tax on undistributed passive income earned in a closely held C corporation) and accumulated earnings tax rules (20% tax on companies holding cash at certain thresholds) but there may be ways to do that – these rules will likely take on greater significance again with these changes in rates

Use of C corps, cont.

- Possible use of section 1202 gain exclusion for qualified small business stock (only available if stock is acquired by taxpayer at original issuance; need holding period of >5 years; 100% exclusion)
- Excess Business Losses limitation does not apply to C corporations – under current rules, the ability to use pass-through loss to offset other taxpayer income was a benefit to the use of a pass-through – can now only deduct up to $250,000 ($500,000);
  - The fact that this new loss limitation applies to both active and passive business loss is a significant departure from previous rules pursuant to which a taxpayer could deduct active business losses against non-business income (as long as the other loss deduction limitations (e.g., basis, at-risk) did not apply. In fact, in the context of certain types of start-up companies, an active investor's return on investment in the early years of the venture was based, in part, on the investor's ability to utilize active losses from the business against other income. The excess business loss limitation will drastically reduce the value of these early-year losses.
  - The existence of this new limitation coupled with the fact that the corporate rate under the 2017 Tax Act is 21% may, in certain circumstances, lead to the conclusion that doing business as a C corporation is a better alternative from a tax perspective. As an example, assume that a start-up technology company expects to generate significant losses in the early years of its existence and the business plan envisions a sale of the company a few years down the road (once the business begins to turn a profit). Consideration should be given to operating as a C corporation, especially if the owners can utilize the §1202 gain exclusion for qualified small business stock to eliminate all or a substantial portion of gain on the ultimate sale of the business. There are many factors to consider in the context of choice of entity and many of the provisions in the 2017 Tax Act could affect this determination.

Use of C Corps, cont.

- Changes in International tax provisions serve as an incentive for U.S. partnerships and S corporations with foreign subsidiaries to be structured as C corporations (because only a C corporation can take advantage of the 100% dividends received deduction against dividends from foreign subsidiaries that conduct active businesses outside the U.S.)
- Need to consider costs of conversion (if applicable)
- Need to consider exit strategies – difficult to get out of a C corp

S corp vs. Partnership/LLC

- Although these are both pass-throughs, they are NOT the same – there are many differences that can create issues and there is far less flexibility in an S corp (e.g., no equivalent of "profits interest;" no ability to do special allocations)
- Sometimes beneficial under current rules to take advantage of the reasonable compensation concept with an S corporation to shield the remainder of income distributed to an active owner from self-employment taxes - not as helpful if most of the owners are passive and most of the income is being distributed to them
- With new rules, the way in which the new pass-through deduction rules apply to a particular set of facts may make an S corp or a partnership more or less attractive – dependent upon application of the limitations to the deduction and the taxpayer's income level

S corp vs. LLC – Examples of New Deduction – Example (1)

Assumptions:

- Assume that the trade or business is NOT a specified service trade or business
- Assume that each taxpayer has over $415,000 of other taxable income on their joint returns

S corporation – two owners – one 80% active owner (A) and one 20% passive investor (20%)

Assume $1,000,000 of income, $400,000 of which is paid to A as reasonable compensation; $600,000 is distributed - $480,000 to A and $120,000 to B. Assume that the S corp pays no other W-2 wages and has $500,000 of unadjusted basis in qualified property

A:

Qualified Business Income = $480,000

W-2 wages and qualified property cap = $160,000 (50% of allocable share of W-2 wages ($320,000 – which is higher than 25% of allocable wages plus 2.5% of allocable share of unadjusted basis in qualified property))

Deduction = $96,000 –not limited by cap

B:

Qualified Business Income = $120,000

W-2 wage and qualified property cap = $40,000

Deduction = $24,000 – not limited by cap

Example (1) cont.

Now assume that the entity is a partnership (or LLC taxed as a partnership):

Same facts – assume that A is paid a guaranteed payment of $400,000

A:

Qualified Business Income = $480,000

W-2 wages and qualified property cap = $10,000 (there are no W-2 wages, so the cap is equal to 2.5% of A's allocable share (80%) of the partnership's unadjusted basis in qualified property (2.5% of $400,000 (80% x $500,000))

Deduction = $96,000 – *limited to $10,000*

Note that A will pay the 3.8% additional self-employment taxes on $880,000 ($400,000 guaranteed payment plus $480,000 allocable share of income) = $33,440

B:

Qualified Business Income = $120,000

W-2 wage and qualified property cap = $2,500

Deduction = $24,000 – *limited to $2,500*

Economically Similar Situations – Dramatically Different Results – is this what was intended?

