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2017 New Tax Law: Pass Through Provisions

*This client alert is part of a special series on the Tax Cuts and Jobs Act and related changes to the tax code, where Blank Rome's lawyers share their analysis of different provisions in the Act and how they may affect you and your business, along with specific action items. To see the full list of client alerts in this series, please click **here.***

On December 20, 2017, Congress passed its comprehensive tax reform bill, the Tax Cuts and Jobs Act ("the Act" or "the Bill"), which was signed into law by President Trump on December 22, 2017. The Bill represents one of the most extensive modifications to the U.S. tax code in recent history, significantly modifying U.S. taxation for individuals and businesses. Most provisions in the Bill took effect on January 1, 2018.

NEW 20 PERCENT PASS THROUGH DEDUCTION

In general, individuals, estates, and trusts are now permitted to deduct up to 20 percent of their "qualified business income" ("QBI") from certain pass through entities, i.e., sole proprietorships, partnerships, limited liability companies taxed as partnerships, and S corporations, as well as 20 percent of the total qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership income.

QBI is the net items of income, gain, deduction, and loss generated from the conduct of a "qualified trade or business," but does not include (1) any guaranteed payment paid by a partnership for services rendered with respect to the partnership; (2) any amount paid by an S corporation that is treated as reasonable compensation; and (3) any amount paid to a partner by a partnership for services rendered other than in his or her capacity as a partner in the partnership. A qualified trade or business is any trade or business other than those involving the performance of health, legal, actuarial science, performing arts, consulting, athletics, financial, or brokerage services, or where the principal asset of the business is the skill or reputation of one or more employees or owners. Also excluded from the definition of qualified trade or business are those trades or businesses that provide investing and investment management services or deal in securities, partnership interest, or commodities.

However, if a taxpayer's taxable income does not exceed $157,500 for individuals or $315,000 for joint filers, the taxpayer may still take the 20 percent deduction even though such income was generated from the operation of these excluded pass through businesses.

The deduction is equal to the sum of (1) the lesser of the taxpayer's combined QBI or (2) 20 percent of taxable income (reduced by net capital gain) plus (i) the lesser of 20 percent of qualified cooperative dividends or (ii) taxable income (reduced by net capital gain).

If a taxpayer's income exceeds $157,500 for individuals or $315,000 for joint filers, the deduction is limited to the lesser of (1) 20 percent of the taxpayer's QBI from the qualified trade or business; or the greater of (a) 50 percent of the W-2 wages with respect to the trade or business or (b) the sum of (i) 25 percent of the wages with respect to the trade or business and (ii) 2.5 percent of the unadjusted basis of all "qualified property." Qualified property is tangible property used in the qualified trade or business that is subject to depreciation under Section 167 of the Code, i.e., it is held by, and available for use in, the qualified trade or business at the close of the tax year; used at any point in the tax year in the production of qualified business income; and the useful life of the property has not ended before the close of the tax year.

For example, a taxpayer earns $500,000 as the sole proprietor of an auto parts manufacturing business purchases $100,000 worth of manufacturing equipment and places it in service in 2020. The business has no employees, thus it pays $0 W-2 wages. The limitation on his QBI deduction is the lesser of (1) 20 percent of the QBI from the business ($100,000); or (2) 50 percent of the W-2 wages paid ($0) or (3) the sum of (a) 25 percent of the W-2 wages paid ($0) and (b) 2.5 percent of the unadjusted basis of the property ($2,500). Thus, even though the manufacturer exceeded the income threshold, the pass through provisions of the Act still provide a modest deduction to his QBI.

Since the 20 percent deduction is based off of W-2 wages, taxpayers who own partnerships or limited liability companies and are compensated by such partnerships or limited liability companies in the form of guaranteed payments will not be able to take full advantage of the 20 percent deduction because their payments are not included in the W-2 wage base. These taxpayers should contact a member of the Blank Rome **Tax, Benefits, and Private Client Group** to determine how to restructure the ownership of these entities so that guaranteed payments can be converted to W-2 compensation.

NEW HOLDING PERIOD REQUIREMENT FOR CARRIED INTEREST

Prior to the enactment of the Bill, a partner in a partnership that provided investment services, i.e., private equity or hedge fund manager, was entitled to preferential long-term capital gains treatment on the gain from the sale, exchange, or disposition of a capital asset held for more than one year. However, the Act requires capital assets to be held for at least three years before the gain or loss on the asset is subject to tax at the preferential long-term capital gains rate. Notably, the Act did not include grandfathering provisions and consequently, any current investment by a private equity fund or hedge fund is subject to the new three year holding period.

S CORPORATION CONVERSION CHANGE

Distributions from an S corporation that revokes its election between December 22, 2017 and December 21, 2019 and have the same owners on both December 22, 2017 and the revocation date will be treated as paid from its accumulated adjustment account and from its earnings and profits.

EXPANSION OF QUALIFYING BENEFICIARIES OF AN ELECTING SMALL BUSINESS TRUST ("ESBT")

The Act expanded the list of eligible beneficiaries of an ESBT to include nonresident aliens. Previously, eligible beneficiaries of an ESBT were limited to individuals, estates, and certain charitable organizations.

There are several other notable provisions of the Bill that may affect the taxation of income from a pass through business. Clients who would like more information about their specific circumstances should contact a member of Blank Rome's Tax, Benefits, and Private Client practice group.

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