



## **The Tax Cuts and Jobs Act: Opportunities for Tax Planning, Investors, and M&A**

Charles J. Morton, Jr., Partner, Co-chair  
Corporate Practice Group

Norman Lencz, Partner  
Tax and Wealth Planning Practice Group

Chris Davidson, Counsel  
Tax and Wealth Planning Practice Group

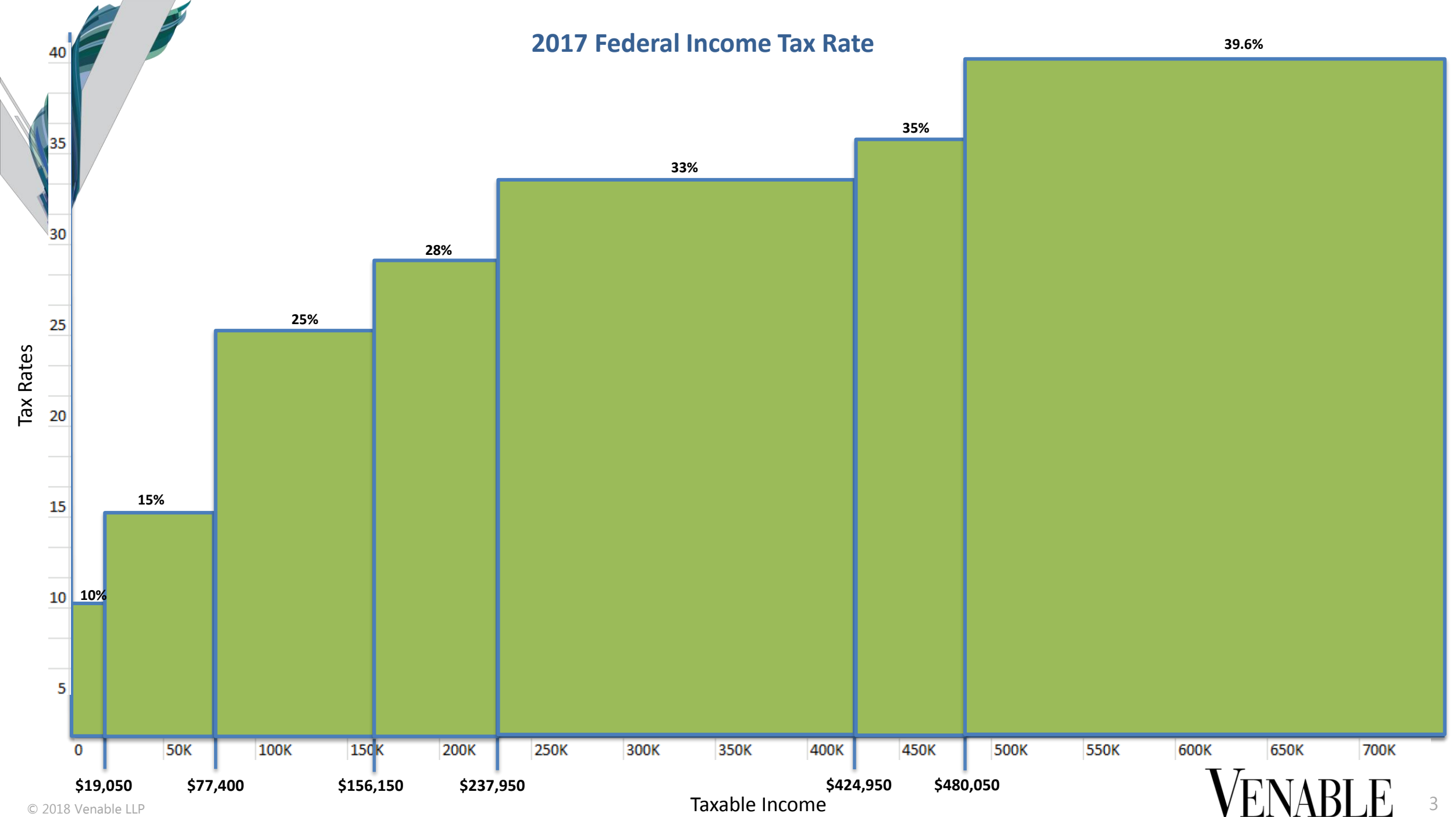
January 30, 2018



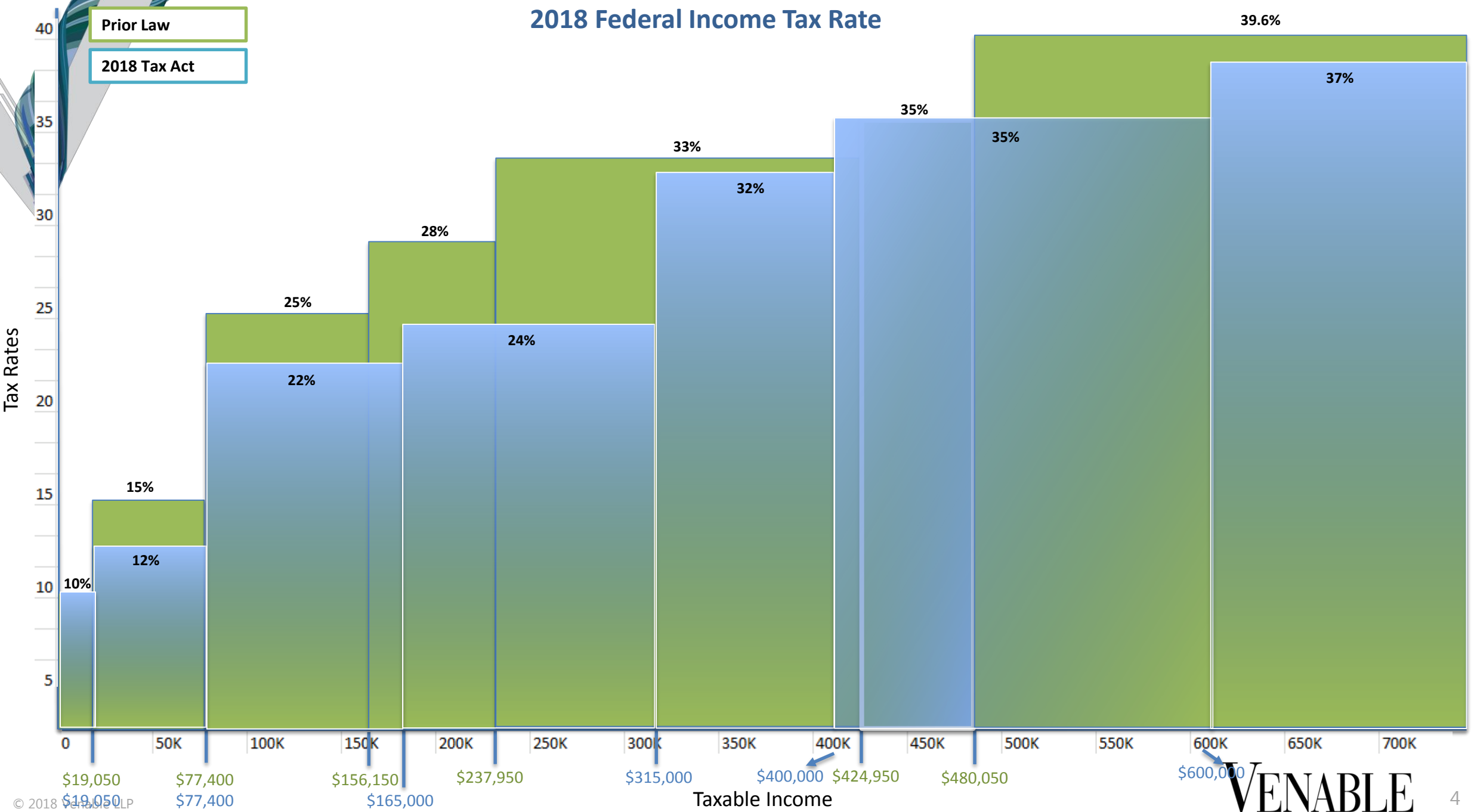
# Introduction

- The recent enactment of the Tax Cut and Jobs Act has dramatically changed the tax landscape for all taxpayers, but the legislation has a particularly significant impact on pass-through entities and their owners (including private equity funds and their investors).
- While the new rules certainly create many opportunities for tax savings, careful planning is necessary to ensure that pass-through entities and their owners take maximum advantage of these new opportunities.
- Given the speed with which the legislation was passed, there are many unanswered questions as to how the new rules will apply.
- This presentation will assist practitioners in understanding how to best navigate these new rules, and will include planning tips and ideas to maximize use of the new 20% pass-through deduction, as well as an in-depth analysis of the impact of the new rules on the “choice-of-entity” decision.

# 2017 Federal Income Tax Rate



# 2018 Federal Income Tax Rate





## Good News

- Rate decreases
