

THE TREATMENT OF CORPORATIONS AND PARTNERSHIPS UNDER THE TCJA

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In December of 2017, Congress passed and the President signed Pub. L. No. 115-97 (the “TCJA”), perhaps the most significant tax act of the last thirty years.¹ This paper describes a number of its critical provisions, although it decidedly does not discuss changes to the international tax regime.

The paper first considers tax changes for C corporations, the most notable of which was the imposition of a flat 21% rate on a C corporation’s taxable income, a change that substantially reduces the stated tax rate for large, profitable corporations. Because the corporate rate now falls far short of the maximum individual rate, the change also reinvigorates two quiescent penalty tax regimes, the personal holding company tax and the accumulated earnings tax. The TCJA also reduced the dividends received deduction for dividends received by corporate shareholders on portfolio stock, a reduction hard to justify except as a political expedient. Further, it repealed the corporate alternative minimum tax and refined the treatment of capital contributions.

The paper next investigates some noteworthy changes benefitting small businesses, which under the TCJA include businesses of a greater size. Under the act, more taxpayers can use the cash method of accounting, and fewer taxpayers must use either the inventory method or completed contract method or must capitalize costs under the uniform

¹ Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified as amended in scattered sections of 26 U.S.C.) [hereinafter TCJA]. Although earlier House and Senate bills would have entitled the act the Tax Cuts and Jobs Act, the Senate parliamentarian decided that the provision titling the bill plus two other provisions violated the “Byrd” rule. Because the Senate could not muster the 60 votes necessary to retain those provisions, they were removed from the bill, as enacted. See 2018 STN Magazine 1-4. Nevertheless, many still refer to the act as the “Tax Cuts and Jobs Act” or the “TCJA,” and this paper follows that practice, labelling the act the “TCJA.” See also DAVIS POLK & WARDWELL LLP, *The New “Not Quite Territorial” International Tax Regime*, TAX REFORM AND TRANSITION BLOG (Dec. 20, 2017), <https://www.taxreformandtransition.com/wp-content/uploads/sites/29/2017/12/2017-12-20-gop-tax-cuts-jobs-act-preview-new-tax-regime.pdf> (for an extended summary of the TCJA).

capitalization rules. The TCJA also expanded when small businesses may expense (*i.e.*, fully deduct) their cost of depreciable property.

That expansion, however, is overshadowed by a change to the bonus depreciation rules, rules discussed to start the third part of the paper. Under those rules as modified, any taxpayer, not just a small business, can expense the cost of most depreciable tangible property other than real property, but generally only if the property is placed in service before 2023. As another major change, bonus depreciation is available whether the purchased property is new *or used* when acquired.

The third part also explores some ways that the TCJA limits deductions. For instance, it generally restricts a taxpayer's deduction for business interest to 30% of taxable income, as adjusted, with any disallowed interest carried to the next year. Further, a taxpayer other than a C corporation cannot deduct any excess business loss in any year, treating the excess instead as a net operating loss. Finally, most taxpayers can no longer carry net operating losses (*i.e.*, broadly net business losses) back to prior years, although they may be carried forward indefinitely. In combination, those changes may make it more likely that a profitable business falling on hard times will fail. Unlike under prior law, the troubled business will be unable to carry its losses back to profitable years and garner a tax refund. In addition, it may suffer an economic loss in a year but still incur a tax cost, no longer able to fully deduct its business interest.

The third part concludes, discussing how the compensation deduction for certain executives of a publicly traded corporation cannot exceed \$1 million. The TCJA broadened the scope of the limitation, expanding the types of compensation and the executives, past and present, to which that rule applies.

The fourth part of the paper describes changes to the tax treatment of current or former S corporations. The TCJA added two changes that apply after an S corporation converts to a C corporation. Because of the conversion, the corporation may change its method of accounting, making adjustments to prevent tax items from being duplicated or omitted from taxable income. Under the TCJA, those adjustments are taken into account over six, rather than four, years. In addition, the act extended the time that distributions by the former S corporation to its shareholders are

deemed paid out of S corporation earnings. Generally, those distributions are tax-free to the shareholders but reduce their stock bases. Finally, although a non-resident alien cannot directly own stock in a corporation treated as an S corporation, the act allowed an electing small business trust to be an S corporation shareholder but still have a non-resident alien as a potential income beneficiary.

Partnership tax changes are considered in the fifth part of the paper. As background for the first change, when a person buys a partnership interest and the partnership has a substantial built-in loss, the partnership adjusts its asset bases, so that the purchaser's basis in her partnership interest matches (or approaches) her share of the partnership asset bases. Under the TCJA, substantial built-in loss is measured not just at the partnership level, but also at the partner level. As a second change, the TCJA expanded the rule that limits a partner's deduction of allocable partnership loss to the basis of her partnership interest. Because of the TCJA, that limitation now applies to the partner's share of partnership deductions for foreign taxes and charitable contributions. As a welcome change, the TCJA also provided that a partnership no longer terminates just because 50% or more of the interests in partnership profits or capital have been sold or exchanged within a 12-month period.

In its loudest partnership tax change, the TCJA addressed carried interests. A carried interest includes a profits interest in a partnership received by an investment manager in exchange for services provided to the partnership. If the partnership profit allocated to the manager is long-term capital gain, the manager arguably enjoys compensation income taxed at preferential rates. With some twists and turns, the act addressed that concern by requiring the holder of a carried interest, which the TCJA calls an "applicable partnership interest," to determine net long-term capital gain with respect to the interest by using a three-year, rather than a one-year, holding period.

In its penultimate part, the paper describes the deduction for qualified business income under new § 199A of the Internal Revenue Code of 1986, as amended (the "Code"), a deduction not available to C

corporations. Because the taxable income of a C corporation is now taxed at a rate substantially below the highest rate imposed on individuals, that differential, without § 199A, would make a C corporation the entity of choice for a wealthy individual operating a business. The § 199A deduction lowers the effective tax rate for business income earned directly or through a pass-thru entity, arguably making the choice of entity more tax-neutral.

Although § 199A defies brief and accurate summary, a typical taxpayer's § 199A deduction for a qualified trade or business is tied to the smaller of (i) 20% of the taxpayer's net income for the trade or business or (ii) an amount that takes into account not only wages paid by the trade or business but also the cost of its depreciable property. Although a qualified trade or business generally is any trade or business, one non-qualified business is the performance of services as an employee. Thus, § 199A treats employees less favorably than the self-employed. Section 199A has considerable added nuance that only a detailed examination may uncover.

The paper concludes with some final thoughts on how the TCJA affects choice of entity. As before the TCJA's enactment, a pass-thru entity or sole proprietorship often will be favored over a C corporation, particularly for lower-income taxpayers. In some cases, however, the TCJA complicates the choice by adding variables that cannot be anticipated with certainty. Of course, even with the TCJA's changes, it remains ill-advised to make that choice by relying indiscriminately on rules of thumb and not carefully considering all relevant facts.

I. C CORPORATION TAX CHANGES

A. Corporate Tax Rates

As one of its signature changes, the TCJA amended § 11(b) of the Code, imposing a flat 21% tax on the taxable income of a C corporation.² This amendment reduced the stated tax rate for many profitable corporations.

² See § 13001(a) of the TCJA. This amendment is effective for taxable years beginning after December 31, 2017. § 13001(c)(1) of the TCJA. Note that unless otherwise stated, a reference to a "§" or "section" is to a section of the Code as it exists on the date of this

Before the amendment, the corporate tax rates were graduated, although the benefit of graduation was eliminated with two add-on taxes. A 15% rate was imposed on the first \$50,000 of taxable income, a 25% rate on the next \$25,000 of taxable income, a 34% rate on the next \$9,925,000 of taxable income, and a 35% rate on any remaining taxable income.³ A 5% add-on tax was also imposed on taxable income between \$100,000 and \$335,000, eliminating the benefit of the lowest two graduated rates,⁴ while a 3% add-on tax was imposed on taxable income between \$15,000,000 and \$18,333,333, eliminating the benefit of the 34% rate.⁵

The TCJA substantially reduces the tax rate for large, profitable corporations and corporate groups,⁶ dropping the stated rate from 35% to 21%, a 40% reduction. However, some smaller or less profitable corporations, formerly taxed at just a 15% rate, will suffer a 40% tax rate increase. Nevertheless, the tax reduction will overwhelm any tax increase, because the taxable income for the large profitable corporations will dwarf the taxable income of the smaller or less profitable corporations.

paper. For convenience, a reference to a Code section followed by the parenthetical like “(before its amendment by the TCJA)” is to the Code provision immediately before the enactment of the TCJA. Further, a reference to a Code section followed by a parenthetical like “(as amended by the TCJA)” or “(as added by the TCJA)” is to the Code section immediately after the relevant effective date of the TCJA.

³ § 11(b) (before its amendment by the TCJA).

⁴ Because of the 5% add-on tax, a corporation with taxable income between \$335,000 and \$10,000,000 was taxed at a flat 34% rate.

⁵ § 11(b) (before its amendment by the TCJA). Because of the 3% add-on tax, a corporation with taxable income exceeding \$18,333,333 was taxed at a flat 35% rate.

⁶ Note that when § 11 still provided graduated rates, a controlled group of corporations could use only one set of graduated rates. *See* § 1561(a)(1) (before its amendment by the TCJA).

