Tax Act: Key Issues for Pass-Through Entities, Including the Carried Interest

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Deduction for Qualified Business Income

General. The new Section 199A generally provides that for taxable years beginning after December 31, 2017, and before December 31, 2025, taxpayers other than corporations are entitled to deductions equal to 20% of their "qualified business income" for that year. The deduction is computed separately for each "qualified trade or business," although losses realized with respect to one qualified trade or business can effectively reduce the amount of the deduction available with respect to other qualified trades or businesses. The deduction is allowable in computing taxable income regardless of whether the taxpayer itemizes deductions.

Limitations. The amount of any deduction under Section 199A with respect to any qualified trade or business is subject to two limitations:

- First, the aggregate amount of deductions for all qualified trades or businesses for a taxable year is generally limited to 20% of the taxpayer's taxable income (determined without regard to any deductions under Section 199A) other than (i) net capital gain and (ii) dividends that qualify for the reduced tax rate applicable to capital gains.

- Second, the deduction with respect to each qualified trade or business cannot exceed the greater of (i) 50% of the W-2 wages paid by the qualified trade or business for the taxable year and (ii) the sum of 25% of such W-2 wages and 2.5% of the "unadjusted basis" (generally the cost) of depreciable property held and used in the trade or business during the year, provided that the period over which the property is depreciated (but no less than ten years) has not ended.

The second limitation does not apply if the taxable income of the taxpayer (determined without regard to any deductions under Section 199A) does not exceed a threshold amount initially established at $157,500 ($315,000 for married taxpayers filing jointly) subject to adjustment for inflation. For taxable income in excess of the threshold amount, the limitation is phased in over the next $50,000 ($100,000 for married taxpayers filing jointly). Thus, for example, if a single taxpayer's taxable income exceeded the threshold amount by $30,000, 60% of the excess of the 20%

deduction over the limitation amount would be disallowed.

Qualified trade or business. The deduction is only available with respect to income from “qualified trades or businesses.” Generally, a qualified trade or business is any trade or business other than “specified service businesses” and the performance of services as an employee. The specified service businesses include businesses involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and related activities relating to securities, or “any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.” The exclusion of specified service businesses does not apply to taxpayers with taxable income less than the threshold amount described in the preceding paragraph. That exclusion is phased out over a $50,000 range ($100,000 for married taxpayers filing jointly) in excess of the threshold amount.

Qualified business income. Generally, the income that qualifies for the 20% deduction consists of income that is “effectively connected” to the conduct of a qualified trade or business.

- The trade or business must be conducted within the United States;
- Passive investment-type income is excluded; and
- Compensation payments (including guaranteed payments made to partners) received by the taxpayer are excluded.

Application to partners and S corporation shareholders. Section 199A is applied at the partner or S corporation shareholder level with respect to the partner's or shareholder's allocable share of “qualified business income,” W-2 wages and “unadjusted basis” of property of the partnership or S corporation, as applicable.

Special applications. Section 199A includes special provisions regarding the computation of the allowable deduction with respect to (i) dividends from REITs, (ii) income from publicly traded partnerships, and (iii) dividends from qualified cooperatives. In general, income from these sources qualifies for the 20% deduction without regard to the W-2 and “unadjusted basis” limitations.

Open questions. There are many unanswered questions regarding the potential application of Section 199A, including:

- How is a “trade or business” determined? Can activities in separate entities be aggregated? Must they be aggregated?
- How does one determine whether the principal asset of a trade or business is “the reputation or skill of one or more of its employees”? Consider how this provision would apply to chefs, masons, barbers, etc. Does this provision penalize highly successful businesses?
- Can the amount of W-2 wages include payments to partners that are treated as “guaranteed payments” rather than “wages” solely because the recipient is a partner?
- Should real estate businesses reorganize as REITs (dividends from which are not subject to the W-2 and “unadjusted basis” limitation and qualify for the 20% deduction regardless of the source of the REIT's income)?

Carried Interests

General. The Tax Act added a new Section 1061 to the Code effectively adopting a three-year holding period (rather than the normal one-year holding period) for long-term capital gain treatment for gain attributable to “applicable partnership interests,” commonly referred to as “carried interests.” The statute applies to both gain from the sale of applicable partnership interests held for three years or less and gain allocated to a partner with respect to an applicable partnership interest to the extent attributable to sales of assets held by the partnership for three years or less.

