Lowenstein Sandler

Client Alert

Tax

December 22, 2017

Key Partnership Tax Provisions

On December 20, 2017, Congress passed a statute originally named the Tax Cuts and Jobs Act (the "Act"), which enacts a broad range of tax changes. The Act was signed by the President on December 22. This alert briefly summarizes some of the key federal income tax provisions of the Act relating to partnerships and their partners.

New Deduction for Income From Certain Partnerships

For taxable years beginning after 2017 (and before 2026), the Act provides a new 20% deduction to individuals, trusts and estates that receive income from certain S corporations, sole proprietorships and partnerships ("pass-throughs"), subject to various limitations.

The 20% deduction is generally not available to partners in a law firm, accounting firm, investment fund or consulting business, but could be used by partners in a real estate investment fund, consumer business or technology company. The devil is in the details. Specifically, the Act provides that partners are allowed a deduction in respect of "qualified business income" ("QBI") from a partnership that constitutes a "qualified trade or business" ("QTB") of that partner.

Qualified Business Income: QBI means the net amount of items of income, gain, deduction and loss that are effectively connected with a QTB of the taxpayer for a taxable year. Notably, QBI does *not* include: capital gain or capital loss, dividends, dividend equivalents, interest income (other than interest allocable to a trade or business), certain other items of passive income, qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income. Guaranteed payments paid to a partner for services rendered to the QTB also do not qualify as QBI. If the net QBI of a taxpayer's QTBs for the year is less than zero, the taxpayer may carry over that loss to the succeeding taxable year.

Qualified Trade or Business: A QTB is any U.S. trade or business, other than the trade or business of being an employee or a trade or business whose principal asset is the reputation or skill of one or more of its employees or owners. Such excluded service businesses include the fields of health, law, accounting, consulting, financial services, brokerage services, investing and investment management, as well as trading or dealing in securities, partnership interests or commodities. However, if a taxpayer makes less than $315,000 (for married individuals filing jointly) or $157,500 (for all other individuals) (as adjusted for inflation), all trades or businesses qualify as QTBs, with a phase-out for taxpayers making more than such threshold amounts.

Calculating the Deduction: Generally, the Act provides for a deduction equal to 20% of the QBI with respect to all QTBs and 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year. The 20% QBI deduction is limited by the greater of (i) the partner's allocable share of 50% of the W-2 wages paid with respect to such QTB and (ii) the partner's allocable share of the sum of 25% of the W-2 wages paid with respect to the QTB and the partner's allocable share of 2.5% of the unadjusted basis of the QTB's depreciable tangible property that is used in the production of QBI, and for which the depreciable period has not ended. (Notably, that computation references the basis of property at the time of its acquisition – regardless of depreciation thereafter – creating a significant benefit to partners in real estate partnerships.) As with the exclusions from QTB status, that limit does not apply to taxpayers with annual, inflation-adjusted earnings of up to $315,000 (for married individuals filing jointly) or $157,500 (for all other individuals), with a phase-in for taxpayers making more than such threshold amounts. The taxpayer's ability to take the 20% deduction in respect of QBI is further limited to the extent it exceeds the taxpayer's taxable income (reduced by net capital gain).

Planning Pointer: In light of this new deduction, pass-through entities and their owners may want to consider reviewing tax distribution provisions of current shareholder and operating agreements to determine whether modifications to such provisions are warranted.

Profits Interest: Limitation on Capital Gains Recognition

Under current rules, if a person (other than a corporation) is allocated taxable income or gain in respect of a partnership interest (regardless of whether such interest is a capital interest or a profits interest), the character of such income or gain is determined at the partnership level. If the partner is allocated capital gain income, whether such capital gain income is long-

term (subject to preferential tax rates) or short-term, is dependent on whether the partnership's holding period in the assets sold exceeded one year. **Generally, the Act imposes additional time-based restrictions on the recognition of long term capital gain in respect of certain profits interests.**

The Act provides that for tax years beginning after December 31, 2017, with respect to an "applicable partnership interest" capital gain recognized in respect of such partnership interest will be treated as long-term capital gain (subject to preferential tax rates) only to the extent the partnership assets producing the gain were held for more than three years (as opposed to the generally applicable one-year holding period threshold). The Act also provides that the direct or indirect transfer of an applicable partnership interest to a family member or another service provider will cause the transferor to recognize at ordinary income tax rates that portion of any gain attributable to capital gain assets not held for more than three years. The Secretary of the Treasury is directed to issue rules preventing this new provision from applying to income or gain from any asset not held for portfolio investment on behalf of third party investors. However, we do not yet know what specific approach such guidance will take.