Proponents of the tax rate reduction argue the lower-taxed corporations will increase workers' wages,⁷ but the amount of any increase is uncertain.⁸ The worker's share of the corporate tax burden may depend on a number of economic factors, including "international capital mobility, international product substitution elasticity, and the capital intensity of the corporate sector."⁹ Other relevant factors may include the extent to which the corporate tax subsidizes debt-financed investment; the extent to which that tax is actually a tax on economic profits; whether the United States' reduction in corporate tax rates prompts a similar response by other countries; and how corporate taxation affects wage bargaining.¹⁰

⁷ See *Will Corporate Tax Cuts Boost Workers' Wages?*, THE ECONOMIST (Oct. 26, 2017), <https://www.economist.com/news/finance-and-economics/21730696-white-house-report-puts-economists-each-others-throats-will-corporate-tax-cuts> (noting that the President's Council of Economic Advisers predicted that the average annual income of workers would increase from \$4,000 to \$9,000 because of the corporate tax reduction although at least left-leaning economists strongly disagree). *Contra Corporate Tax Cuts Will Not Increase Wages for Working Families*, ECONOMIC POLICY INSTITUTE (Oct. 25, 2017), <http://www.epi.org/press/corporate-tax-cuts-will-not-increase-wages-for-working-families> (concluding that the reduction in corporate tax rates will not increase wages for working families); see Paul Krugman, *Bonuses and Bogosity*, N.Y. TIMES (Feb. 27, 2018), <https://www.nytimes.com/2018/02/27/opinion/bonuses-and-bogosity.html> (asserting that the "long run effect" of the corporate tax cut on wages will be "small"); Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. 433, 460 (2012) (concluding that the evidence that higher corporate tax rates lower wages "is not persuasive"). Note that workers in more capital-abundant countries earn higher wages. *Id.* at 458.

⁸ Economists disagree on how to measure not only the incidence of corporate tax, but also the relative portions of corporate tax borne by capital and labor. See generally Clausing, *supra* note 7 (reviewing the work of several economists); Jennifer Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, 66 NAT'L TAX J. 185 (2013) (noting that the conclusions about corporate incidence vary depending on the assumptions made); Arnold C. Herberger, *The Incidence of the Corporation Income Tax Revisited*, 61 NAT'L TAX J. 303 (2008) (reviewing some different methodologies to determine corporate tax incidence).

⁹ See Clausing, *supra* note 7, at 436 (listing these and other factors).

¹⁰ *Id.* (noting that prior studies of corporate tax incidence had failed to take these and other factors into account).

Worker's wages may also be affected by other tax changes.¹¹ In combination, these variables defy precise measurement, making it a fool's errand to predict a typical worker's benefit from a reduction in corporate tax rates. However economists may view that likely benefit, the run-up in the stock market suggests what many investors likely believe—that the corporate tax rate reduction will predominantly benefit holders of capital.¹²

As a collateral effect, the corporate tax rate reduction revitalizes two nearly moribund penalty taxes, the personal holding company tax and the accumulated earnings tax. Those two complimentary regimes buttress the double-tax system for C corporations and their shareholders by encouraging corporations to pay taxable dividends to their shareholders. Without those penalty taxes, corporations and their shareholders may be motivated to warehouse earnings at the corporate level, at least when the maximum individual tax rates substantially exceed the maximum corporate rates, as they do now for the first time in over thirty years.¹³

¹¹ For example, the TCJA may limit debt-financed, capital investment by corporations, not only because the TCJA's corporate rate change reduced the economic benefit of a corporation's interest deduction, but also because it limited the deduction for business interest. See *infra* notes 107–133 and accompanying text (for a discussion of that limitation). Those changes could reduce overall capital investment, perhaps dampening workers' wages.

¹² See David Goldman & Jeanne Sahadi, *Only 13% of Business' Tax Cuts Are Going to Workers*, *Survey Says*, CNN MONEY (Feb. 9, 2018), <http://money.cnn.com/2018/02/09/news/companies/tax-cut-bonuses-buybacks/index.html> (describing a survey of Morgan Stanley analysts who estimated that only 13% of the corporate tax cut would be paid to workers with the remainder used to fund shareholder dividends and share buybacks, capital investment, and mergers and acquisitions, among other things).

¹³ The TCJA created that disparity, because the reduction in the maximum corporate rate far exceeded the reduction in the maximum individual rate. See § 1(j) (as modified by § 11001(a) of the TCJA) (providing a maximum individual rate of 37%); § 11(b) (as modified by 13001(a) of the TCJA) (imposing a flat 21% tax on the taxable income of a C corporation). See also § 1411(a) (adding a 3.8% tax on net investment income for higher-income taxpayers).

When corporate rates are lower than individual rates, an individual may try to shift income to corporations, incorporating investment assets, providing personal services through a corporation, or transferring personal assets to a corporation and then renting them back from the corporation. The personal holding company tax provisions attack each of those devices. If a corporation is a personal holding company, a 20% tax is imposed on its undistributed personal holding company income, in addition to other taxes imposed under the Code.¹⁴ Because the personal holding company tax is intended to encourage distributions, this additional tax can be avoided if the corporation pays adequate dividends.¹⁵

To be a personal holding company, a corporation must meet ownership and income tests. It meets the ownership test for a taxable year if at any time during the last half of the year, five or fewer individuals own, directly or indirectly, more than 50% (by value) of its stock.¹⁶ The corporation meets the income test if at least 60% of its “adjusted ordinary gross income” is personal holding company income.¹⁷

Adjusted ordinary gross income is gross income reduced by gains from the sale or exchange of capital and § 1231 assets and with

¹⁴ § 541. For a more complete discussion of the personal holding company tax regime, see RICHARD L. DOERNBERG, HOWARD E. ABRAMS & DON A. LEATHERMAN, FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS 492–95 (5th ed. 2014); HOWARD E. ABRAMS, RICHARD L. DOERNBERG & DON A. LEATHERMAN, FEDERAL CORPORATE TAXATION 378–84 (7th ed. 2013).

¹⁵ § 543 (defining undistributed personal holding company income as taxable income, with some adjustments, reduced by a dividends paid deduction); § 561 (defining the deduction for dividends paid). Those dividends may include “deficiency” dividends paid after liability for the personal holding company tax is established by a closing or other agreement with the IRS or by a decision by the Tax Court or a court of competent jurisdiction that has become final. § 547(a) (allowing the deduction for those dividends to determine the tax but not interest, additional amounts, or assessable penalties).

¹⁶ § 542(a)(2). For this purpose, constructive ownership rules apply. *See* § 544 (attributing stock owned by entities proportionately to owners and attributing to an individual stock owned by a partner or family member (*i.e.*, sibling, spouse, lineal descendants or ancestors)).

¹⁷ § 543(a)(1).

adjustments for certain high-gross/low net income activities.¹⁸ Broadly speaking, personal holding company income is passive income, such as dividends, interest, annuities, and certain royalties and rent.¹⁹ To reach payments for incorporated personal assets, personal holding company income may also include payments made by a 25% shareholder for use of tangible corporate property.²⁰ It may also include amounts received under a personal service contract if the service provider owned at any time during the taxable year at least 25% of the corporation's stock.²¹

¹⁸ § 543(b)(1) (for the reduction for gains from capital and § 1231 assets); § 543(b)(2)(A) (computing the rental income amount as gross rent reduced by deductions for depreciation, property taxes, interest, and rent); § 543(b)(2)(B) (computing the income amount for mineral, oil, and gas royalties as the gross royalties reduced by deductions for depreciation, property and severance taxes, certain interest, and certain rent).

Note that capital gain is not personal holding company income. For lower-taxed individuals, the corporate tax rate on capital gains will exceed the individual rate; for higher-taxed individuals, the corporate rate typically is just less than the individual rate. § 11(b) (as modified by § 13001(a) of the TCJA) (imposing a flat 21% tax on the taxable income of a C corporation); § 1(h)(1)(D) (providing that the typical maximum individual rate on long-term capital gain is 20%); § 1411(a) (adding a 3.8% tax on net investment income for higher-income taxpayers). Even that modest benefit for higher-taxed individuals is countered by the possible double tax on the gain. Thus, individuals have little incentive to shift capital gain to corporations, justifying excluding capital gain from personal holding company income.

¹⁹ § 543(a). Special rules distinguish between rents and royalties generated by active business operations (which are excluded from personal holding company income) and those generated through passive investments (which are included). See § 543(a)(2)–(5).

²⁰ § 543(a)(6)(B) (including the payment if the corporation has personal holding company income, as adjusted, in excess of 10% of its ordinary gross income). Note that these payments are taken into account whether or not the shareholder had transferred the rental property to the corporation.

²¹ § 543(a)(7) (also providing that some person other than the corporation must have the right to designate (by name or description) the service provider or the service contract must designate (by name or description) the service provider).

If the personal holding company tax regime stood alone, individuals may still be motivated to warehouse income in corporations. For example, that regime would countenance an individual shifting higher-taxed income to a corporation as long as more than 40% of the corporation's adjusted ordinary gross income was not personal holding company income. If the individual retained the corporation's stock until death, the stock would take a fair market value basis,²² and the individual's successor could sell the stock with little or no tax.²³

That tax-avoidance concern is addressed by the accumulated earnings tax regime, which may apply when a corporation accumulates earnings beyond the reasonable needs of its business.²⁴ If that regime applies to a corporation, a 20% tax is imposed on its accumulated taxable

²² § 1014(a).

²³ § 1001; *see also* §§ 302(a), 303 (treating certain redemptions of stock as sales or exchanges).