- Alternative Minimum Tax (AMT) exemption increases
- Pass through deduction
- Higher standard deduction



## Deductions Lost

- State and local tax > \$10,000
- Miscellaneous itemized deductions (e.g., fund investor's share of fund expenses including management fee)
  - Does not include expenses incurred if activities rise to the level of a trade or business
  - Does not include share of portfolio company expenses if engaged in trade or business
- Mortgage interest to the extent new indebtedness exceeds \$750,000
- Interest on home equity indebtedness

# Federal and Effective New York State and Local Rates

Examples of Effective Rate Change:	2017 Approx. Combined Federal and Effective New York State and Local Rates	2018 Approx. Combined Federal and New York State and Local Rates
Married couple filing jointly with taxable income of \$155,000	32.75%*	32.33%*
Married couple filing jointly with taxable income of \$200,000	35.58%**	34.53%**
Married couple filing jointly with taxable income of \$470,000	41.97%***	45.73%***
Married couple filing jointly with taxable income of \$500,000	46.08%****	45.73%****
Married couple filing jointly with taxable income of \$2,200,000	47.27%*****	49.70%*****

\* Assuming a 2017 Federal income tax rate of 25%; a 2018 Federal income tax rate of 22%; a New York income tax rate of 6.45%; and a local city/county income rate of 3.876%

