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TAX PLANNING LETTER

DECEMBER 2017, #245

Highlights of the "Tax Cuts and Jobs Act" (S Corp, Partnership & Other Changes)

On 12/22/17, President Trump signed into law H.R. 1, the "Tax Cuts and Jobs Act," a sweeping tax reform law that will entirely change the tax landscape. The legislation reflects the largest major tax reform in over three decades.

This **Tax Planning Letter**, which refers to the Act by its commonly used name, "Tax Cuts and Jobs Act"(or simply, the "Act") describes key changes made under that Act that would affect **sole proprietorships, S corporations, partnerships, tax-exempt organizations, electing small business trusts, and retirement plans, including a new deduction for pass-through income.**

For comprehensive summaries on other areas of the new law, see:

(#243) Highlights of the "Tax Cuts and Jobs Act"- Business Tax Changes
(#244) Highlights of the "Tax Cuts and Jobs Act"- Individual Tax Changes

PASS-THROUGHS

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New Deduction for Pass-Through Income

Pre-Act law: The net income of these pass-through businesses (sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations) was not subject to an entity-level tax and was instead reported by the owners or shareholders on their individual income tax returns. Thus, the income was effectively subject to individual income tax rates.

New law: Generally for tax years beginning after 12/31/17 and before 1/1/26, the Act adds a new section, §199A, "Qualified Business Income," under which a non-corporate taxpayer, including a trust or estate, who has qualified business income (QBI) from a partnership, S corporation, or sole proprietorship is allowed to deduct:

- the lesser of: (a) the "combined qualified business income amount" of the taxpayer, or (b) 20% of the excess, if any, of the taxable income of the taxpayer for the tax year over the sum of net capital gain and the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year; plus
- the lesser of: (i) 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year, or (ii) taxable income (reduced by the net capital gain) of the taxpayer for the tax year.

The “combined qualified business income amount” means, for any tax year, an amount equal to:

- the deductible amount for each qualified trade or business of the taxpayer (defined as 20% of the taxpayer’s QBI subject to the W-2 wage limitation; see below), plus
- 20% of the aggregate amount of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

QBI is generally defined as the net amount of “qualified items of income, gain, deduction, and loss” relating to any qualified trade or business of the taxpayer. For this purpose, qualified items of income, gain, deduction, and loss are items of income, gain, deduction, and loss to the extent these items are effectively connected with the conduct of a trade or business within the U.S. under §864(c) and included or allowed in determining taxable income for the year. If the net amount of qualified income, gain, deduction, and loss relating to qualified trade or businesses of the taxpayer for any tax year is less than zero, the amount is treated as a loss from a qualified trade or business in the succeeding tax year. QBI does not include: certain investment items; reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business; any guaranteed payment to a partner for services to the business under §707(c); or a payment under §707(a) to a partner for services rendered with respect to the trade or business.

The 20% deduction is not allowed in computing adjusted gross income (AGI), but rather is allowed as a deduction reducing taxable income.

Limitations. For pass-through entities, other than sole proprietorships, the deduction cannot exceed the greater of:

- 50% of the W-2 wages with respect to the qualified trade or business (“W-2 wage limit”), or
- the sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all “qualified property.” Qualified property is defined in §199A(b)(6) as meaning tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of qualified business income, and the depreciable period for which has not ended before the close of the tax year.

Observation: The second limitation, which was newly added to the bill during Conference, apparently allows pass-through businesses to be eligible for the deduction on the basis of owning property that qualifies under the provision (e.g., real estate).

For a partnership or S corporation, each partner or shareholder is treated as having W-2 wages for the tax year in an amount equal to his or her allocable share of the W-2 wages of the entity for the tax year. A partner’s or shareholder’s allocable share of W-2 wages is determined in the same way as the partner’s or shareholder’s allocable share of wage expenses. For an S corporation, an allocable share is the shareholder’s pro rata share of an item. However, the W-2 wage limit begins phasing out in the case of a taxpayer with taxable income exceeding $315,000 for married individuals filing jointly ($157,500 for other individuals). The application of the W-2 wage limit is phased in for individuals with taxable income exceeding these thresholds, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).