²⁴ § 532(a) (generally imposing the accumulated earnings tax on a corporation “formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being . . . distributed”); § 533(a) (in applying § 532(a), providing that the purpose to avoid tax is established if the earnings and profits of the corporation are accumulated beyond the “reasonable needs of the business” unless the corporation by the preponderance of evidence proves the contrary); § 533(b) (providing that if the corporation is a holding or investment company, that status is *prima facie* evidence of the purpose to avoid tax); Treas. Reg. § 1.533-1(c) (as amended in 1963) (defining a holding company as a corporation that has practically no activities other than “holding property and collecting the income therefrom or investing therein”); *id.* (defining an investment company as (i) a corporation whose activities consist substantially of buying and selling stocks, securities, real estate, or other investment property, so that its income is derived from investment yield and market appreciation or (ii) a corporation which conducts not only the activities described in (i) but also the activities of a holding company); *see also* § 532(b) (excepting from the accumulated earnings tax a personal holding company, among other corporations).

The burden to prove that earnings and profits have not been unreasonably accumulated is generally on the taxpayer, although in certain circumstances the burden shifts to the government in cases before the Tax Court. *See* § 533(a) (placing the initial burden on the taxpayer); § 534 (for circumstances where the burden may shift to the government in proceedings before the Tax Court).

income, in addition to other taxes imposed under the Code.²⁵ Because the accumulated earnings tax is intended to encourage distributions, that tax can also be avoided if the corporation pays adequate dividends.²⁶

In applying the accumulated earnings tax regime, the Internal Revenue Service (the “IRS”) and taxpayers focus on whether the corporation has accumulated earnings and profits (“e&p”) beyond the reasonably anticipated needs of its business. As the regulations caution, that determination is based on facts and circumstances, but the regulations suggest some grounds that may support the accumulation of e&p, including the following:

- (i) to provide for the bona fide expansion of a business or replacement of a plant;
- (ii) to acquire a business by purchasing stock or assets;
- (iii) to provide for the retirement of bona fide indebtedness created in connection with the business (*e.g.*, by establishing a sinking fund);
- (iv) to provide necessary working capital for the business; or

²⁵ § 531. For a more complete discussion of the accumulated earnings tax regime, see DOERNBERG, ABRAMS & LEATHERMAN, *supra* note 14, at 483–92; ABRAMS, DOERNBERG & LEATHERMAN, *supra* note 14, at 372–78.

²⁶ § 535 (defining accumulated taxable income as taxable income, with some adjustments, reduced by a dividends paid deduction); § 561 (defining the deduction for dividends paid). Note that the accumulated earnings tax regime does not allow a taxpayer to escape the tax through the payment of deficiency dividends after liability for the tax has been established by agreement or final court decision. *Cf.* § 547(a) (providing for deficiency dividends to avoid the personal holding company tax).

(v) to provide loans to suppliers or customers if necessary to maintain the business.²⁷

Of course, the e&p accumulation may be justified on other grounds (*e.g.*, to fund pension plans, make necessary capital improvements, or provide worker training). No matter the justification, however, the corporation must have “specific, definite, and feasible plans for the use of such accumulation.”²⁸

If the corporation has accumulated e&p beyond its reasonably anticipated business needs, it must pay an extra 20% tax on its accumulated taxable income.²⁹ That income amount equals its taxable income, with some adjustments to more accurately measure dividend-paying capacity, minus the dividends paid deduction, and minus the accumulated earnings credit.³⁰ Because of the accumulated earnings credit, a corporation can accumulate a minimum amount of e&p without being subject to the accumulated earnings tax. Generally that amount is \$250,000, and it is measured cumulatively, not annually.³¹

²⁷ Treas. Reg. § 1.537-2(b) (as amended in 1986) (adding as another ground to provide for the payment of reasonably anticipated product liability losses). *Cf.* Treas. Reg. § 1.537-2(c) (offering a non-exclusive list of non-qualifying purposes for accumulating e&p including making loans to shareholders or other loans with no reasonable relationship to the business, investment in properties unrelated to the activities of the business, and retention of e&p to hedge against unrealistic hazards).

²⁸ Treas. Reg. § 1.537-1(b) (as amended in 1986).

²⁹ § 531.

³⁰ § 535(a); *see also* § 535(b) (among other things, providing that taxable income is reduced by non-deductible taxes, disallowed charitable contributions, and disallowed capital losses and increased by any dividends received deduction, net operating loss deduction, and deduction for capital loss carryovers).

³¹ § 535(c)(2)(A) (providing that the minimum credit for a taxable year is generally the amount by which \$250,000 exceeds the accumulated e&p at the end of the preceding year); *see* § 535(c)(2)(B) (providing a minimum cumulative credit of \$150,000 for a corporation if its principal function is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting); § 535(c)(1) (providing that the accumulated earnings credit generally can be increased by the excess of (i) the amount necessary to meet the reasonable needs of the business over (ii) net capital gains described in § 535(b)(6) (an amount that also reduces

Despite the personal holding company tax and accumulated earnings tax regimes, individuals may still be prompted to minimize tax by transferring investment assets to C corporations. For example, if a high-taxed, elderly individual owns the stock of a C corporation that operates an active business, she may acquire and transfer highly taxed investment assets to the corporation to hold until her death. Because of the corporation's active business income, it may avoid the personal holding company tax. Further, the \$250,000 accumulated earnings credit may shield the corporation from the accumulated earnings tax. If the corporation can avoid those penalty taxes until the individual's death, the individual will have reduced her overall tax burden by shifting the investment income to the corporation,³² and her successors will be able to sell the corporation's stock with little or no tax.³³

Note that an individual may incorporate investment assets even if the corporation will currently distribute all net investment earnings, because the overall tax may be slightly reduced by interposing the corporation. For example, assume that an individual is taxed at a 40.8% rate on ordinary net investment income and is considering buying corporate bonds that will pay \$100,000 of interest annually. If the individual transfers the bonds to a wholly owned corporation, and the corporation distributes the interest income, net of tax, to the individual

accumulated taxable income); § 535(c)(3) (providing that the cumulative credit for a holding or investment company cannot exceed \$250,000); *see also* § 1561(a) (as amended by § 13001 of the TCJA) (allowing only one \$250,000 minimum credit for a controlled group of corporations).

³² If the individual's investment income would be taxed at a 40.8% rate (the highest aggregate individual rate), she can reduce the tax burden on that income by 48.5% by shifting it to the corporation. *See* § 1(j) (as modified by § 11001(a) of the TCJA) (providing a maximum individual rate of 37%); § 1411(a) (providing a 3.8% tax on certain investment income); § 11(b) (as modified by § 13001(a) of the TCJA) (imposing a flat 21% tax on the taxable income of a C corporation).

³³ § 1014(a) (providing that a decedent's property takes a basis equal to its fair market value on or near the date of the decedent's death).

each year, the individual will net more than if she retained the corporate bonds.³⁴ If she retained the bonds, she would net just \$59,200 each year after tax (\$100,000 interest income minus \$40,800 tax). If she interposes the corporation, the corporation would net \$79,000 annually after tax (\$100,000 interest income minus \$21,000 tax), an amount it would distribute to the individual as a dividend. Because that dividend would be taxed at a 23.8% rate as qualified dividend income,³⁵ the individual would net \$60,198 after tax (\$79,000 dividend minus \$18,802 tax).

Thus, the interposition of a corporation could provide a modest federal income tax benefit (*i.e.*, \$998), even if corporation currently distributes all net investment earnings.³⁶ As a caveat, however, that this modest benefit may be overwhelmed by added administrative costs and increased state and local taxes that may result from the scheme.³⁷

B. Dividends Received Deduction

Although corporate rates were reduced, not every aspect of the TCJA was good news for corporations. In § 13002(a) of the act, Congress reduced the dividends received deduction for certain dividends received by a corporate shareholder from a domestic corporation.³⁸ As under prior

³⁴ The distribution will eliminate any possible personal holding company or accumulated earnings tax on those earnings. *See* § 535(a); § 543(a); *cf.* § 269 (for an anti-abuse rule that may apply if a controlled corporation is used for the principal purpose of avoiding tax).

³⁵ § 1(h)(11).

³⁶ An individual would be ill-advised to employ this scheme for dividends on portfolio stock, however, because the two levels of tax (10.5% at the corporate level plus 23.8% at the shareholder level for a combined rate of 31.8% (*i.e.*, 1 – (89.5% times 76.2%)) would exceed the 23.8% rate that would apply if the individual simply retained the portfolio stock. *See* § 1(h)(1)(D), (h)(11) (providing for a maximum 20% rate on qualified dividend income); § 1411(a) (providing a 3.8% tax on certain investment income); *see also infra* notes 40 and 47 and accompany text (for a discussion of the effective tax on dividends received by a domestic corporation).

³⁷ For example, added administrative costs may include costs to prepare federal and state corporate tax returns and to observe corporate formalities.

³⁸ This amendment applies to taxable years beginning after December 31, 2017. § 13002(f) of the TCJA; *see also* § 243 (providing for dividends received deductions for dividends paid by domestic corporations). Note that an individual may still have an

law, a corporation still will deduct an amount equal to 100% of any qualifying dividend.³⁹ However, under the TCJA, it will receive a deduction equal to only 65% (rather than 80%) of any dividend received from a “20% owned” domestic corporation and only 50% (rather than 70%) of any other dividend received from a domestic corporation.⁴⁰

Congress first reduced the dividends received deduction below 100% in 1935, at the same time that it introduced graduated rates for corporations.⁴¹ It justified the reduction “to prevent the evasion of the

incentive to transfer dividend-paying stock to a corporation even though the individual may be taxed at preferential rates on any dividends received, at least if the corporation can substantially defer distributions related to those dividends. *See* § 1(h)(1)(D), (h)(11) (providing for a maximum 20% rate on qualified dividend income). Because of the dividends received deduction, the corporation will pay tax at a rate of no more than 10.5% on any dividend income, a potential reduction in tax of 47.5%. *See infra* notes 40 and 47 and accompanying text (for a discussion of the effective tax on dividends received by a corporate shareholder from a domestic corporation).

