What does the Tax Cuts and Jobs Act mean for pass-through entities?

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Agenda

- Changes impacting pass-through entities
- Deep dive into the Qualified Business Income deduction
- Entity choice and structure considerations
Overview of pass-through income tax provisions
Some history . . .

Number of returns filed
1980 – 2012

Source: IRS
Key tax changes in Tax Cuts and Jobs Act

• Reduction of C corporation tax rate from 35 percent to 21 percent
• Reduction of top pass-through rate from 39.6 percent to 37 percent or 29.6 percent
• Loss of ability to deduct most state taxes at the individual level
• New limits on interest deductions and business losses
Individual impacts: Income

- Seven tax brackets
  - 10, 12, 22, 24, 32, 35, and 37 percent
  - The top individual rate will apply at incomes of $500,000/$600,000

- State and local tax deduction
  - Deductions capped at $10,000 for property, income or sales taxes
  - Includes taxes related to pass-through income

- Alternative Minimum Tax (AMT)
  - Retained with higher exemptions ($70,300 / $109,400); phase-out of exemption increased to $500,000 / $1 million
Important changes to NOL deductions

• Carryback and carryforward
  − Repeals the carryback period (two-year)
  − Provides for an indefinite carryforward period
  − Applicable to losses arising in taxable years ending after Dec. 31, 2017

• Limits NOL deduction to 80 percent of taxable income for losses arising in taxable years beginning after Dec. 31, 2017
New loss limitation rule applies to taxpayers other than corporations

• Prohibits deducting ‘excess business losses’ against wage and/or investment income
• Excess business loss
  – The excess of deductions from all trades or businesses of the taxpayer in excess of
  – Gross income from such businesses plus $250,000 (single or MFS) or $500,000 (joint)
• Limitation is applied at the individual or trust level, not at the entity level
• Excess losses carry over as NOL
• Excess loss limit applied after passive activity loss limits are applied
Business interest expense limitation

• Caps net interest deduction at 30 percent of an amount based on earnings (EBITDA) for four years, then limits the deduction to 30 percent of earnings before interest and taxes (EBIT) for subsequent years
• Taxpayers with average gross receipts of $25 million or less and car dealers using floor plan financing loans to fund their inventory are excluded from the interest limitation
• Allows ‘limited’ deductions to carry forward indefinitely
• Various exceptions for real estate, utilities, farming and certain small businesses
• Special rules for partners and partnerships
Interest limitation using EBITDA

Company worth $3 million
Debt of $2 million @ 5 percent
Equity of $1 million

Earnings before interest and depreciation = $500,000
Depreciation = $200,000
Interest = $100,000
Taxable income before limitation = $200,000

Base for limitation = $500,000

30 percent of base = $150,000
No limitation applies
Interest limitation using EBIT

Company worth $3 million
Debt of $2 million @ 5 percent
Equity of $1 million

Earnings before interest and depreciation = $500,000
Depreciation = $200,000
Interest = $100,000
Taxable income before limitation = $200,000

Base for limitation = $300,000

30 percent of base = $90,000
$10,000 interest is ‘limited’

Carryforward allowed indefinitely
Interest deductions: Partnership provisions

- Limit is initially computed at the partnership level.
- If excess interest expense is present, it is allocated to partners as a separate item.
- Individual owners may carry forward to offset future business income.
- Reduces partner’s basis in the partnership, but if interest is sold, any unused expense is treated as additional basis to offset gains.
Interest deductions: S corporation provisions

• Limit is computed at the S corporation level
• If excess interest expense is present, it is suspended at the corporate level
• Does not reduce shareholder’s basis in the corporation
Capital investments

**Bonus depreciation**
- Increase to 100 percent bonus depreciation through 2022, then phases out through 2026
- Applies to new and used property
- Applies to purchases after Sept. 27, 2017

**Section 179 deduction**
- Increased to $1 million, subject to limitations and phase-outs (limited to taxable income)
- Permanent
- Phase-out of deduction begins after $2.5 million threshold of total additions
Profits interests generally

- Issued by partnerships to founders or service partners
- Generally non-taxable when received, if no ‘liquidation value’
- Ability to generate capital gains if company is sold, despite no capital investment
- Unvested interests generally treated as if vested for income tax purposes
Treatment of carried interest

• Different treatment for profits interests in an ‘applicable trade or business’, which is defined as:
  – A regular, continuous and substantial activity of:
    • Raising or returning capital, and either
      – Investing in or disposing of specified assets, or
      – Developing specified assets
    • Specified assets include securities, commodities, real estate, cash, options, derivatives and partnership interests

• Applies a three-year holding period
Treatment of carried interest: Uncertainties

- The three-year holding period requirement applies to the sale of the partnership interest, but application to partnership level gains is unclear.