Sometimes Being a Sole Proprietor Yields a Higher Deduction…

- Ignoring the downsides to conducting business as a sole proprietor (e.g., liability issues), consider the following example:

Assume a sole owner of a business with no employees (work done through outside contractors); not a specified service business (taxpayer makes widgets); no qualified property

Assume $250,000 of qualified business income; taxable income on return is under thresholds for limitation

Deduction if sole proprietor = $50,000 (20% of $250,000; no wage/QP limitation)

If S corporation, some amount will be required to be treated as reasonable comp. Assume $100,000. Deduction is only $30,000 (20% of $150,000)

If partnership and t/p is paid a guaranteed payment of $100,000, deduction is only $30,000; if no guaranteed payment, deduction is $50,000

- Interestingly, the sole proprietorship does not yield a better result once taxpayer income is above the thresholds – if taxpayer's income is above $415,000, then:

Deduction if sole proprietor = $0 (no "wages" and no "qualified property" and over taxable income threshold)

Deduction if S corporation and $100,000 of reasonable compensation, deduction is $30,000 (20% of $150,000 with W-2 limit of $50,000)

Deduction if partnership = $0 (again, no "wages" and no "qualified property")

Summary – Use of the Deduction

(1)Results are highly dependent on the interaction between the type of business, the definition of qualified business income; the application of the wage and qualified property limit *and the disparity in the way in which compensation is treated depending on type of business*.

(2)If the wage and qualified property limit is an issue and, therefore, you need the “wages” earned by the active owner to be counted toward that limit, might want to consider an S corp

(3)Choice is specific to FACTS and CIRCUMSTANCES

Takeaways (1)

(1)There is not going to be a “mad dash” to convert to C corporations

(2)There are more “sheltering” opportunities with C corps due to rate changes

(3)The fact that the basis step-up at death was not changed, coupled with the lower corporate rate provides opportunities to leave assets in the corporation, receive step-up to market and never pay the second level of tax (if stock is sold with FMV basis or corporation is liquidated); in limited instances in which owners know that they will not be selling the business and will be leaving profits in the entity to re-invest and grow the company –should discuss with tax advisors and vet use/conversion to a C corp

(4)Exit strategy needs to be considered

(5)The new deduction has added a new layer of analysis and complexity

Takeaways (2)

There is no easy, quick answer to “which entity is better under the new rules?” No one size fits all.

Choice is specific to facts and circumstances…

- The decision got a little more complex with the passage of these new rules - you are now comparing a fairly complicated new deduction (without guidance) that is only applicable through 2025 with a reduced corporate rate that is known and “permanent”
- Even if the bottom line doesn’t change – the conversation is important

Election out of 163(j) Limitation

Section 163(j) Business Interest Limitation

- There is an election out of this limitation available to a “real property trade or business” (defined in 469(c)(7)(C) as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business); also available to a farming business
- BUT there is a cost: the business is required to depreciate its nonresidential real property, residential rental property, and qualified improvement property using the alternative depreciation system (ADS). For property placed in service after December 31, 2017, the ADS recovery period for nonresidential real property is 40 years; the ADS recovery period for residential rental property is 30 years; and the ADS recovery period for qualified improvement property is (supposedly) 20 years. In addition, a real property trade or business that makes this election will not be able to take advantage of bonus depreciation under §168(k).
- Election is irrevocable
- Need to model possible election out

Challenges

The 199A Deduction

The Section 199A Deduction – Open Questions: Application of 469 Grouping Rules

- Are the section 469 (passive loss) grouping rules applicable (e.g., to combine activities for W-2 wage & qualified property limitation or to combine activities in order to qualify as a t/b?) Answer appears to be no. Will create complexity

Example (1):

- Individual A holds interests in Partnership X (retail business) and Partnership Y (entity that manufactures clothing sold to Partnership X). A is passive re: the business of Partnership X but Partnership X has significant payroll. A is active in Partnership Y but Y uses contract manufacturers and has no depreciable assets.
- Assume A receives a K-1 from X showing $1,000,000 ordinary loss and from Y showing $11,000,000 of ordinary income
- The 469 grouping rules will allow A to report ONE activity and net the loss against the income and report $10 million on Schedule E.
- But what about the new deduction? The 469 grouping rules specifically apply only to 469. Nothing in the new rules states that 469 grouping can be applied – so each K-1 would be evaluated separately and because the wage and qualified property limit is zero for Y, A has no deduction.