³⁹ *See* § 243(a)(3), (b). A qualifying dividend must meet two requirements. First, it must be paid by one corporation to a second corporation and at the close of the distribution date both corporations must be members of the same affiliated group. § 243(c)(1)(A). Second, the distribution must have been paid out of e&p for a taxable year on each day of which the distributing and shareholder corporations were members of the same affiliated group. § 243(c)(1)(B)(i).

Among other things, a shareholder corporation is considered affiliated with a distributing corporation if it owns at least 80% of the vote and at least 80% of the value of the distributor's stock. § 1504(a)(2). Those 80% determinations are made by disregarding “pure vanilla preferred” stock, which is non-voting, non-convertible preferred stock that does not participate in corporate growth to any significant extent and does not have an unreasonably high redemption or liquidation premium. § 1504(a)(4).

⁴⁰ A 20% owned corporation is one in which the shareholder corporation owns at least 20% of its stock (by vote and value), disregarding pure vanilla preferred stock.

⁴¹ Revenue Act of 1935, Pub. L. No. 74-407, § 102(h), 49 Stat. 1014, 1016 (1935); *see also* § 102(a), 49 Stat. 1015 (1935) (introducing graduated corporate tax rates).

graduated tax by means of a multiplicity of corporations.”⁴² Consistent with that theory, it allowed a 100% dividends received deduction for qualifying dividends in 1964, because those dividends could not serve to evade the graduated corporate tax.⁴³ Congress retained a reduced dividends received deduction for other dividends, presumably because the deduction might still be used to evade graduated rates, even though the tax cost of the reduced deduction often exceeded the tax savings offered by graduated rates.

It became harder to justify the reduced deduction for large, profitable corporations after Congress eliminated the benefit of graduated rates for those corporations.⁴⁴ In the accompanying legislative history, Congress neither justified that elimination nor discussed its impact on the dividends received deduction.⁴⁵ Perhaps the reduced dividends received deduction was retained for administrative reasons—until the taxable year for a distributing corporation was closed, it might not be possible to determine whether the corporation could benefit from graduated rates.

However, Congress has eliminated that administrative concern for dividends paid out of e&p generated in taxable years beginning after December 31, 2017, years in which all C corporations are taxed at a flat rate. The reduced deduction also means that at least some corporate earnings continue to be subject to three levels of tax (*i.e.*, two at the corporate level and one at the individual level). Consequently, it is hard to justify retaining dividends received deductions below 100% for those

⁴² H.R. REP. NO. 74-1681, at 7 (1935); *see also* S. REP. NO. 74-1240, at 6 (Part I) (1935) (to the same effect); *cf.* S. REP. NO. 74-1240, at 7–8 (Part II) (1935) (minority report) (opposing the graduated corporate tax and the reduced dividends received deduction, stating that the reduction was “an admittedly unsound provision . . . to prevent the evasion of an admittedly unsound tax [the graduated corporate tax]”).

⁴³ *See* Revenue Act of 1964, Pub. L. No. 88-272, § 214, 78 Stat. 19, 52–54 (1964) (amending § 243 to add provisions dealing with qualifying dividends); *see also id.* at § 235, 78 Stat. 116–125 (1964) (adding § 1561 - § 1563, which in part provided that absent an election, a controlled group could use only one surtax exemption); *id.* at § 121, 78 Stat. 25 (1964) (providing for a corporate surtax).

⁴⁴ *See* Tax Reform Act of 1984, Pub. L. No. 98-369, § 66(a), 98 Stat. 494, 585 (1984).

⁴⁵ *See* H.R. REP. NO. 98-861, at 848–49 (1984) (Conf. Rep.).

dividends⁴⁶ and even harder to justify further reducing those deductions.⁴⁷ A cynic might suggest that the reduction was adopted simply as a means to lower the cost of the TCJA and help avoid the “Byrd” rule, which would have required a 60-person Senate majority to pass the act.

C. *Alternative Minimum Tax*

In § 12001 of the TCJA, Congress repealed the alternative minimum tax (“AMT”) for corporations.⁴⁸ Before the repeal, a corporation paid an “add-on” alternative minimum tax equal to the excess, if any, of its tentative minimum tax for the year over its regular tax.⁴⁹ A corporation’s tentative minimum tax for a taxable year equaled 20% of the excess of the alternative minimum taxable income for the year over an exemption amount.⁵⁰ Its alternative minimum taxable income for the year

⁴⁶ It is also not clear that retaining reduced dividends received deductions for dividends paid out of e&p generated in earlier years is worth the administrative complexity, because relatively little of the associated taxable income would have been taxed at graduated rates.

⁴⁷ However, with the reduced reduction, those dividends bear about the same rate of tax as before the TCJA. Under former law, dividends from a 20% owned corporation bore an effective tax of 5.25% (*i.e.*, 15% of 35%) and other non-qualifying dividends bore an effective tax of 10.5% (30% of 35%). Under the TCJA, those dividends bear tax at effective rates of 7.3% (50% of 21%) and 10.5% (50% of 21%). *See* H.R. REP. NO. 115-466, at 342 n.426 (2017) (Conf. Rep.) (implying that the reductions were supported to preserve equivalent taxes on those dividends).

⁴⁸ The repeal is effective for taxable years beginning after December 31, 2017. § 12001(c) of the TCJA.

⁴⁹ § 55(a) (as in effect before the enactment of the TCJA); *see also* § 55(c) (defining regular tax liability).

⁵⁰ § 55(b)(1)(B) (also reducing the AMT by the alternative minimum tax foreign tax credit for the year); *id.* at (d)(2), (3) (providing that the exemption amount equaled \$40,000, reduced (but not below zero) by 25% of the amount by which alternative minimum taxable income exceeded \$150,000).

equaled its taxable income for the year, increased by items of tax preference, and increased or decreased by certain other adjustments.⁵¹

Section 53 allows a corporation to take a credit for its alternative minimum tax paid in prior years, and the TCJA not only allows a corporation to take that credit but may accelerate its use.⁵² Generally, the credit for a taxable year is limited to the excess of (i) the corporation's regular tax liability for the year, reduced by certain credits, over (ii) the tentative minimum tax for the year.⁵³ Under the TCJA, those amounts are computed by taking into account the law in effect before the corporate AMT repeal.⁵⁴ In addition, under the act, a corporation's AMT credit is increased by 50% of any unused AMT credit for any taxable year beginning in 2018, 2019 and 2020 and by 100% of any unused AMT credit for a taxable year beginning in 2021.⁵⁵ Because that increase is a refundable credit, a corporation will be able to use the full amount of its AMT credit by the end of 2021.⁵⁶

⁵¹ § 55(b)(2); *see* H.R. REP. NO. 115-466, at 319–22 (2017) (Conf. Rep.) (for a more complete description of the corporate AMT).

⁵² § 53(b), (d) (providing that the credit equals the excess, if any, of (i) the aggregated alternative minimum tax paid in all prior years beginning after 1986 over (ii) the amount allowable as a credit in prior years).

⁵³ § 55(c).

⁵⁴ § 12002(b) of the TCJA (adding § 53(d)(3)).

⁵⁵ § 12002(a) of the TCJA (adding § 53(e)).

⁵⁶ *See* § 53(e)(3) (as added by § 12002(a) of the TCJA); *see also* H.R. REP. NO. 115-466, at 323 (2017) (Conf. Rep.).

Although Congress assured that a corporation could use its AMT credit, it undercut that benefit for at least some corporations by enacting the base erosion and anti-abuse tax (often referred to as the “BEAT”). *See* § 14401 of the TCJA (adding § 59A); *see also* DAVIS POLK & WARDWELL LLP, *The New “Not Quite Territorial” International Tax Regime*, TAX REFORM AND TRANSITION BLOG (Dec. 20, 2017), <https://www.taxreformandtransition.com/wp-content/uploads/sites/29/2017/12/2017-12-20-gop-tax-cuts-jobs-act-preview-new-tax-regime.pdf> (describing the BEAT, stating that it “can function almost as a ‘backdoor’ alternative minimum tax in some cases”). The BEAT’s technical provisions belie short summary, but its purpose can be readily stated: The tax targets base erosion that arises when U.S. corporations serve U.S. markets through foreign subsidiaries located in low-tax jurisdictions and make deductible

D. Contributions to Capital

Under § 118, before its amendment by the TCJA, a corporation generally did not include in gross income any contribution to its capital.⁵⁷ However, a corporation included in gross income any contribution to capital in aid of construction or any other contribution as a customer or potential customer, except for certain contributions received by a regulated public utility that provided water or sewage disposal services.⁵⁸

The TCJA removed the regulated public utility exception and also provided that contributions to capital do not include “any contribution by any governmental entity or civic group (other than a

payments to those foreign subsidiaries. *Id.*; *see also* H.R. REP. NO. 115-409, at 400 (2017) (noting that base erosion may be a concern with both U.S. and foreign-parented multinationals and that “the need for anti-base erosion measures remains critical as long as there are foreign jurisdictions in which corporations can achieve effective tax rates lower than that which they can achieve in the United States”).