"An applicable partnership interest" is a partnership interest received by the taxpayer in connection with the taxpayer's (or a related person's) performance of substantial services in the trade or business of raising or returning capital and either investing in, or disposing of, securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivatives, and similar interests or developing such assets. Accordingly, the provision was intended to apply to carried interests and other profits interests granted in respect of a portfolio or asset management business, although it is too soon to gauge the ultimate breadth of this provision's application.

Gain on the Sale of a Partnership Interest by a Foreign Person

The Act provides that after November 27, 2017, if a foreign person sells, exchanges or otherwise disposes of an interest in a partnership that engages in any United States trade or business, gain or loss on the disposition will be treated as "effectively connected income" to the extent the foreign person would have had effectively connected income had the partnership sold its assets. **Accordingly, the sale of a partnership interest by a foreign person will be subject to U.S. graduated income tax rates if the partnership is engaged in a U.S. trade or business**.

The transferee of a partnership interest subject to this new provision is required to withhold a tax equal to 10% of the amount realized on the disposition of such interest, unless the transferee receives an affidavit confirming that the transferor is not a foreign person. If the transferee fails to withhold, the partnership is required to withhold from distributions to the transferee in an amount equal to the amount the transferee failed to withhold, plus interest. These new withholding provisions go into effect for dispositions after December 31, 2017.

Historically, in a much criticized 1991 ruling, the Internal Revenue Service had taken a position consistent with the new Act provision. However, in 2017, the Tax Court had found the ruling invalid. The Act resolves the uncertainty in favor of the IRS.

Other Technical Changes

Repeal of Technical Termination Rule: Historically, a partnership is treated as terminated if within a 12-month period there is a sale or exchange of 50 % or more of the total interest in partnership capital and profits (a "technical termination"). The Act eliminates technical terminations for taxable years beginning after December 31, 2017.

Mandatory Adjustment to Basis of Partnership Property: The Act imposes a mandatory adjustment to the basis of partnership property in connection with the transfer of a partnership interest where there is a substantial built-in loss: i.e., if the transferee partner would be allocated a loss exceeding $250,000 if the partnership assets were sold for fair market value immediately after such transfer. Before the Act, the mandatory basis adjustment was triggered only if there were a substantial built-in loss at the partnership level. For taxable years beginning after December 31, 2017, the Act extends the substantial built-in loss test to the partner level.

Charitable Deductions and Foreign Taxes: Generally, a partner may not deduct losses in excess of the partner's basis in the partnership interest. After 2017, that basis limitation will include reductions for a partner's distributive share of charitable contributions made by the partnership and foreign taxes paid by the partnership. However, for contributions of appreciated property, the new rule disregards the partner's distributive share of the excess of the fair market value of the contributed property over its adjusted basis.

This Alert provides only a simple overview of complex and nuanced tax provisions. Given the fluid fiscal and legislative environment, there may be additional changes coming. To learn more about the Act and its implications for you or your business, please contact one of the Lowenstein Sandler attorneys listed.

For more information about other provisions of the Act, please see the links below:

KEY CORPORATE & BUSINESS TAX PROVISIONS
KEY INDIVIDUAL TAX PROVISIONS
KEY FOREIGN TAX PROVISIONS
KEY TAX-EXEMPT ORGANIZATION TAX PROVISIONS
KEY TRUST & ESTATE TAX PROVISIONS
KEY TAX PROVISIONS AFFECTING HEDGE FUNDS, PRIVATE EQUITY FUNDS AND OTHER INVESTMENT VEHICLES

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