Example (2):

- What if one entity conducts two qualified trades or businesses? If both businesses are on the K-1, appears that the answer is yes to evaluating them as a combined business.

The Section 199A Deduction – Open Questions: “Reputation or Skill” of Employee or Owner

When is the principal asset of a trade or business the “**reputation or skill” of one or more of its owners or employees?**

- PLR 201717010:
  - Company uses a tool it developed; analyzes the results of testing and provides reports to healthcare providers; reports do not discuss diagnosis or treatment; the skills employees bring to Company are not useful in performing the tests and the skills they develop at Company are not useful to other employers; IRS – company is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees
- PLR 201436001
  - Company provided products and services in the pharmaceutical industry; company worked with clients to help develop successful drug manufacturing processes. Company did research, used physical assets including manufacturing and clinical testing facilities, and also used IP.
  - IRS: “the thrust of …1202(e)(3) is that businesses are not qualified trades or business if they offer value to customers **primarily in the form of services**. In this PLR, the IRS took a narrow view, however, of when the value is primarily in the form of services; looked at whether the services themselves are the end product or whether they are a means to producing a product; IRS - this company was “not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers.”
- **Will similar businesses be treated in a dissimilar manner? [e.g., owner-restaurant versus celebrity-chef restaurant?]**

The Section 199A Deduction – Open Questions: Definition of "Trade or Business"

There is no specific definition of a "trade or business" for purposes of §199A.

- Section 199A does not specifically refer to §162 but the phrase "trade or business" in 199A most likely refers to a §162 trade or business (regular, continuous and substantial). If this is the case, then a rental real estate activity that rises to the level of a §212 activity but not a §162 trade or business would not be a qualified trade or business for purposes of the deduction. There is currently no guidance on the circumstances under which a rental real activity rises to the level of a §162 trade or business for purposes of the 199A deduction.
- The § 1411 (net investment income tax) regulations provide some guidance, but it is not technically applicable to §199A. [*"A, an unmarried individual, rents a commercial building to B for $50,000 in Year 1. A is not involved in the activity of the commercial building on a regular and continuous basis, therefore, A's rental activity does not involve the conduct of a trade or business…"*]
- Additional guidance from the IRS is needed.

The Section 199A Deduction – Open Questions: Gain on Sale of Assets/Interest

- Gain on sale of business? PTP – qualified publicly traded partnership income includes any gain recognized upon disposition of partnership interest to the extent the gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751- but no mention in context of gain from sale of interest in other entities
- Makes sense that a sale of a business asset that generates ordinary income (e.g., cash-basis receivables) should generate income that is considered QBI – but not clear
- Is §1231 capital gain excluded from the definition of qualified business income?
  - Arguably not entirely clear in the statute. According to §199A(c)(3)(B)(i), qualified business income does not include "any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss." That wording would seem to exclude §1231 gain from qualified business income. However, the introductory sentence to the list of items in §199A(c)(3)(B) refers to those items as "investment items" – that wording would imply that §1231 gain is *not* excluded because it is not technically an "investment item." Although it is likely that Congress intended to exclude §1231 gain from qualified business income, clarification would be helpful.

Planning Into the Section 199A Deduction : How might clients re-structure/re-think to take better advantage this deduction?