If, without regard to any AMT credit, a corporation would be subject to the BEAT, the credit will provide an illusory benefit, because it will be fully offset by an increase in the BEAT. *See* § 59A(b) (computing the base erosion minimum tax amount as the excess of 10% of modified taxable income over the difference between (i) the regular tax and (ii) certain credits, including the AMT credit). Thus, because many U.S. multinationals will be subject to the BEAT, they may enjoy little or no benefit from the AMT credit.

⁵⁷ § 118(a) (before its amendment by the TCJA).

⁵⁸ § 118(b)–(c) (before its amendment by the TCJA); *see also* § 362(c) (before its amendment by the TCJA) (providing that property contributed to a corporation’s capital and not contributed by a shareholder as such took a \$0 basis).

contribution made by a shareholder as such).”⁵⁹ Section 118 continues to apply only to corporations.⁶⁰

II. CHANGES AFFECTING SMALL BUSINESSES

A. Accounting Changes

Under the TCJA, more taxpayers may use the cash method of accounting, and fewer taxpayers will be required to use the inventory method or completed contract method or to capitalize costs under the uniform capitalization rules.⁶¹

1. Accrual Method

Generally, a corporation or partnership with a corporate partner must use the accrual method of accounting.⁶² However, that entity can use the cash method for a taxable year if it meets a gross receipts test.⁶³ Under the TCJA, the entity meets that test (the “\$25 million gross receipts test”) for a taxable year if it had average annual gross receipts of no greater than \$25 million over the preceding three years.⁶⁴ Under prior law, to

⁵⁹ § 118(b) (as amended by § 13312 of the TCJA; *cf.* *Brown Shoe Co. v. Comm’r*, 339 U.S. 583, 592 (1950) (concluding that payments by a community to induce a corporation to locate or expand manufacturing operations in the community were contributions to capital for excess profits and income tax purposes); *Edwards v. Cuba R.R. Co.*, 268 U.S. 628, 632 (1928) (concluding that payments by the Cuban government to a railroad to induce it to construct and operate a railroad were capital contributions).

⁶⁰ H.R. REP. NO. 115-466, at 398 (2017) (Conf. Rep.). The amendment applies to contributions made after the date of the enactment (*i.e.*, December 22, 2017), except those made by a governmental entity “pursuant to a master development plan that has been approved prior to such date by a governmental entity.” § 13312(b) of the TCJA.

⁶¹ Generally, these amendments are effective for taxable years beginning after December 31, 2017. § 13102(e)(1) of the TCJA. However, the amendment relating to the percentage completion method applies to contracts entered into after December 21, 2017 in taxable years ending after that date. § 13102(e)(3).

⁶² *See* § 448(a)(1), (2).

⁶³ § 448(b)(3).

⁶⁴ § 13102(a)(1) of the TCJA (modifying § 448(c)(1)). In making this determination, all members of a controlled group of corporations (as defined under § 1563(a) by substituting 50% for 80%) are treated as one corporation. § 52(a); § 448(c)(2). Further,

apply the exception, the average annual gross receipts could not exceed \$5 million.⁶⁵

2. The UNICAP Rules

The TCJA also liberalized the uniform capitalization (“UNICAP”), inventory, and completed contract rules for small businesses. If a taxpayer meets the \$25 million gross receipts test, it is not required to apply the UNICAP rules, generally keep inventories, or use the percentage completion method.⁶⁶

Under the UNICAP rules, a taxpayer must capitalize (or include in inventory) certain direct and indirect costs allocable to real or tangible personal property that the taxpayer produced or acquired for resale.⁶⁷ Under prior law, the UNICAP rules did not apply to *any personal property acquired by the taxpayer for resale* during a taxable year if the taxpayer’s average annual gross receipts for the preceding three-year period did not exceed \$10 million.⁶⁸ That \$10 million exception did not apply to any property produced by the taxpayer or to real property acquired by the taxpayer for resale.⁶⁹

The TCJA exempted the application of the UNICAP rules in their entirety for a taxpayer that meets the \$25 million gross receipts test.⁷⁰

all partnerships under common control are treated as one partnership. § 52(b); § 448(c)(2).

⁶⁵ See § 448(c)(1) (before its amendment by the TCJA).

⁶⁶ § 13102(b) of the TCJA (for the UNICAP rules); § 13102(c) (for inventories); § 13102(d) (for the percentage completion method).

⁶⁷ See § 263A.

⁶⁸ § 263A(b)(2)(B) (before its amendment by the TCJA).

⁶⁹ § 263A(b)(1).

⁷⁰ § 263A(i) (as amended by § 13102(b) of the TCJA) (applying the gross receipts test of § 448(c) but adding that the exemption does not apply to a tax shelter prohibited from using the cash method under § 448(a)(3)). It is not altogether clear how the \$25 million

Thus, if a corporation or partnership meets that test, it does not have to apply the UNICAP rules to allocate costs, whether or not the property is real or personal property and whether or not it is property produced by the taxpayer or acquired for resale.⁷¹

3. The Inventory Method

The TCJA also limited when a taxpayer must use the inventory method. In general, a taxpayer must account for inventories if the production, purchase, or sale of merchandise is an income-producing factor for the taxpayer.⁷² Under prior law, a taxpayer generally did not have to use the inventory method if its average annual gross receipts did not exceed \$1 million.⁷³ Under § 471(c), as amended by the TCJA, a taxpayer does not have to use that method as long as it meets the \$25 million gross receipts test.⁷⁴ If the taxpayer does not use the inventory method, it must account for inventory either by treating it as non-

gross receipts test applies to an individual who operates separate businesses. Section 263A(i)(2), as amended by § 13102(b) of the TCJA, states that “[i]n the case of any taxpayer which is not a corporation or partnership [e.g., an individual], the gross receipts test of section 448(c) shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership.” If one individual owned separate corporations, those corporations would all be members of one controlled group and would be treated as a single corporation in applying the \$25 million gross receipts test. *See* § 1563(a)(2) (defining a brother-sister controlled group). Thus, the gross receipts of all of those corporations would be combined to measure whether the gross receipts test were met. It would make sense to do the same for separate businesses owned by one individual, and the language quoted above should be read to reach that result.

⁷¹ *See* H.R. REP. NO. 115-466, at 380 (2017) (Conf. Rep.); *cf.* § 263A(b)(2)(B) (before its amendment by the TCJA) (applying the gross receipts exemption only for personal property acquired by the taxpayer for resale).

⁷² Treas. Reg. § 1.471-1 (1960).

⁷³ Rev. Proc. 2001-10, 2001-1 C.B. 272; *see also* Rev. Proc. 2002-28, 2002-1 C.B. 815 (providing an exception for a taxpayer in certain industries if its gross receipts did not exceed \$10 million).

⁷⁴ § 13102(c) of the TCJA.

incidental materials or supplies or by conforming to its method of accounting reflected in an applicable financial statement.⁷⁵

4. Percentage Completion Method

As a final change that relaxed accounting rules for small businesses, the TCJA loosened the requirement to use the percentage completion method for long-term contracts. Under that method, a taxpayer accounts for a long-term contract each taxable year by including in gross income the product of (i) the gross contract price and (ii) the percentage of the contract completed during that year.⁷⁶ Under the TCJA, a taxpayer is not required to use the percentage completion method for long-term construction contracts if it meets the following two requirements: (i) it satisfies the \$25 million gross receipts test and (ii) it is expected when the contract is entered into that the contract will be completed within two years of its commencement.⁷⁷ Before this change, the gross receipts threshold to apply this exception was just \$10 million.⁷⁸

B. Expensing under § 179

Under § 179, at a taxpayer's election, the taxpayer may deduct (*i.e.*, expense) all or part of the cost of "section 179 property" in the taxable year it places the property in service. Section 13101 of the TCJA both increased the deductible amount and generally expanded the categories of section 179 property.⁷⁹

⁷⁵ § 471(c)(1) (as amended by § 13102(c) of the TCJA).

⁷⁶ See § 460(a)–(b); *see also* H.R. REP. NO. 115-466, at 379 (2017) (Conf. Rep.).

⁷⁷ § 460(e)(1)(B)(ii) (as amended by § 13102(d) of the TCJA). *See also* § 460(e)(1)(A) (providing that a home construction contract does not need to be accounted for under the percentage completion method).

⁷⁸ § 460(e)(1)(B)(ii) (before its amendment by the TCJA).

⁷⁹ These amendments are effective for property placed in service in taxable years beginning after December 31, 2017. § 13101(d) of the TCJA.

As amended, the maximum amount deductible under § 179 cannot exceed \$1,000,000, but that amount is reduced to the extent that the cost of section 179 property placed in service during that year exceeds \$2,500,000.⁸⁰ Both the \$1,000,000 and \$2,500,000 amounts are adjusted for inflation.⁸¹

Section 179 property must be depreciable property that is purchased for use in the taxpayer's trade or business.⁸² Generally, that property must be tangible personal property,⁸³ but, at the election of the taxpayer, it also includes qualified real property.⁸⁴ Qualified real property is qualified improvement property,⁸⁵ as well as the following

⁸⁰ § 13101(a)(1)–(2) of the TCJA (amending § 179(b)(1)–(2)). In 2017, the applicable limits were \$510,000, rather than \$1,000,000 and \$2,030,000, rather than \$2,500,000. Rev. Proc. 2016-55, 2016-45 I.R.B. 707, 713.

