Passthrough Entity and Corporate Tax Changes under the Tax Cuts and Jobs Act of 2017

STEP – TEL AVIV

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Corporate Tax Rate Changes

- Flat 21 percent Federal corporate tax rate
- Corporate tax rate is approximately equal to the non-corporate capital gains rate
- Dividend rate to individuals remains the same: 20 percent
- Why not keep earnings in corporations indefinitely?
  - Accumulated earnings tax and personal holding company tax
- Start to focus on Section 1202 stock sale gain exclusion
- States may not be enacting all Federal changes

20 Percent "Passthrough Business Deduction"

I. Reduced Business Income Tax Rates

A. Permanent Corporate Income Tax Rate Reduction to 21%

1. Reduces individual ETR to 39.8% (21 % + (79% x 23.8%)) from 50.5% (35% + (65%*23.8%)) (including Net Investment Income Tax)

B. Temporary 20% Pass-through Entity Deduction[1]

1. Reduces highest individual ETR to 29.6% from 39.6% for those who qualify for the deduction

2. Deduction taken by individuals (including trusts and estates)

3. Deduction available for "combined qualified business income" ("QBI") from a sole proprietorship, S corporation, or entity treated as a partnership

   a) Domestic income, gain, loss, and deduction from a "qualified business" (i.e., no capital gains, investment income, foreign source income, Subpart F income)

   b) 20% of qualified REIT dividends (whether domestic or foreign) (i.e., non-capital gain dividends) and publicly-traded partnership domestic income

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[1] IRC § 199A set to expire for tax years beginning after December 31, 2025.

20 Percent “Passthrough … (cont’d)

c) Does not include reasonable compensation, guaranteed payments, or non-partner-capacity payments

d) Foreign individuals and trusts may take advantage of this deduction on “effectively connected” income

4. No limitations when taxable income is below $157,500/315,000 “threshold amount” (inflation adjusted) with phase-out over next $50,000/$100,000 of taxable income. Limitations above threshold amount of taxable income

5. Limitations above threshold amount of taxable income:

   a) Deduction is limited to greater of:

      (1) 50% of W-2 wages with respect to qualified trade or business, or

      (2) 25% of W-2 wages with respect to qualified trade or business plus 2.5% of unadjusted basis of qualified property (i.e., depreciable property used in qualified trade or business and held at end of tax year)

20 Percent “Passthrough … (cont’d)

5. Limitations above threshold amount of taxable income: (cont’d)

   b) Income must arise from “qualified trade or business” - i.e., any trade or business other than:

      (1) Performing services as an employee, or

      (2) “Specified service trade or business”

         (a) Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial

         (b) Any trade or business “where the principal asset ... is the reputation or skill of 1 or more of its employees or owners,” or

         (c) Investing and investment management, trading, or dealing in securities, paiinership interests, or commodities

   c) Deduction is limited to excess of taxable income over net capital gains. Deduction cannot lower the capital gains tax rate.

Choice of Entity Under Section 199A

$500,000 of net income

$125,000 compensation paid to owner

	SOLE PROP.	S. CORP.
Business Income	$500,000	$500,000
W-2 Wages	n/a	($125,000)
Net Income	$500,000	$375,000
QBI	$500,000	$375,000
Tentative Deduction	$100,000	$75,000
50% of W-2 Wages Limitation	$0	$62,500
Final Deduction	$0	$62,500

Choice of Entity … (cont’d)

$200,000 of net income

$80,000 paid to owner

	SOLE PROP.	S. CORP.
Business Income	$200,000	$200,000
W-2 Wages	n/a	($80,000)
Net Income	$200,000	$120,000
QBI	$200,000	$120,000
Tentative Deduction	$40,000	$24,000
50% of W-2 Wages Limitation	n/a	$40,000
Final Deduction	$40,000	$24,000

Interest Deductions under Section 163(j)

A. Under Prior law, interest limitation applied only if interest was due to a "related" party.

B. Net Business Interest Expense Limitation

   1. Applies without regard to who it is owed
   2. Deduction limited to 30% of EBITDA for 2018-2021, and EBIT beginning in 2022
   3. Exception for businesses with less than $25 million in average annual gross receipts for 3-prior tax years. Exception for real estate businesses
   4. Disallowed interest carried forward indefinitely

Limitations on Like Kind Exchanges

- Limited to Real Property for Real Property
- No longer applies to art, sports franchises, etc.
- Opportunity Zone Funds may provide an ability to defer gain from assets no longer qualifying for like kind exchange treatment.

100 Percent Bonus Depreciation

- Applies to tangible personal property
- Applies to used as well as new assets
- 100% of assets placed in service before 2023
- 80% of assets placed in service in 2023
- 60% of assets placed in service in 2024
- 40% of assets placed in service in 2025
- 20% of assets placed in service in 2026
- 0% of assets placed in service after 2026
- Real property depreciation basiscally unchanged, but special rules apply to real property if taxpayer opts out of the 30 percent interest limitation of Section 163(j)

“Carried Interest” Limitations

A. Carried Interest of Service Partners

1. The “carry” is typically the share of the profits of an investment that are paid to the investment manager for their services in excess of the manager's capital interest.
2. Under current law, the receipt of a profits interest in exchange for services is generally not taxable, whereas receipt of a capital interest for services would be taxable. Section 83 determines amount and timing of income inclusion to service provider and deduction for service recipient.
3. Under the new law, a portion of taxpayer's long-term capital gain “with respect to” an “applicable partnership interest” should be treated as short-term capital gain unless partner meets 3-year asset holding period.
    - a) “Applicable Partnership Interest” is an interest transferred to, or held by, a taxpayer in connection with performance of substantial services by taxpayer (or related person) in “any applicable trade or business,” which consists of:
        - (1) raising or returning capital; and
        - (2) either:
            - (a) investing in / disposing of “specified assets,” or
            - (b) developing “specified assets” (securities, rental real estate, etc.)

“Carried Interest” Limitations (cont’d)

4. Exceptions

   a) Partnership interest held by a corporation

   b) Interest is a capital interest providing right to share in capital commensurate with:

      (1) amount of capital contributed for partnership interest, or

      (2) value of interest included in income under IRC § 83 upon receipt or vesting

   c) Income/gain is attributable to an asset not held for portfolio investment on behalf of "third party investors"

      (1) Third party investors include persons (including related persons) who (I) do not hold partnership investment in connection with an applicable trade or business and (ii) are not actively engaged in providing substantial services related to an applicable trade or business

5. If applicable partnership interest is transferred to a family member or colleague within 3 years, may have to recognize short term capital gain

6. Section 83(b) election does not avoid 3-year holding period requirement

Net Operating Loss Limitations

- No carrybacks
- Indefinite carryforward
- Limited to 80% of taxable income
- Losses generated on asset acquisition may produce loss carryforwards of lesser benefit. Benefits will be lower due to lower tax rates.
- Coupled with the repeal of the corporate alternative minimum tax

Opportunity Zone Funds

- Gains can be rolled over into funds which invest in economically distressed areas.
- Partial exclusion of gain recognized if asset held for more than 5 years and more than 7 years
- If asset held for more than 10 years, then all post acquisition appreciation is excluded