- If the W-2 Wage and Qualified Property cap would otherwise limit a company's ability to utilize the pass-through deduction: consideration should be given to **re-structuring independent contractor relationships as employment relationships**
- The W-2 Wage and Qualified Property cap does not apply to the 20% deduction applicable to qualified REIT dividends or qualified publicly traded partnership income; ***if this cap would otherwise limit the deduction and the entity is eligible***, **consideration should be given to operating as a REIT or PTP**
- If the deduction is unavailable because the passthrough is operating a specified service business but the entity is also operating a second business that is not a specified service business or the entity is operating an ancillary service, it is not entirely clear how the deduction applies – how are these businesses/activities grouped? **Consideration should be given to separating out a business/activity to which the deduction is available**
- It appears that compensation paid to a partner/LLC member is included in qualified business income BUT wages paid to an employee, a guaranteed payment made to a partner and/or a payment to a person in a non-partner capacity are carved out; **in limited circumstances, consideration should be given to (1) re-structuring employment relationships as partnership interests (does not help unless there is sufficient payroll/qualified property to avoid limitation) and/or (2) use of a profits interest in lieu of a guaranteed payment – there are, of course, significant limitations to the ability to do this**

Challenge: Interaction between the new Audit Rules and the Pass-through Deduction

Reminder – the new audit rules are effective for returns filed for 2018

Of course, like all aspects of tax law, everything is interrelated and the new Tax Act will impact some of the choices under the audit rules

E.g., If a partnership is audited under the new rules and there is an imputed underpayment that the partnership pays, the partnership is paying tax at 37% with no benefit of the pass-through deduction. This is another factor to be considered when evaluating the benefit of a push-out election …

The 163(j) Business Interest Limitation

The 163(j) Business Interest Limitation

- **Taxpayer's deduction for business interest expense cannot exceed (1) the taxpayer's business income plus (2) 30% of the taxpayer's "adjusted taxable income"**
- Adjusted taxable income = (1) items of income, gain, deduction or loss not properly allocable to the trade or business; (2) business interest expense; (3) the new pass-through deduction; and for tax years prior to 2022, the deductions for amortization, depreciation and depletion
- Does not apply to "small businesses" (average annual gross receipts for the three-year annual period ending the prior year of $25 million or less) or certain public utilities; no limit on floor plan financing interest (indebtedness used to finance acquisition of motor vehicles for sale or lease)
- Real property trade or business (as well as farming business or specified agricultural or horticultural cooperative) may elect out of limitation (but this election comes with a cost - discussed more fully later in presentation)
- Disallowed interest expense can be carried forward indefinitely
- Existing debt is not grandfathered

The Section 163(j) Limitation – Open Questions: Consolidated Group

- There has been some question as to how the §163(j) limitation will apply to a consolidated group. On January 25th, at a District of Columbia Bar Community of Taxation event, Brenda Zent, special adviser, Treasury Office of International Tax Counsel, stated that Treasury intends to issue guidance stating that §163(j) will apply on a consolidated basis and taxpayers will not be able to elect to apply it any other way.

The 163(j) Limitation – Application to Partnerships

“Excess Taxable Income”= New Concept

- Equal to the amount (if any) of the partnership’s (or S corporation’s) adjusted taxable income (ATI)(as computed for purposes of §163(j)) that bears the same ratio to the partnership’s (or S corporation’s) total ATI as the unused amount of the 30% of ATI limitation bears to 30% of ATI. The unused amount of the 30% of ATI limitation is the amount by which 30% of ATI exceeds the partnership’s or S corporation’s net business interest expense. The statutory language, written as a ratio, is as follows:

$$\frac{\text{ETI}}{\text{ATI}} = \frac{\text{(30\% of ATI) minus net business interest expense}}{\text{30\% of ATI}}$$

- Put another way, ETI is computed by multiplying ATI by a fraction, the numerator of which is the unused portion of the 30% of ATI limitation and the denominator of which is 30% of ATI, as follows:

$$\text{ETI} = \text{ATI} \times \frac{\text{unused portion of 30\% of ATI limitation}}{\text{30\% of ATI}}$$

Example:

Example:

Partnership WXYZ has 4 equal partners and is subject to the §163(j) limitation. Assume the following in Year One:

- Partnership's Adjusted Taxable Income (ATI) computed under §163(j)(8): $30,000,000
- Business Interest: $3,000,000
- 30% of ATI = $9,000,000 [The Partnership could deduct up to $9,000,000 of business interest under §163(j). However, the Partnership has only paid $3,000,000 of business interest, which means that there is excess taxable income (ETI) to be allocated to the partners.]
- 30% of ATI minus net business interest expense = $6,000,000
- $6,000,000 is what percentage of $9,000,000? = 66.6%
- So, 66.6% of ATI ($30,000,000) is ETI = $20,000,000
- Each partner is allocated $5,000,000 of excess taxable income, which the partner can include in its computation of its own adjusted taxable income for purposes of applying the §163(j) limitation to other business interest.