<table>
<thead>
<tr>
<th></th>
<th>Partner sale of interest</th>
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<th>Sale of capital asset held two years</th>
<th>Sale of capital asset held four years</th>
<th>Sale of business asset held two years</th>
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Repeal of deductions for entertainment expenses

- Expenses for entertainment
  - Deduction repealed for entertainment expenses when directly related to the conduct of trade or business
  - Applicable for:
    - Entertainment, amusement or recreation expenditures
    - Membership dues for any club organized for business, pleasure, recreation or other social purposes, or
    - A facility or portion of a facility used in connection with any of the above
  - Meals still deductible (50 percent) if directly connected to business
    - Certain de minimis fringes now subject to 50 percent limitation
Like-kind exchanges

- Section 1031–like-kind exchanges
  - Limits applicability to exchanges of real property
  - Does not apply to real property held primarily for sale
  - Impact on equipment leasing businesses (tangible and intangible personal property)
  - New rules apply to exchanges completed after Dec. 31, 2017
  - Transition rules apply to property relinquished on or before Dec. 31, 2017
  - Impact may be blunted by expanded depreciation provisions
Other good news

- Expanded use of cash method of accounting for partnerships with C corporation partners
- Expands the uniform capitalization (UNICAP) small business exception
- Generally exempts certain small business taxpayers from requirement to keep inventory
- Expands percentage of completion method exception for certain construction contracts
- Retains R&D credit (but amortization of costs after Dec. 31, 2022)
- Retains other credits including TIPs and WOTC (for hires on or before Dec. 31, 2019)
- Repeals technical termination of partnerships
Other not so good news

- Repeal of domestic production activity deduction
- Modifies the exclusion from income of certain contributions to capital (e.g., state/city grants)
- Changes public company executive compensation deductibility (section 162(m)) rules
Qualified business income deduction
Pass-through entity deduction

- A 20 percent deduction that effectively reduces the top rate on certain business income from 37 percent to 29.6 percent
- Does not apply to “service” businesses
- Additional limitations based on wages paid or tangible assets
- Only applies to income taxes (not self employment or net investment income tax calculations)
Pass-through entity deduction (cont.)

- Pass-through deduction limited to the greater of:
  - 50 percent of W-2 wages (employees and owners), or
  - 2.5 percent of original cost of depreciable, tangible property plus 25 percent of wages
- Application of these limits to related or similar businesses and activities is uncertain
- Partners’ share of:
  - W-2 wages is the same as their share of wage expenses,
  - Cost of assets is equal to their share of depreciation expense
Pass-through entity deduction (cont.)

• Deduction does not reduce owner’s outside basis
• Trusts are eligible for the deduction
• Passive vs. active status of owner does not impact eligibility
• Wage/asset and service business limitations do not apply to individuals with taxable income < $157,500/$315,000
Pass-through entity deduction (cont.)

• Does not apply to
  – Investment income
  – Wages paid to shareholders
  – Guaranteed payments for services
  – Foreign source income

• May apply to
  – Gain from the sale of business assets
  – Income allocations to service partners not receiving guaranteed payments
Specified service businesses

- “any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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 1 or more of its employees [OR OWNERS]”
Example 1

- Investor with $1 million of salary income buys an empty lot for $1 million, paying $200,000 of cash and borrowing $800,000 at 5 percent interest, to use as a parking lot that generates gross parking fees of $200,000.

- With $200,000 of gross income, but paying $40,000 to an independent contractor to manage the lot, and $20,000 for insurance and $40,000 of interest, there is $100,000 of net income.

- The 20 percent deduction does not apply—not enough ‘wages’ and not enough ‘depreciable property’.
Example 2

- Investor with $1 million of salary income buys an empty lot for $1 million, paying $200,000 of cash and borrowing $800,000 at 5 percent interest, to use as a parking lot that generates gross parking fees of $200,000.
- With $200,000 of gross income, but paying $40,000 to an employee to manage the lot, and $20,000 for insurance and $40,000 of interest, there is $100,000 of net income.
- The 20 percent deduction applies—because at least $40,000 of wages were paid.
Example 3

- Investor with $1 million of salary income buys parking structure for $1 million, paying $200,000 of cash and borrowing $800,000 at 5 percent interest, to generate gross parking fees of $200,000. With $200,000 of gross income, but paying $40,000 to a contractor to manage the facility, and $20,000 for insurance and $40,000 of interest, there is $100,000 of net income. Assume no depreciation deductions for simplicity.