\*\* Assuming a 2017 Federal income tax rate of 28%; a 2018 Federal income tax rate of 24%; a New York income tax rate of 6.65%; and a local city/county income rate of 3.876%

\*\*\* Assuming a 2017 Federal income tax rate of 35%; a 2018 Federal income tax rate of 35%; a New York income tax rate of 6.85%; and a local city/county income rate of 3.876%

\*\*\*\* Assuming a 2017 Federal income tax rate of 39.60%; a 2018 Federal income tax rate of 35%; a New York income tax rate of 6.85%; and a local city/county income rate of 3.876%

\*\*\*\*\* Assuming a 2017 Federal income tax rate of 39.60%; a 2018 Federal income tax rate of 37%; a New York income tax rate of 8.82%; and a local city/county income rate of 3.876%



# C Corporation Changes

- Corporate income tax rate is permanently lowered to 21% beginning in 2018
- Corporate AMT permanently repealed
- Dividends received deduction reduced





# Pass-Through Deduction – In General

- New “below the line” deduction for “qualified business income” from pass-through entities and sole proprietorships
- Maximum deduction is 20% of “qualified business income” (QBI)
- Non-corporate taxpayers (including estates and trusts) are eligible to claim the deduction
- Effectively reduces the rate on pass-through income to eligible taxpayers to 29.6%
- Sunsets in 2026