Application to Partnerships, Cont.

Excess Business Interest Carryforward at Partner Level

- For partnerships with excess business interest (nondeductible because it exceeds the §163(j) limit), that excess is *not* carried forward at the partnership level. Instead, the excess business interest is allocated to the partners. Excess business interest is allocated in the same manner as nonseparately stated partnership taxable income or loss. The *partners* carry forward that excess and it is treated as paid or accrued by the partners in succeeding taxable years but only to the extent of “excess taxable income” (if any) allocated to the partners from that same partnership.
- Only applies to partnerships

Example – statutory language is flawed

- The statutory language governing excess business interest and excess taxable income for partners is problematic and does not seem to lead to the right result.
- First, the statute provides that “excess business interest shall be treated as business interest **paid or accrued by the partner** in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only **to the extent of such excess taxable income** [emphasis added].”
- Second, any portion remaining (excess business interest that has not been treated as paid or accrued under the previous rule), shall be “treated as business interest paid or accrued in succeeding taxable years,” to the extent of excess taxable income in those succeeding years.
- The problem with this language is that it ignores the fact that interest that is treated as paid or accrued by the partner is *not* the same as interest that is deductible by the partner because that interest should be subjected to the §163(j) limitation (similar to the manner in which a carryforward at the corporate level will be subjected to the limitation in succeeding years). If excess business interest is treated as paid or accrued **to the extent of excess taxable income** and only the remaining portion (if any) continues to be carried forward and treated as paid or accrued in future years, then the carryforward is reduced by the amount treated as paid or accrued, not the amount actually deducted (which should be limited to 30% of excess taxable income).

Example, cont.

Consider, for example, a partner whose distributive share of excess business interest in Year One is $1,000,000 and whose distributive share of excess taxable income in Year Two is $1,500,000.

- The statutory language would treat the entire $1,000,000 excess business interest as paid or accrued by the partner in Year Two. But then what? There is only $1,500,000 of excess taxable income from the partnership. The partner should only be able to deduct $450,000 of the excess business interest (30% of excess taxable income). What happens to the remaining $550,000? The statute does not contemplate continuing to carry this forward, but that is not the right result.
- In addition, the language in §163(j)(4)(B)(ii)(II)(flush language) further complicates the analysis. It provides that "excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account [for purposes of the 30% of ATI limit] with respect to *any business interest other than excess business interest* from the partnership until all such excess business interest for such taxable year and all preceding taxable years has been treated as paid or accrued." In this example, all excess business interest has, in fact, been treated as paid or accrued (even though it has not all been deducted), which seems to mean according to this statutory provision that some amount of the excess taxable income is available for the partner to include in its adjusted taxable income when determining whether other business interest can be deducted. Again, this does not make economic sense when there is not sufficient excess taxable income to fully deduct the excess business interest from the partnership.

Example, cont. – Problematic in context of basis rules as well

- The statutory approach is also problematic in the context of the basis rules, as discussed more fully below. A partner's basis is reduced by its distributive share of excess business interest.

- However, upon a disposition of the interest, the partner is able to increase its basis, immediately before the disposition, by the "amount by which the allocated excess business interest amounts (that have previously reduced basis) exceed the excess business interest that has been **treated as paid or accrued by the partner** [emphasis added]."

- Again, because the amount treated as paid or accrued is not the same as the amount actually deducted, this provision does not accomplish its goal of eliminating the basis reduction for amounts that the partner has never been able to deduct.

Statutory Fix?