Applicable partnership interests. An “applicable partnership interest” generally is an interest in a partnership (including a limited liability company taxed as a partnership) transferred to the taxpayer in connection with the performance of substantial services by the taxpayer in an applicable trade or business. Exclusions exist for:

- Interests held by corporations
- Capital interests in partnerships (*i.e.,* interests that allow their owners to participate in the economics of the partnership based upon the amount of capital the owner contributed or the amount of taxable income the owner realized upon the receipt or vesting of the partnership interest)

Applicable trade or business. An “applicable trade or business” is generally an activity that consists, in whole or in part, of (i) raising or returning capital from investors and (ii) investing in, disposing of, or developing, any of: securities, commodities, real estate held for rental or investment, cash, options or derivative contracts with respect to any of the foregoing types of assets, and interests in partnerships attributable to such assets (referred to as “specified assets”). The activity does not need to rise to the level of a “trade or business” as that term is used elsewhere in the Code.

Effective date. Section 1061 is effective for gain realized in taxable years beginning after December 31, 2017. There are no “grandfathering” rules for pre-existing partnership interests or assets held by pre-existing partnerships.

Open Questions. Section 1061 is relatively brief and leaves open many questions, including:

- On a sale of an applicable partnership interest that has been held for more than three years, would Section 1061 apply to recharacterize gain economically attributable to assets held by the partnership for less than three years as short-term capital gain (since Section 1061, on its face, does not include a “look through” rule)?
- If a partnership distributes assets in-kind in redemption of some or all of an applicable partnership interest, would gain from the sale of the distributed asset be subject to the three-year holding period requirement if the partnership interest had not been held for more than three years, or if the distributed asset had not been held for more than three years, or if other assets of the partnership had not been held for more than three years?
- Although rental real estate is included in the definition of “applicable trade or business,” a technical reading of the statute leads to the conclusion that it does not apply to gain attributable to depreciable assets or real property used in a trade or business. Is a

technical correction to the statute necessary to correct this seeming oversight?

- Section 1061 only applies with respect to net long-term capital gain "if one or more applicable partnership interests are held by a taxpayer at any time during the taxable year." If an applicable partnership interest is sold for an installment note, is the gain realized in a subsequent year immune from recharacterization under this provision? Would it matter that the taxpayer owned an applicable partnership interest in another partnership at the time the installment payment was received?
- Section 1061(b) provides that "to the extent provided by the Secretary," the general rule of Section 1061 shall not apply to gain "attributable to any asset not held for portfolio investment on behalf of third-party investors." Will this exception be available prior to the promulgation of regulations (or similar) by the IRS?
- If investors lend the service provider the amount necessary to buy a "capital interest" that has the same share of profits as the carried interest would have had, does Section 1061 apply? Does it matter whether the loan is recourse or nonrecourse (secured by the purchased interest)?

Limitation on Business Losses

The new Section 461(l) limits the ability of taxpayers other than corporations to use losses attributable to trades or businesses to offset more than $250,000 ($500,000 for joint returns) of non-trade or business income. The $250,000 ($500,000) amount is subject to adjustment for inflation. The limitation is applied after application of the passive loss rules, and any loss disallowed under Section 461(l) is carried over to the following year and treated as a net operating loss carryover (which, as a result of the Tax Act, can now only offset 80% of taxable income). For taxpayers who are partners in partnerships or shareholders of S corporations, the limitation is determined at the partner or shareholder level, as applicable. Section 461(l) is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

Repeal of Technical Terminations of Partnerships

The Tax Act repealed Section 708(b)(1)(B) of the Code, which previously provided that a partnership would be considered to have terminated for federal income tax purposes if there was a sale or exchange of 50% or more of the total interests in partnership capital and profits. Such a technical termination of the partnership generally created two short taxable years, terminated all of the partnership's tax elections, required the partnership to restart depreciation periods and could change the holding period that the partners had for their interests in the partnership. Although elimination of the provision will allow taxpayers to avoid the administrative and substantive tax costs associated with a termination, it will also eliminate a tax-planning tool that could be employed to eliminate tax elections, change accounting methods and rectify missed elections under Section 754 of the Code.

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