# Pass-Through Deduction - Qualified Business Income

- Generally, the ordinary income, gain, deduction, and loss of a qualified trade or business
  - What is a “qualified trade or business”?
    - Generally, any business other than a specified service business or the trade or business of performing services as an employee
    - Specified service business - a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or where the principal asset of the business is the reputation or skill of one or more of its employees, or which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests or commodities.
- Excluded items: the taxpayer’s wages (or reasonable compensation), guaranteed payments, and investment-type income (capital gains, interest, dividends)



# Pass-Through Deduction - Calculation

Subject to certain limits and thresholds, the deduction generally is the sum of:

- The lesser of:
  - 20% of the taxpayer's qualified business income; or
  - The greater of:
    - 50% of the W-2 wages with respect to the business, or
    - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property
- Plus 20% of REIT dividends and distributions from publicly traded partnerships



# Pass-Through Deduction – Limits

Availability and/or calculation of the deduction is subject to limits based on the taxpayer's income and the type of business conducted:

Total Taxable Income	Not Exceeding Threshold (Single - \$157,500 / Joint - \$315,000)	Threshold Plus Phase In	Over Threshold (Single - \$207, 501 / Joint - \$415, 001)
<b>Specified Service</b>	Full 20% deduction, no W2/basis limit	20% deduction subject to phase-out, W2/basis limit phased in	No deduction permitted
<b>Non-Specified Service</b>	Full 20% deduction, no W2/basis limit	20% deduction subject to phase-in of W2/basis limit	20% deduction permitted but fully subject to W2/basis limit



# Pass Through Deduction - Example

- **Example 1:** A wholly-owned business purchases an office building for \$6M (\$3M building, \$3M land). The building generates annual rental income of \$500,000. The maximum potential allowable pass-through deduction would be \$100,000 (20% of \$500,000). If the business paid no wages, the business would qualify for a deduction of only \$75,000 ( $2.5\% \times \$3M = \$75,000$ ).



# Pass Through Deduction - Example

- **Example 2:** Same facts as Example 1, but assume \$4M is allocated to the building. The deduction would not be limited and thus the full \$100,000 ( $2.5\% \times \$4M = \$100,000$ ) would be deductible.



# Pass Through Deduction - Example

- **Example 3:** Same facts as Example 1, but assume the business pays \$100,000 of W-2 wages. The full \$100,000 pass-through deduction would now be available, calculated as follows:
  - $25\% \times \$100,000$  of W-2 wages = \$25,000
  - $2.5\% \times \$3\text{M}$  unadjusted basis = \$75,000
  - $\$25,000 + \$75,000 = \$100,000$



# Pass Through Deduction – Taxable Income Limit

- Deduction is limited to 20% of the excess of taxable income over net capital gain
- **Example:** \$100,000 of QBI, \$200,000 of long-term capital gain and \$50,000 of itemized deductions, resulting in taxable income of \$250,000.
- Before application of this limit, deduction is equal to 20% of QBI of \$100,000, or \$20,000
- Taxable income less net capital gain is \$50,000 ( $\$250,000 - \$200,000 = \$50,000$ ).
- So the deduction will be reduced under this limit from \$20,000 to 20% of \$50,000, or \$10,000
- Note that dividends are not subtracted, even though taxed at capital gain rate





# Pass-Through Deduction - Open Issues

- Is rental real estate a “qualified trade or business”?
- Aggregation/grouping issues – multiple projects under common ownership
  - Real estate management company model – do management company wages count?
  - Two buildings, one fully-depreciated, with high income, the other brand new, with no or little income.
  - If treated as separate businesses, no 20% deduction available
  - If they can be aggregated, full 20% deduction available
- When is a principal asset of the business “the reputation or skill of one or more of its employees”?
- Will “reasonable comp” principles apply to partnerships?