- Section 163(j)(4)(B)(i) should read as follows: “such excess business interest shall be treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, **but only to the extent of *30% of* such excess taxable income**.”
  - Going back to the example of the partner with $1,000,000 of excess business interest carryforward from Year 1 and $1,500,000 of excess taxable income in Year 2, this rule would treat $450,000 of the $1,000,000 excess business interest carryforward as paid or accrued by the partner in Year 2.
  - The partner would determine the deductibility of that $450,000 against the $1,500,000 of excess taxable income, 30% of which is $450,000. The remaining $550,000 of excess business interest would be carried forward until there was additional excess taxable income from the partnership.
  - There would be no excess taxable income in Year 2 to take into account for any other business interest of the partner because not all of the $1,000,000 excess business interest has been treated as paid or accrued.
  - In addition, if the partner disposed of its partnership interest at the beginning of Year 3, the application of §163(j)(4)(B)(iii)(II) would lead to the right result because basis would be increased by $550,000 (the amount by which the allocated excess business interest amounts ($1,000,000) exceed the excess business interest that has been treated as paid or accrued by the partner ($450,000)). Again, if, instead, the amount treated as paid or accrued had been $1,000,000 (which is the way the statute currently reads), there would be NO increase in basis, which leaves the partner recognizing an inappropriate amount of gain.
- Although there does seem to be an easy fix to the statutory language, it is not what the statute currently provides for. It does seem that this was an oversight but it is not entirely clear. It is also unclear whether the IRS could provide for this result in regulations or whether legislative change is necessary.

The 461(l) Excess Business Loss Limitation

Section 461(l) – Limitation on Excess Business Losses

- New section 461(l) – taxpayers other than C corporations are NOT allowed to deduct “excess business loss”
- “Excess business loss” = the excess of the aggregate deductions attributable to the taxpayer’s trades or businesses over the sum of the taxpayer’s aggregate gross income or gain from those business, to the extent that the the loss exceeds $250,000 (for single filers) or $500,000 (for joint filers) –in other words, excess business loss over $250,000 ($500,000) is NO LONGER DEDUCTIBLE, regardless of whether it is active loss
- Carried forward indefinitely as an NOL under section 172 (which, under the new rules, are limited to 80% of taxable income); no carryback
- Applies at the partner/S-corp shareholder level
- Applies after the passive loss rules are applied
- SIGNIFICANT change – can no longer use excess active losses against other income (e.g., salary income, fee income, portfolio income).

The Section 461(l) Limitation – Open Questions, cont.

Interaction with Passive Loss Rules – The excess business loss limitation is applied after the passive loss rules.

Example:

- Partner A - individual, unmarried taxpayer, owns a 25% limited partnership interest in Partnership ABCD.
- Partner A does not materially participate in the activities of the partnership. In Year One:
  - A's allocable share of net partnership loss = $600,000. Assume that Partner A's deduction of its distributive share of partnership losses is not limited by the adjusted basis limitation rules of §704(d) or the at-risk rules of §465. The loss is, however, a passive loss and is subject to the limitations in §469.
  - A's ability to deduct the $600,000 loss is dependent upon whether A has passive income from another trade or business to offset the loss. If A has no passive income, the entire $600,000 deduction is disallowed under §469 and A has a passive loss carryover of $600,000. There is no need to apply the excess business loss limitation because §469 has disallowed the loss deduction in its entirety.
- What if A has $300,000 of passive income from a separate trade or business?
  - Section 469 would allow A to deduct $300,000 of the loss from Partnership ABCD. It does not appear that A has an excess business loss because, after application of §469, A's aggregate deductions for the taxable year which are attributable to the taxpayer's trades or businesses (without regard to the limitation on excess business loss) ($300,000) does not exceed the sum of (1) the taxpayer's aggregate gross income or gain attributable to such trades or businesses ($300,000) plus (2) $250,000. A would have a $300,000 passive loss carryover.

Example, cont.

What if A has no other trade or business activities but has a §212 activity for the production of income and has $300,000 of passive income from that activity?

- Section 469 allows passive losses to offset passive income from §212 activities. So, in this instance, §469 would allow A to deduct $300,000 of the passive loss from partnership ABCD against the $300,000 of passive income from the §212 activity. A would also have a $300,000 passive loss carryover.
- However, A now has to test deductibility of the $300,000 loss otherwise allowed under the passive loss rules under the new 461(l) limitation. The excess business loss calculation refers only to "trades or businesses," so A would have a nondeductible excess business loss of $50,000 under §461(l) – the excess of A's aggregate deductions for the taxable year which are attributable to the taxpayer's trades or businesses (without regard to the limitation on excess business loss) ($300,000) over the sum of (1) the taxpayer's aggregate gross income or gain attributable to such trades or businesses ($0- because the $300,000 of income from the 212 activity would not be counted) plus (2) $250,000. In this case, it appears that §461(l) would limit A's deduction to $250,000. The $50,000 excess business loss would be carried forward and become part of A's §172 NOL in the following taxable year. Although the statute is not entirely clear as to whether this is the correct result in this circumstance, a literal reading of the statutory language does lead to a different result depending upon whether passive income is attributable to a trade or business or a §212 activity. Query whether this result was intended.

