PIECES OF THE PUZZLE

December 2017

2017 Tax Reform: S-Corporation, Partnership and Other Changes in the "Tax Cuts and Jobs Act"

New Deduction for Pass-through Income

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

Generally for tax years beginning after December 31, 2017 and before January 1, 2026, the "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:

(1) the *lesser* of: (a) the "combined qualified business income amount" of the taxpayer or (b) 20% of 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***

(2) 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: (i) the deductible amount for each qualified trade or business taxpayer (defined as 20% of the taxpayer's QBI subject to the W-2 wage limitation; see below); *plus (ii)* 20% of the aggregate amount of the 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. 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; or a payment under code section 707(a) to a partner for services rendered with respect to the trade or business.

The 20% deduction is not allowed in computed 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: (1) 50% of the W-2 wages with respect to the qualified trade or business ("W-2 wage limit"), or (2) the sum of 25% of the wages paid with respect to the qualified trade or business *plus* 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property."

This 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 a 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 a 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).

Repeal of Partnership Technical Termination

Under a "Technical Termination", 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 interests 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 the new partnership, followed by a deemed distribution of interest in the new partnership to purchasing partners and the other remaining partners.

For partnership tax years beginning after December 31, 2017, the rule providing for the technical termination of a partnership is repealed. The repeal doesn't affect the pre-Act law rule 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 capital asset. For sales and exchanges on or after November 27, 2017, 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 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 interest in the partnership in the same manner as non-separately stated income and loss.

Charitable Contributions & Foreign Taxes in Partner's Share Loss

Under 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 a loss occurred. For partnership tax years beginning after December 31, 2017, in determining the amount of partner's loss, the partner's distributive shares of partnership charitable contribution 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 distributed share of the excess is not taken into account.

TAX-EXEMPT ORGANIZATION PROVISION

UBTI Separately Computed for Each Trade or Business Activity

There are several provisions that effect tax exempt organizations. Currently, a tax-exempt organization determines its Unrelated Business Taxable Income (UBTI) by subtracting, from its gross unrelated business income, deductions directly connected with the unrelated trade or business. Under regulations, an organization that operates multiple unrelated trades or businesses aggregates incomes from all such activities and subtracts from the aggregate gross income the aggregate of deductions. For tax years beginning after December 31, 2017, losses from one unrelated trade or business may not be used to offset income derived from another unrelated trade or business. Gains and losses have to be calculated and applied separately.

RETIREMENT PLAN PROVISION

Repeal of the Rule Allowing Re-Characterization of IRA Contributions

Under pre-Act law, if an individual makes a contribution to an IRA (traditional or Roth) for a tax year, the individual is allowed to re-characterize 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 of the individual's income tax return of that year. In the case of a re-characterization, 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 re-characterized as having been made to a traditional IRA.

For tax years beginning after December 31, 2017 the rule that allows a contribution to one type of IRA to be re-characterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus re-characterization cannot be used to unwind a Roth conversation.

This is a summary of certain S-corporation, partnership, and other changes in the Tax Cuts and Jobs Act. There are other provisions that affect these entities such as a the modification of a partnership substantial built in loss, the treatment of S-corporation's converted to C-corporations, excise tax on tax-exempt organization excess executive compensation, and Electing Small Business Trust (ESBT) provisions.

If you have any questions, please feel free to contact us.

Source: Thomson Reuters/Tax & Accounting - Weekly Alert, 12/28/2017

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