# Pass-Through Deduction – Planning Opportunities

- Switch from W-2 employee to 1099 independent contractor (IC)
  - Loss of employee benefits (e.g., health insurance, 401K, etc.)
  - IC must pay all self-employment taxes
  - Employer may prefer paying W-2 employees in order to “max out” on its pass-through deduction
  - Need to revisit employee vs. IC classification criteria
- Can a “specified service business” “spin off” qualifying portions of its business (e.g., HR, IT, IP)?
- Separate books and records for two lines of business, one a “specified service business” and the other a “qualified trade or business”?



# Pass-Through Deduction – Planning Opportunities

- “Multiply” \$157,500 per person threshold through children and trusts
- Switch from guaranteed payments (which don’t qualify) to preferred returns (which do qualify)
- S corp vs. LLC
  - Wages paid to S corp owners “count” towards W-2 limit, guaranteed payments to LLC don’t because of K-1 rule
  - Possible solution – use tiered structure, employed at lower-tier, own equity through upper-tier
  - “reasonable comp” requirement for S corps
- Switch from 1099 (IC) to W-2 employee to increase W-2 limit



## Choice of Entity – Effective Rates

As a result of the new lower corporate rate, should taxpayers reconsider their choice of entity?

	C Corporation	Pass-Through
Income Tax Rate	21%	29.6% (effective)*
Dividend/Exit Tax Rate	20% + 3.8% = 23.8%	0%
Aggregate Tax Rate	39.8%	29.6%
State/Local Tax Deduction	100%	Property taxes deductible, SALT income taxes not deductible

\*Assumes no 3.8% tax applicable and full use of 20% pass-through deduction



# Choice of Entity – Other Considerations

- Potential for future changes
- Easy to move into C corp status, but difficult to move out
  - Triggering of Section 311(b) gain on conversion/liquidation
  - But S corp election possible after potential 5-year wait
- Limits on ability to defer C corp distributions
  - Cash needs of shareholders
  - Accumulated earnings tax
  - Personal holding company rules
- Many disadvantages to C corp status



## Choice of Entity - REITs

- REITs do especially well:
  - Only one level of tax
  - Shareholders entitled to a 20% qualified business income deduction for ordinary distributions – with no W2/basis limits
- But REIT compliance and maintenance rules are onerous



# Carried Interest

- New 3 year holding period for certain long-term capital gains
- Holding period applies to sale of either underlying asset or partnership interest
- Qualified dividend income is unaffected



## Carried Interest (continued)

- Applies only to “applicable partnership interests”
  - Partnership interest transferred to, or held by, a taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in an “applicable trade or business”
  - No guidance on what constitutes “substantial services”
- “Applicable trade or business” is generally defined to mean (i) raising or returning capital and (ii) either investment or development activities with respect to “specified assets”
- Specified assets include (i) securities, commodities, real estate held for rental or investment and cash or cash equivalents and (ii) options or derivative contracts with respect to, and interests in partnerships relating to, any of these assets





## Carried Interest (continued)

- Has no effect on capital interests
  - Interests received for capital contributions
  - Interests included in compensation
- Does not apply to an interest held by a person who is employed by any entity other than the issuing partnership if (i) such entity conducts a trade or business other than an applicable trade or business and (ii) the person to whom the interest is issued provides services only to that entity (e.g., an executive of a portfolio company that owns equity in a holding entity).
- Related party transfers



# Excess Business Loss Limitation

- Taxpayers cannot claim business losses in excess of threshold amounts (\$250,000 for single filers / \$500,000 for joint filers)
- Previously, concern was generally whether a taxpayer was “passive” or “active” with respect to the business activity
- Now, even “active” losses cannot be used to offset wages or investment income
- Income and loss from all businesses first netted against each other
- Excess loss not suspended until sale, but “rolls into” NOL carryforward, subject to “80% limit” annually
- Taxpayers no longer able to pay “zero tax”
- Applies at partner or S corporation shareholder level
- Sunsets in 2026