The Section 461(l) Limitation – Open Questions, cont.

If, during the taxable year, a taxpayer disposes of his entire interest in any passive activity, §469 generally allows the taxpayer to utilize suspended passive losses against nonpassive income. The suspended passive losses are treated as active losses once the disposition occurs. Although not entirely clear, it appears that the §461(l) limitation applies to limit the use of those losses.

Recovery Period – Qualified Improvement Property

Recovery Period – Qualified Improvement Property

- What is the new recovery period for “qualified improvement property?”
  - New law eliminates separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property; now have one category = “qualified improvement property” (QIP)
  - Intent appears to have been to institute a 15-year MACRS recovery period and 20-year ADS recovery period – but the statute is not technically clear on this - the Joint Explanatory Statement includes the following statement – “the conference agreement provides a general 15-year MACRS recovery period for qualified improvement property”
  - Congress did not add QIP to the list of 15-year property in §168(e)(3)(E), and Congress's addition of a cross-reference to nonexistent §168(e)(3)(D)(V) in the table in §168(g)(3)(B) suggests an intent to add QIP, which would classify it as 10-year property. In the absence of a technical correction, must QIP be depreciated over the 39-year life of the building and is not eligible for bonus depreciation? It is unclear whether the IRS will challenge a taxpayer's deduction of bonus depreciation or a shorter recovery period with respect to QIP acquired and placed in service after September 27, 2017.

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Carried Interest

Carried Interest – New Holding Period Rule

Open Questions:

- "Applicable partnership interest" does not include "any interest … held directly or indirectly by a corporation" – does this include an S corporation?? Unlikely that this is what Congress intended, but it is not clear. Can IRS fix this is regulations or would it need a legislative fix?
- What is the relevant capital asset (for the new 3-year holding period)? The partnership interest or the assets held by the partnerships? Or both??

162(m) – Excessive Comp

Challenge: Changes to 162(m) executive comp

- The 2017 Tax Act *eliminates the exceptions for commissions and performance-based compensation* from the definition of compensation subject to the deduction limit. There is a transition rules for remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017 and which was not modified in any material respect on or after such date
- Problem: the plan in the example in the conference committee report does not allow for negative discretion (ability for comp committee to reduce or eliminate a comp award) and then concludes that the transition relief is applicable. Query: does the example intend to say that if the plan allows for negative discretion (which they very often do), then transition relief is not available? Does not seem like the intent – why grant relief and then make it inapplicable to such a wide universe of plans? Unclear; companies also can't modify their plans to deal with this because if they are modified, they are no longer grandfathered!

Nondeductibility – certain settlement agreements

Changes to Deductibility of Settlement Awards

Changes in tax law are necessitating changes to contractual agreements:

- Payments to settle claims of sexual harassment or sexual abuse (and related attorneys' fees) will not be deductible if the settlement agreement includes language that requires the parties to keep the settlement confidential
- Question: Is nondeductibility of legal fees limited to fees related to drafting the release or all fees (e.g., investigatory work, etc.)?
- Problem – most severance agreements (even those in the normal course) have a broad release and a confidentiality provision – does that "broad release" settle a claim for sexual harassment or sexual abuse? Technically, yes. The one sure way to insure deductibility of the payments is to remove the confidentiality provision from the draft Separation Agreement, or to expressly exclude sexual harassment or abuse claims from the scope of the release – many companies will not be willing to do this
- Compromise – add language: "Employee has not asserted any claim for sexual harassment or sexual abuse by any of the Released Parties and is not aware of any facts supporting such a claim." Does this work? Still some risk of nondeductibility

New Reporting/Recordkeeping Requirements

Challenge: Additional Recordkeeping for Pass-throughs

- Qualified Business Income – 199A
- Qualified Business Loss – 199A
- Excess Business Interest – 163(j)
- Excess Taxable Income – 163(j)
- Allocable Share of W-2 wages
- Allocable Share of Unadjusted Basis of Qualified Property