- Even without wages the $20,000 deduction would be allowed
  - The alternative annual limitation is 2.5 percent of the taxpayer’s original $1 million investment in depreciable tangible property or $25,000 – plus 25 percent of wages paid if any
  - $1 million base is not ‘depreciated’ down—it is unadjusted—for 10 years or full life if longer—as long as property is used in business
Reasonable compensation rules may vary by entity type

- Allocations of income from a partnership may not be subject to reasonable compensation limitations for purposes of the 20 percent deduction

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<th>Partnership</th>
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<tr>
<td>Allocation of business income</td>
<td>$1,500,000</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Wages</td>
<td>$1,000,000</td>
<td>-</td>
</tr>
<tr>
<td>Income taxes on business income</td>
<td>$444,000</td>
<td>$740,000*</td>
</tr>
<tr>
<td>Income taxes on wages</td>
<td>$370,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total Taxes</strong></td>
<td><strong>$814,000</strong></td>
<td><strong>$740,000</strong></td>
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*Assumes no wage limitation
Entity choice considerations
Reconsidering your taxable entity type

- Tax reform brings dramatic changes in the way many entities are taxed
- These analyses are complex, and must look beyond comparisons of stated tax rates
- Requires a comprehensive review of current and future state of your business, and potentially a crystal ball
C corporation

- Lower C corporation tax rates may facilitate retention of additional cash to drive business growth
- C corporations are subject to two levels of tax, but the second layer might be deferred for years, and might be avoided entirely in certain circumstances
Pass-through entities

- Pass-through businesses are subject to a higher rate, but do not face a second layer of tax.
- Pass-through entities may see lower tax rates on certain asset sales.
- Only certain streams of income from pass-throughs will qualify for the new 20 percent deduction.
- Partnership and S corporations may compute the 20 percent deduction differently.
C corporation rate reduction: An example for an individual shareholder

- **Previous income tax rules**
  - $100 of corporate income
    - Less $35 tax at 35 percent rate
  - $65 of cash on balance sheet

- **New income tax rules**
  - $100 of corporate income
    - Less $21 tax at 21 percent rate
  - $79 of cash on balance sheet
C corporation rate reduction: An example for an individual shareholder (cont.)

- **Previous income tax rules**
  - $100 of corporate income
    - Less $35 tax at 35 percent rate
  - $65 of cash on balance sheet
    - Less $15.47 tax at 23.8 percent rate
  - $49.53 of after tax cash
  - All-in 50.47 percent tax rate

- **New income tax rules**
  - $100 of corporate income
    - Less $21 tax at 21 percent rate
  - $79 of cash on balance sheet
    - Less $18.8 tax at 23.8 percent rate
  - $60.20 of after tax cash
  - All-in 39.8 percent tax rate
Comparing rates on operating income

<table>
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<th>Active pass-through</th>
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<tr>
<td></td>
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<td>Tax rate on undistributed income</td>
<td>21%</td>
<td>29.6%</td>
<td>37%</td>
</tr>
<tr>
<td>All-in rate</td>
<td>39.8%</td>
<td>29.6%</td>
<td>37%</td>
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- Most businesses structured as C corporations will face an effective rate somewhere between 21 percent and 39.8 percent
## Comparing rates on certain asset gains

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<td>16% or 20%</td>
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- The application of the 20 percent deduction to gains from the sale of business assets is uncertain.
Additional growth of retained earnings may offset second layer of tax

- A reduced rate on retained income may drive additional growth

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<tr>
<td>Retained earnings–year 20</td>
<td>$60,000,000</td>
<td>$45,650,000</td>
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<tr>
<td>Tax on distribution of cash</td>
<td>$14,280,000</td>
<td>$0</td>
</tr>
<tr>
<td>Net cash</td>
<td>$45,720,000</td>
<td>$45,650,000</td>
</tr>
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Avoiding the second layer of tax

• Defer the 20 percent tax and 3.8 percent tax by reinvesting cash in the business

• Avoid the 20 percent and 3.8 percent tax at death
  • Or with stock gifts to charity that would otherwise be made in cash

• Reduce the 20 percent and 3.8 percent tax if shares are held by lower-rate taxpayers, including from gifts, trusts, etc.

• Revisit application of qualified small business stock rules
Reviewing your entity choice

- Retroactive changes may be available if elections are made before March 15, 2018, but later changes can be implemented on date of election
- Tax impacts of both near and long term should be modeled
- A simple conversion may not be the only answer; hybrid structures may provide additional benefits
- May have dramatic impacts in estate planning, international taxation, state and local taxes, compensation structures, and many other areas
Thank you

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