⁸¹ § 13101(a)(3) of the TCJA (amending § 179(b)(6)).

⁸² § 13101(b)(1) of the TCJA (modifying § 179(d)(1)). All acquired property is purchased, except property acquired (i) from certain related persons, (ii) in a carryover-basis transaction, or (iii) by inheritance or bequest from a decedent. § 179(d)(2) (defining purchase). Further, “a taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business.” Treas. Reg. § 1.179-2(c)(6)(ii) (as amended in 2005) (also providing that the “active business” requirement is intended to prevent a passive investor from using § 179).

⁸³ § 179(d)(1) (defining § 179 property as § 1245 property that is depreciable tangible property or computer software and that is acquired by purchase for use in the active conduct of a trade or business). Tangible property that is not considered § 179 property includes property used outside the United States, property used by certain tax-exempt organizations, and certain property used by government units or foreign persons. § 50(b); § 179(d)(1); *see also* § 179(d)(5) (excluding certain property leased by the taxpayer to others). The TCJA expanded the definition of section 179 property to include certain depreciable personal property used predominantly to furnish lodging or in connection with the furnishing of lodging, including beds and other furniture, refrigerators, ranges and other equipment used in the living quarters of a lodging. *See* § 13101(c) of the TCJA (modifying the last sentence of § 179(d)(1) to insert “(other than paragraph (2) thereof)” after “section 50(b)”; *see also* H.R. REP. NO. 115-466, at 375 (2017) (Conf. Rep.) (describing this change).

⁸⁴ *See* § 179(f).

⁸⁵ § 179(f)(1) (as modified by § 13101(b)(2) of the TCJA; *see also* § 168(e)(6) (as modified by § 13204(a)(4)(B) of the TCJA) (defining qualified improvement property as “any

improvements to nonresidential real property that are placed in service after the real property was first placed in service: roofs, heating, ventilation, and air-conditioning property, fire protection and alarm systems, and security systems.⁸⁶

III. DEDUCTIONS AND CARRYOVERS

A. Bonus Depreciation

The § 179 deduction is dwarfed by the 100% bonus depreciation deduction.⁸⁷ Under § 168(k), a taxpayer is entitled to take a bonus depreciation deduction for eligible property in addition to any regular accelerated cost recovery deduction under § 168 for that property. Note that a taxpayer may elect not to take this bonus depreciation deduction for any class of property placed in service during a taxable year.⁸⁸

Under prior law, a taxpayer was entitled to take a bonus depreciation deduction for the year that the eligible property was placed in service, but generally only if that property was acquired and placed in

improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service"; certain improvements are excluded (*i.e.*, a building enlargement, an elevator or escalator, or an improvement to the internal structural framework of a building)). Under prior law, § 179 property included qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property described in former § 168(e)(6)–(8). Generally, each of those types of property are also qualified improvement property, as defined by current § 168(e)(6). Former § 168(e)(6) through § 168(e)(8) were removed by the TCJA. § 13204(a)(1)(B) of the TCJA.

⁸⁶ § 13101(b)(2) of the TCJA (amending § 179(f)(2)).

⁸⁷ *See* § 168(k). Unlike the § 179 deduction, the bonus depreciation deduction is not limited to small businesses. However, under the TCJA, the 100% deduction generally applies only to eligible property placed in service before 2023 and does not apply to qualified improvement property. Further, it is possible that the income tax systems for some states may incorporate § 179 but not the bonus depreciation rules.

⁸⁸ § 168(k)(7).

service before January 1, 2020.⁸⁹ The deduction equaled 50% for property placed in service in 2017. It was scheduled to be reduced to 40% for property placed in service in 2018 and 30% for property placed in service in 2019.⁹⁰

The TCJA generally increased the deduction to 100% for eligible property placed in service after September 27, 2017 and before January 1, 2023.⁹¹ The deduction is reduced by 20% each year for property placed in service beginning in 2023.⁹²

Property eligible for bonus depreciation is called "qualified property," and that property includes (i) depreciable tangible property with a recovery period of 20 years or less⁹³ and (ii) computer software for which a deduction under § 167(a) is allowed.⁹⁴ To be qualified property, property

⁸⁹ See § 168(k)(1) (before its amendment by the TCJA).

⁹⁰ § 168(k)(6) (before its amendment by the TCJA) (applying the 40% and 30% rules to certain property having longer production period and placed in service in 2019 and 2020).

⁹¹ § 13201(a) of the TCJA (amending § 168(k)(6) and also providing special rules for property with longer production periods (extending the 100% bonus depreciation for another year) and for certain plants bearing fruit and nuts (applying to plants that are planted or grafted during the applicable time period rather than acquired)); see also § 13201(h)(1) (providing that the changes to bonus depreciation generally apply to property that is acquired after September 27, 2017, and placed in service after that date). Note that the 100% bonus depreciation deduction may tilt the balance toward an asset purchase (or stock purchase with a § 338 election) over a stock purchase with no § 338 election.

⁹² § 168(k)(6) (as amended by § 13201(a) of the TCJA) (providing special rules for property with longer production periods and for certain plants bearing fruit and nuts). Thus, generally, the deductions are 80%, 60%, 40%, and 20% for property placed in service in 2023, 2024, 2025, and 2026, respectively.

⁹³ § 168(k)(2)(A)(i)(I) (providing more precisely that qualified property is property to which § 168 applies that has a recovery period of 20 years or less).

⁹⁴ § 168(k)(2)(A)(i)(II); see also § 168(k)(2)(D)(i) (providing that qualified property does not include property for which the alternative depreciation system must be used); § 197(e)(3)(A) (describing computer software that is not subject to § 197 and therefore may be depreciable under § 167). Qualified property also includes water utility property, qualified film or television productions, and qualified live theatrical productions. § 168(k)(2)(A)(i)(III)–(V) (2012 & Supp. III 2015).

must also be placed in service before January 1, 2027.⁹⁵ Note that as a technical foot fault, it appears that qualified property does not include qualified improvement property.⁹⁶

Under prior law, the taxpayer had to be the first to use the property,⁹⁷ but the TCJA allows *used* property acquired by the taxpayer to

⁹⁵ § 168(k)(2)(A)(iii) (as amended by 13201(b)(1) of the TCJA). Before the amendment, the property had to be placed in service before 2020. See § 168(k)(2)(A)(iii) (before its amendment by the TCJA).

⁹⁶ Unlike under prior law, qualified property does not include qualified improvement property, because it has a recovery period exceeding 20 years. See § 13204(a)(4)(A) of the TCJA; see also Asha Glover, *AICPA Says Qualified Improvement Property Omission Must Be Fixed*, 2018 TNT 37-2 (suggesting that a technical correction should provide that qualified improvement property is 15-year recovery property and therefore eligible for bonus depreciation); James B. Sowell and Jon G. Finkelstein, *Tax Reform and Investment in U.S. Real Estate*, 159 TAX NOTES 285 (Apr. 16, 2018) (noting the problem); H.R. REP. NO. 115-466, at 367 (2017) (Conf. Rep.) (stating that qualified improvement property will have a 15-year recovery period); cf. § 168(k)(2)(A)(IV) (before its amendment by the TCJA). But see H.R. Rep. No. 115-466, at 362–67 (2017) (Conf. Rep.) (describing the change in the law but not discussing that qualified improvement property was no longer eligible for bonus depreciation). Under the law as amended by the TCJA, qualified improvement property apparently has a 39-year recovery period. See § 168(c) (providing a 39-year recovery period for nonresidential real property); § 168(i)(6) (providing that any deduction for an improvement to property is computed in the same manner as if the property had been placed in service at the time of the improvement). Note that the rule for qualified improvement property replaced rules for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, all properties that had a 15-year recovery period. See § 168(e)(3)(E)(v), (vi), (ix) (before its amendment by the TCJA); see also *supra* notes 84–86 and accompanying text (noting that if the requirements of § 179 are met, the cost of qualified improvement property may be expensed under § 179).

⁹⁷ See § 168(k)(2)(A)(ii) (before its amendment by the TCJA) (stating that the original use of the property must commence with the taxpayer); see also Treas. Reg. § 1.48-2(b)(7) (as amended in 1985) (defining original use as the first use to which property is put; noting that reconditioned or rebuilt property acquired by the taxpayer was not treated as put to original use by the taxpayer).

be treated as qualified property if the following additional requirements are met:

- (i) The taxpayer did not use the property at any time before the acquisition (*e.g.*, did not use it as a lessee);
- (ii) The taxpayer did not acquire the property from a person related to the taxpayer under § 267 or § 707(b) or from a member of the taxpayer's controlled group; and
- (iii) The taxpayer did not acquire the property in a carryover-basis transaction (*e.g.*, as a gift or in a § 351, § 361 or § 721 transfer) or as a bequest or inheritance from a decedent.⁹⁸

Note that if the taxpayer acquired the property in an exchanged-basis transaction (*e.g.*, a like-kind exchange), the bonus depreciation rule does not apply to “so much of the basis of [the] property [received] as is determined by reference to the basis of the property” surrendered by the taxpayer.⁹⁹

By taking 100% bonus depreciation, a taxpayer may enjoy a negative tax, as illustrated by the following examples. The first example illustrates how the immediate 100% deduction corresponds to a tax-exempt return on investment.

A corporation, taxed at a 21% rate, can buy equipment that will generate a 10%, before-tax return. Suppose that it has \$158,000 available to invest in the equipment. If it purchased equipment

⁹⁸ § 13201(c)(2) of the TCJA (amending § 168(k)(2)(E)(ii) and referring to the requirements in § 179(d)(2)); *see also* § 179(d)(2) (laying out those requirements).