Thresholds and exclusions. The deduction does not apply to specified service businesses (i.e., trades or businesses described in §1202(e)(3)(A), but excluding engineering and architecture; and trades or businesses that involve the performance of services that consist of investment-type activities). However the service business limitation begins phasing out in the case of a taxpayer whose taxable income exceeds $315,000 for married individuals filing jointly ($157,500 for other individuals), both indexed for inflation after

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2018. The benefit of the deduction for service businesses is phased out over the next $100,000 of taxable income for joint filers ($50,000 for other individuals). The deduction also does not apply to the trade or business of being an employee.

The new deduction for pass-through income is also available to specified agricultural or horticultural cooperatives, in an amount equal to the lesser of:

• 20% of the co-op's taxable income for the tax year, or
• the greater of:

  o 50% of the W-2 wages of the co-op with respect to its trade or business, or
  o the sum of 25% of the W-2 wages of the cooperative with respect to its trade or business plus 2.5% of the unadjusted basis immediately after acquisition of qualified property of the cooperative.

PARTNERSHIP PROVISIONS

Repeal of Partnership Technical Termination

Under a "technical termination" under §708(b)(1)(B), a partnership is considered as terminated if, within any 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. A technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners. As a result of a technical termination, some of the tax attributes of the old partnership terminate; the partnership's tax year closes; partnership-level elections generally cease to apply; and the partnership depreciation recovery periods restart.

New Law: For partnership tax years beginning after 12/31/17, the §708(b)(1)(B) rule providing for the technical termination of a partnership is repealed. The repeal doesn't change the pre-Act law rule of §708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Look-Through Rule Applied to Gain on Sale of Partnership Interest

Gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from the sale or exchange of a capital asset. However, the amount of money and the fair market value of property received in the exchange that represent the partner's share of certain ordinary income-producing assets of the partnership give rise to ordinary income rather than capital gain.

A foreign person that is engaged in a trade or business in the U.S. is taxed on income that is "effectively connected" with the conduct of that trade or business (i.e., effectively connected gain or loss). Partners in a partnership are treated as engaged in the conduct of a trade or business within the U.S. if the partnership is so engaged.

In a Revenue Ruling, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, IRS applied an asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that U.S. business. However, a Tax Court case has instead held that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.

New law: For sales and exchanges on or after 11/27/17, gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. Any gain or loss from the hypothetical asset sale by the partnership must be allocated to interests in the partnership in the same manner as non-separately stated income and loss.

For sales, exchanges, and dispositions after 12/31/17, the transferee of a partnership interest must withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.

Partnership "Substantial Built-In Loss" Modified

In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a **one-time election** under §754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer. If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in his or her partnership interest.

Pre-Act law: A substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property. Certain securitization partnerships and electing investment partnerships are not treated as having a substantial built-in loss in certain instances and thus are not required to make basis adjustments to partnership property. For electing investment partnerships, in lieu of the partnership basis adjustments, a partner-level loss limitation rule applies.

New law: For transfers of partnership interests after 12/31/17, the definition of a substantial built-in loss is modified for purposes of §743(d), affecting transfers of partnership interests. In addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

Charitable Contributions & Foreign Taxes in Partner's Share of Loss

Pre-Act law: A partner was allowed to deduct his or her distributive share of partnership loss only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of the loss over basis was allowed as a deduction at the end of the partnership year in which the excess was repaid to the partnership. IRS has taken the position in a private letter ruling that the §704(d) loss limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's charitable contributions. While the regs relating to the §704(d) loss limitation do not mention the foreign tax credit, a taxpayer may choose the foreign tax credit in lieu of deducting foreign taxes.

New law: For partnership tax years beginning after 12/31/17, in determining the amount of a partner's loss, the partner's distributive shares under §702(a) of partnership charitable contributions and taxes paid or accrued to foreign countries or U.S. possessions are taken into account. However, in the case of a charitable contribution of property with a fair market value that exceeds its adjusted basis, the partner's distributive share of the excess is not taken into account.