# Interest Expense Limitation

- Generally, no deduction for interest expenses that exceed 30% of the taxpayer's adjusted taxable income
- For pass-through entities, the limit applies at the entity (not the owner) level
- Applies to new and existing debt
- Real estate business can elect out of the limit, but in exchange, depreciation periods extended and no bonus depreciation except for TPP and land improvements



# Tax Exempt Investor Considerations

- New 1.4% excise tax on “net investment income”
  - Applies to private institutions of higher learning if (i) institution has at least 500 tuition-paying students more than 50% of which are located in U.S. and (ii) aggregate value of non-educational assets is at least \$500,000 per student
  - “Net investment income” includes items such as interest, dividends, rent, payments with respect to securities loans, royalties, and capital gains (i.e., generally such institution’s share of income from an investment fund)
- UBTI computed separately for each business
  - Thus, can’t use losses in one business to offset gain in another
  - Losses incurred before 2018 taxable year are grandfathered
  - Could lead to increase in use of blockers or less investment in funds with operating partnerships by tax exempts
  - If tax exempt has unblocked interest in a fund with operating partnerships, fund will need to provide information that separates out the net income and net loss generated by each operating partnership



# Foreign Investor Considerations

- Codification of Rev. Rul. 91-32
  - 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
  - Effective for dispositions after November 27, 2017
- 10% withholding on the gross purchase price on the sale of a partnership interest unless the seller can establish that it is a U.S. person or that no portion of the gain is attributable to effectively connected income generating assets
  - Effective for dispositions after December 31, 2017
  - Presumably applies to a redemption
  - If buyer fails to withhold, the partnership is liable for the withholding tax (plus interest) – statute requires the partnership to deduct such amounts from distributions otherwise payable to the transferee



# Bonus Depreciation

- 100% bonus depreciation deduction for qualified property, whether new or used, acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023
- Phases down beginning in 2023 and sunsets in 2026
- If a real estate business elects out of the interest expense limit, depreciation periods extended and no bonus depreciation except for TPP and land improvements



# NOL Limitations

- No NOL carrybacks, only carryforwards
- Carryforward is indefinite
- Amount of an NOL carryforward that is deductible in any taxable year is limited to 80% of that year's taxable income
- Negative impacts on target cash flow in M&A transactions



# Deemed Repatriation

- As part of the switch to a territorial system of taxation, there is a one-time tax on a deemed repatriation of foreign earnings
  - 15.5% rate on E&P invested in cash or cash equivalents
  - 8% to the extent invested in other assets
- Can elect to pay in 8 back-loaded annual installments
  - First five installments of 8% of tax, sixth of 15%, seventh of 20%, and eighth of 25%
  - No interest charge or penalty for making this election
- Implications
  - Frees up previously “trapped” cash





# Like-Kind Exchanges

- Like-kind exchanges still are permitted for real estate
- No property other than real estate can be exchanged in a like-kind exchange
- What about TPP included in real estate? Will this always constitute taxable “boot”? Will there be a *de minimis* exception?



# Technical Terminations of Partnerships

- Under former Section 708(b)(1)(B), a partnership terminated upon a sale or exchange of 50% or more of a partnership's equity within 12 months
- This provision is now repealed—no restart of depreciation periods, no filing short-year return on termination, and no “clean slate” for elections



# FOR FURTHER INFORMATION, CONTACT:



**Norman Lencz**

Venable LLP

Baltimore, MD

410-244-7842

[nlencz@venable.com](mailto:nlencz@venable.com)



**Charles J. Morton, Jr.**

Venable LLP

Baltimore, MD

410-244-7716

[cjmorton@venable.com](mailto:cjmorton@venable.com)



**Chris Davidson**

Venable LLP

Baltimore, MD

410-244-7780

[csdavidson@venable.com](mailto:csdavidson@venable.com)