⁹⁹ *See* § 179(d)(3). For example, if a taxpayer transferred like-kind property plus boot in a § 1031 exchange for like-kind property, the bonus depreciation rule could apply only to the portion of the like-kind property received with a basis equal to the value of the surrendered boot. Treas. Reg. § 1.1031(d)-1(a) (as amended in 1967) (providing that if a taxpayer surrenders like-kind property and boot solely in exchange for like-kind property in a § 1031 exchange, the basis of the like-kind property received equals the adjusted basis of the like-kind property surrendered plus the value of the boot surrendered).

worth \$158,000, that equipment would generate a \$15,800 before-tax return.

It can generate a \$15,800 after-tax return if it can deduct the full cost of any equipment it purchases, because it will receive a tax benefit equal to 21% (*i.e.*, its tax rate) of the equipment's purchase price (*i.e.*, its deduction).¹⁰⁰ Thus, it should be able to buy equipment that costs \$158,000 plus the tax benefit or \$200,000.¹⁰¹ Because the equipment produces a 10%, before-tax return, the equipment would generate a \$20,000 before-tax return and a \$4,200 tax (*i.e.*, 21% of \$20,000), resulting in a net after-tax return of \$15,800 (*i.e.*, \$20,000 minus \$4,200).

Thus, if the cost of an asset can be immediately deducted in full, that deduction is equivalent to exempting the return on the asset from tax (and providing no deduction for its cost).

The second example shows that funding a purchase of qualified property with debt may lead to a negative tax.

The facts are the same as in the preceding example, except that the corporation borrows the entire \$200,000 purchase price of the equipment. Assume that the loan bears interest at a 2.2% rate and requires 15 annual payments of \$15,800. Assume as well that the purchased equipment will generate a \$20,000 before-tax return each year for 15 years. Thus, before accounting for any interest deduction on the loan, the after-tax return on the equipment (\$15,800) exactly matches the required principal and interest payments on the loan.

¹⁰⁰ If it is paying estimated taxes, that benefit will nearly coincide with the purchase.

¹⁰¹ If c is the cost of the equipment, stated as a formula –

$$\begin{aligned} c &= 158,000 + .21c \\ .79c &= 158,000 \\ c &= 200,000 \end{aligned}$$

In total, the loan will generate \$37,000 of interest over 15 years (the excess of (i) \$237,000 (*i.e.*, \$15,800 times 15) over \$200,000 (*i.e.*, the principal payments)). Those interest payments will generate an aggregate \$7,770 tax benefit (*i.e.*, 21% of \$37,000), a negative tax resulting from the deduction for interest payments.¹⁰²

Because the 100% bonus depreciation deduction has the effect of exempting income on investments from tax, arguably the interest on those investments should not be deductible.¹⁰³ However, the TCJA provides no special limitation on interest deductions on loans used to purchase or carry investments depreciated under the new bonus depreciation scheme

B. Deduction of Business Interest

The act did, however, limit the deduction of business interest. Historically under § 163, interest paid or accrued by a business has generally been deductible.¹⁰⁴ As one exception, to prevent earnings stripping, § 163(j) had disallowed an interest deduction for a corporation's disqualified interest if the corporation's debt to equity ratio exceeded 1.5 to 1 and its net interest expense exceeded 50% of its adjusted taxable income.¹⁰⁵ Among other things, disqualified interest included interest paid or accrued by the corporation on debt to a related person if there was no income tax imposed under the Code on that interest income.¹⁰⁶

¹⁰² Those interest payments will have about a \$6,870 present value, assuming a 2.2% discount rate, therefore resulting in almost a 3.5% negative tax (*i.e.*, \$6,870 divided by \$200,000).

¹⁰³ *Cf.* § 265(a)(2) (disallowing any interest deduction for interest on indebtedness incurred to purchase or carry tax-exempt obligations).

¹⁰⁴ Among other limitations for a taxpayer other than a corporation, for any taxable year, investment interest on debt allocable to investment property is deductible only to the extent of the taxpayer's net investment income. § 163(d).

¹⁰⁵ § 163(j)(2) (before its amendment by the TCJA).

¹⁰⁶ § 163(j)(3)(A) (before its amendment by the TCJA); *see also* § 163(j)(4)(A) (in general, defining a related person as any person related to the taxpayer under § 267(b) or 707(b)(1)). Disqualified interest also included interest on debt to a non-related person in certain cases that was guaranteed by certain related persons and interest on debt owed by

The TCJA amended § 163(j) to limit the deduction of “business” interest for any taxpayer, whether or not a corporation.¹⁰⁷ Under § 163(j)(1), the deduction for net business interest generally cannot exceed 30% of the taxpayer’s adjusted taxable income (“ATI”).¹⁰⁸

a real estate investment trust (“REIT”) to a taxable REIT subsidiary. *See* § 163(j)(3)(B)–(C) (before its amendment by the TCJA).

¹⁰⁷ *See* § 13301 of the TCJA; *see also* § 13301(c) of the TCJA (providing that the amendment to § 163(j) applies to taxable years beginning after December 31, 2017). The broadened limitation makes it more difficult for a corporation to enjoy a negative tax by using debt to fund the purchase of assets expensed under the bonus depreciation rule of § 168(k).

¹⁰⁸ More precisely, the deduction for business interest cannot exceed the sum of 30% of the taxpayer’s ATI, the taxpayer’s business interest income, and its “floor plan financing” interest. § 163(j)(1) (as amended by § 13301(a) of the TCJA). Floor plan financing interest is interest on debt used to finance the acquisition of motor vehicles for sale or lease that is secured by the inventory acquired. § 163(j)(9)(A)–(B) (as amended by § 13301(a) of the TCJA). *See also* § 163(j)(9)(C) (as amended by § 13301(a) of the TCJA) (defining a motor vehicle as “[a]ny self-propelled vehicle designed for transporting persons or property on a public street, highway, or road”; a boat; or farm machinery or equipment). Because ATI cannot be less than zero, the business interest limitation must at least equal the amount of floor plan financing interest, and therefore the deduction of that type of interest is not limited by § 163(j). *See* H.R. REP. NO. 115-466, at 387 (2017) (Conf. Rep.) (stating that “[b]y including business interest income and floor plan financing interest in the limitation, the rule operates to allow floor plan financing interest to be fully deductible and to limit the deduction for net interest expense (less floor plan financing interest) to 30 percent of adjusted taxable income”).

Unlike former § 163(j), § 163(j) as amended, does not state that all members of an affiliated group are treated as one taxpayer in applying the interest limitation. *Cf.* § 163(j)(6)(C) (before its amendment by the TCJA). Nevertheless, under the amended provision, all members of a consolidated group should be treated as one taxpayer. First, that approach follows a directive in the House report, and the Senate and Conference bills in relevant part adopted the House approach. H.R. REP. NO. 115-409, at 248 (2017) (stating that “[t]he limitation [under § 163(j)] applies at the taxpayer level. In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.”); H.R. REP. NO. 115-466, at 390-92 (2017) (Conf. Rep.) (providing in relevant part that the Senate and Conference bills follow the House approach). Further, the limitation under § 163(j) does not apply if a taxpayer meets the

Business interest is interest on debt properly allocable to a trade or business.¹⁰⁹

For this purpose, a taxpayer's ATI is its taxable income, computed by excluding the following amounts: (i) its tax items not properly allocable to a trade or business; (ii) any business interest or business interest income; (iii) any net operating loss carryover; (iv) any deduction under § 199A; and (v) for taxable years beginning before 2022, any deduction for depreciation, amortization, or depletion.¹¹⁰

To the extent a deduction for business interest is disallowed for any taxable year under § 163(j), it is carried to the next year and treated as business interest paid or accrued in that year.¹¹¹ That carryover is also

\$25 million gross receipts test under § 448(c), and that test is applied by a consolidated group on a consolidated basis, suggesting that § 163(j) should be as well. *See* § 448(c)(2); *see also* § 52(a) (more precisely applying the test by looking to a controlled group as a whole). Finally, if the § 163(j) limitation is applied on a consolidated basis, it makes it less likely that the transfer of assets within a consolidated group will affect consolidated taxable income or consolidated tax liability, helping to satisfy the purpose of the intercompany transaction rules. *See* Treas. Reg. § 1.1502-13(a) (as amended in 1995) (providing that the purpose of those rules is to prevent intercompany transactions from affecting consolidated taxable income or consolidated tax liability). Thus, the better approach is that a consolidated group should be treated as one taxpayer in applying § 163(j). The IRS has announced that regulations will be issued providing that result. Notice 2018-28, 2018-10 I.R.B. 1 (sec. 5) (also noting other consolidated issues that the regulations will address).

¹⁰⁹ § 163(j)(6) (as amended by § 13301(a) of the TCJA) (also providing that business interest excludes investment interest). Business interest income is interest income included in gross income and properly allocable to a trade or business. § 163(j)(7) (as amended by § 13301(a) of the TCJA) (also providing that business interest income excludes investment income). A C corporation has neither investment income nor investment expense for purposes of § 163(d). *See* § 163(d)(1) (applying to taxpayers other than corporations). Thus, all interest and expense of a C corporation is allocable to a trade or business. *See* H.R. REP. NO. 115-466, at 386 n.688 (2017) (Conf. Rep.); Notice 2018-28, 2018-10 I.R.B. 1 (sec. 4) (noting that regulations will be issued to provide for that result). Note, however, that some trades or businesses are excluded from the application of § 163(j). *See* § 163(j)(7)(A) (as amended by § 13301(a) of the TCJA).