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S CORPORATION PROVISIONS

Treatment of S Corporation Converted to C Corporation

Under present law, in the case of an S corporation that converts to a C corporation, distributions of cash by the C corporation to its shareholders during the post-termination transition period (PTTP), to the extent of the amount in the accumulated adjustment account),are tax-free to the shareholders and reduce the adjusted basis of the stock.

The PTTP is:

- the period beginning on the day after the last day of the corporation's last tax year as an S corporation and ending on the later of (a) the day that is one year after that day, or (b) the due date for filing the return for the corporation's last tax year as an S corporation (including extensions);
- the 120-day period beginning on the date of any determination (as defined in Reg. § 1.1377-2(c)) with respect to an audit of the taxpayer that follows the termination of the corporation's election and that adjusts a Subchapter S income, loss or deduction item that arises during the S corporation period (i.e., the most recent continuous period during which the corporation was an S corporation); and
- the 120-day period beginning on the date of a determination that the corporation's S election had terminated for an earlier year.

New law: On the date of enactment, any §481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (i.e., a change from the cash method to an accrual method) is taken into account ratably during 6-tax year period beginning with the year of change. An eligible terminated S corporation is any C corporation which:

- is an S corporation the day before the date of enactment;
- during the 2-year period beginning on the date of enactment revokes its S corporation election; and
- all of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of such enactment.

In the case of a distribution of money by an eligible terminated S corporation, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account bears to the amount the accumulated earnings and profits.

TAX-EXEMPT ORGANIZATION PROVISIONS (Outside the Scope of this Tax Planning Letter)

- Excise Tax on Excess Tax-Exempt Organization Executive Compensation
- Excise Tax Based on Investment Private Income of Colleges and Universities
- UBTI Separately Computed for Each Trade or Business Activity

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ESBT PROVISIONS

Qualifying Beneficiaries of an ESBT

An electing small business trust (ESBT) may be a shareholder of an S corporation. Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly.

Pre-Act law: a nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT.

New law: Effective on 1/1/18, the Act allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

Charitable Contribution Deduction for ESBTs

Pre-Act law: the deduction for charitable contributions applicable to trusts, rather than the deduction applicable to individuals, applied to an ESBT. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income, generally with a 5-year carryforward of amounts in excess of this limitation.

New law: For tax years beginning after 12/31/17, the Act provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

RETIREMENT PLAN PROVISIONS

Repeal of the Rule Allowing Recharacterization of IRA Contributions

Pre-Act law: if an individual makes a contribution to an IRA (traditional or Roth) for a tax year, the individual is allowed to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year. In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

New law: For tax years beginning after 12/31/17, the rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion.

Extended Rollover Period for Rollover of Plan Loan Offset Amounts

If an employee stops making payments on a retirement plan loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. Such a distribution is generally taxed as though an actual distribution occurred, including being subject to a 10% early distribution tax, if applicable. A deemed distribution isn't eligible for rollover to another eligible retirement plan.

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Pre-Act law: A plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employee's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in employee's account balance is offset by the amount of the unpaid loan balance, referred to as a loan offset. A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20% income tax withholding.

New law: For plan loan offset amounts which are treated as distributed in tax years beginning after 12/31/17, the Act provides that the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution would be extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the tax year in which the plan loan offset occurs (e.g. the tax year in which the amount is treated as distributed from the plan). A qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a §403(b) plan, or a governmental § 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's separation from service, whether due to layoff, cessation of business, termination of employment, or otherwise. A loan offset amount under the Act (as before) is the amount by which an employee's account balance under the plan is reduced to repay a loan from the plan.

Retirement Plan Provisions (Outside the Scope of this Tax Planning Letter)

• Length of Service Award Programs for Public Safety Volunteers

BOND PROVISIONS (Outside the Scope of this Tax Planning Letter)

• Repeal of Advance Refunding Bonds
• Credit Bonds Repealed

Questions?

For more details on information presented in this Tax Planning Letter or other issues, please feel free to call Roger Rossmeisl, CPA direct at (714) 325-0442 or via e-mail at roger@khopatel.com.

This Tax Planning Letter is assembled by Roger Rossmeisl and is intended to provide accurate, general information on the matters contained herein and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Since tax laws are constantly changing, and are subject to differing interpretations, you are urged to do additional research before acting on the information contained in this document.

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