¹¹⁰ § 163(j)(8) (as amended by § 13301(a) of the TCJA) (adding that it is “computed with such other adjustments as provided by the Secretary”).

¹¹¹ § 163(j)(2) (as amended by § 13301(a) of the TCJA).

treated as a pre-change loss for purposes of § 382.¹¹² In addition, if a corporation transfers its assets to another corporation in a § 381 transfer, the acquirer succeeds to that carryover.¹¹³

The deduction limitation under § 163(j) does not apply to a taxpayer that meets the \$25 million gross receipts test under § 448(c).¹¹⁴ The limitation also does not apply to the following trades or businesses: (i) the performance of services as an employee;¹¹⁵ (ii) certain regulated public utilities,¹¹⁶ and (iii) at the taxpayer's irrevocable election, a real property trade or business or a farming business.¹¹⁷ Note that if the

¹¹² § 13301(b)(2) of the TCJA (adding § 382(d)(3)). The amendment appears to have a technical glitch. It provides that pre-change loss includes any "carryover" of disallowed business interest described in § 163(j)(2). However, § 163(j) may also limit the use of business interest for the taxable year that includes the change date, but that loss may not be a carryover loss. Thus, under a literal reading of the amendment, business interest that arises in the change year before the change date may not be pre-change loss limited by § 382.

¹¹³ § 13301(b)(1) of the TCJA (adding § 381(c)(20)). Although this provision also refers to loss carryovers, the technical glitch identified in the preceding footnote is generally not a problem. Because the taxable year of the distributor or transferor ends on the date of the transfer (except for a § 368(a)(1)(F) reorganization), the pre-transfer loss will generally be a loss carryover.

¹¹⁴ § 163(j)(3) (as amended by § 13301(a) of the TCJA; *see supra* notes 63-64 (for a description of the \$25 million gross receipts test).

¹¹⁵ § 163(j)(7) (as amended by § 13301(a) of the TCJA).

¹¹⁶ *Id.* Those public utilities cannot use bonus depreciation. *See* § 168(k)(9)(A) (as amended by § 13201(d) the TCJA).

¹¹⁷ *Id.* These elections come at a cost, because the electing trade or business must use the alternative depreciation system. *See* § 168(g)(1)(F)–(G) (as amended by § 13205(a) of the TCJA).

A real property trade or business is defined in § 469(c)(7)(C), and a farming business is defined in § 263A(e)(4) and § 199A(g)(2). Thus, a real property trade or business is "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." § 469(c)(7)(C). A farming business includes operating a nursery or sod farm

deduction limitation does not apply to a taxpayer's trade or business, the tax items of that trade or business are not taken into account in computing taxpayer's ATI, business interest, or business interest income.¹¹⁸

If a taxpayer has a real property or farming business, it may be unclear whether the taxpayer should elect to exclude the application of § 163(j) for that business, because it may be unclear whether the election will provide a tax benefit. If the election is made, the taxpayer will have to use the alternative depreciation system for at least some of its property, thereby deferring depreciation deductions to which the business otherwise would be entitled.¹¹⁹ More problematically, the election is not certain to increase allowable interest deductions and in certain cases may even reduce those deductions. The election could increase allowable deductions for the taxpayer if § 163(j) would restrict the interest deduction if it were applied to the real property or farming business by considering only its tax items. Otherwise, it would reduce the allowable deductions (or at least not increase them).¹²⁰ Because the election's effect depends on future events, it may be difficult to predict whether the allowable interest deductions

and raising or harvesting of ornamental trees or trees bearing fruit, nuts, or other crops. § 263A(e)(4)(B). A farming business also includes certain agricultural or horticultural cooperatives. *See* § 199A(g)(2) (as added by § 11011(a) of the TCJA).

¹¹⁸ § 163(j)(7) (providing that those trades or businesses are not treated as trades or businesses for purposes of § 163(j)); § 163(j)(5) (defining business interest as interest properly allocable to a trade or business); § 163(j)(6) (defining business interest income as interest income properly allocable to a trade or business); § 163(j)(8) (providing that ATI does not include tax items not properly allocable to a trade or business).

¹¹⁹ § 168(g)(3)(F), (8) (as added by § 13204(c) of the TCJA) (requiring that the alternative depreciation system must be used for any nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business); § 168(g)(1)(G) (as added by § 13205 (a) of the TCJA) (requiring that the alternative depreciation system must be used for any property with a recovery period of 10 years or more that is held by an electing farming business). Because the alternative depreciation system must be used for that property, that property is not eligible for bonus depreciation. § 168(k)(2)(D)(i).

¹²⁰ By excluding the tax items of the business from the § 163(j) computations, although net business interest may decline, ATI should decline by a greater percentage, thereby reducing the amount of allowable interest.

would increase if an election were made and therefore whether the election should be made.

Finally, special rules apply to partnerships, S corporations, and their owners. The partnership rules are a curious blend of aggregate and entity principles. The business interest limitation is applied both at the partnership and partner levels as follows:¹²¹ As a first step, a partnership deducts allowable business interest in computing its non-separately stated taxable income or loss.¹²²

A partner then determines her ATI by generally disregarding all partnership items.¹²³ However, except as described in the next paragraph,

¹²¹ See § 163(j)(4) (as amended by § 13301(a) of the TCJA); see also § 702(a)(8) (providing for non-separately stated taxable income or loss, sometimes called “bottom-line” income or loss). It would have been simpler for a partnership to simply allocate business interest and other partnership tax items among the partners, with the § 163(j) limitation applied only at the partner level. That approach would also have avoided problems with the partnership rules noted below. However, under that approach, the deductibility of interest could have varied depending on the choice of entity. Cf. H.R. REP. NO. 115-409, at 247 (2017) (Conf. Rep) (stating that “it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses are organized so as not to create distortions in the choice of entity”). In addition, Congress may have incorporated entity principles into the partnership rules under § 163(j), because a limited liability company (an “LLC”) is often treated as a partnership for federal income tax purposes but offers its owners limited liability.

¹²² See § 163(j)(4)(A)(i). Curiously, it appears that if a partner is specially allocated allowable business interest, she can deduct that interest without regard to her aggregate ATI.

Note that a partnership’s business interest for a taxable year is allowable to the extent it does not exceed the sum of 30% of the partnership’s ATI, its business interest income, and its floor plan financing interest for the year. See § 163(j)(1).

¹²³ § 163(j)(4)(A)(ii)(I). A partner still adjusts her basis in her partnership interest by taking the distributive share of partnership items into account. § 705(a); see also § 163(j)(4)(B)(iii) (for an additional reduction to a partner’s partnership basis to account for “excess business interest allocated to the partner”); *infra* note 131 and accompanying text (describing the basis reduction).

she increases her ATI by her distributive share, if any, of the partnership's "excess taxable income."¹²⁴ A partnership has excess taxable income if it has enough ATI so that it could deduct additional business interest without limitation under § 163(j). In that case, excess taxable income equals (i) the full amount of any additional business interest that the partnership could deduct under § 163(j) divided by (ii) 30%.¹²⁵ The partner determines its distributive share of excess taxable income in the same manner as its distributive share of non-separately stated taxable income or loss of the partnership.¹²⁶

If a partnership cannot deduct a portion of its business interest under § 163(j), that portion is *not* treated as a carryover by the

¹²⁴ § 163(j)(4)(A)(ii)(II). *But see* § 163(j)(4)(B)(ii) (last sentence) (providing that the partner's share of excess taxable income does not increase the partner's ATI to the extent that it offsets the partner's share of excess business interest). This approach allows the partner to take her share of the partnership's ATI into account (directly and through the partnership) once but not more than once. *See* H.R. REP. NO. 115-466, at 388 (2017) (Conf. Rep.) (stating that "[i]n the absence of such a rule, the same dollars of [ATI] of a partnership could generate additional interest deductions as the income is passed through to the partners").

¹²⁵ § 163(j)(4)(C) (as amended by § 13301(a) of the TCJA). The formula in the text simplifies the statutory formula. One factor in the statutory formula is the excess, if any, of the partnership's business interest (reduced by floor plan financing interest) over its business interest income. *See* § 163(j)(4)(C)(i)(II). For convenience, that factor is referred to as "net business interest." Using that reference, excess taxable income equals the partnership's ATI multiplied by the following fraction: (i) the excess, if any, of 30% of the partnership's ATI over its net business interest, divided by (ii) 30% of the partnership's ATI. Simplifying that product, excess taxable income equals (i) the excess, if any, of 30% of the partnership's ATI over its net business interest, divided by (ii) 30%. Because factor (i) (*i.e.*, the excess, if any, of 30% of the partnership's ATI over its net business interest) is the amount of additional business interest that the partnership could deduct without limitation under § 163(j), the excess taxable income of the partnership can be restated as provided in the text.

¹²⁶ § 163(j)(4)(C) (as amended by § 13301(a) of the TCJA). This determination seems wrong or uncertain in some cases. For example, § 1231 gain or loss may be included in the computation of ATI but allocated among partners differently than non-separately stated taxable income. Further, non-separately stated taxable income may be allocated differently than non-separately stated taxable loss, making this determination uncertain.

partnership.¹²⁷ Instead, it is treated as excess business interest allocated among the partners in the same manner as non-separately stated taxable income or loss of the partnership.¹²⁸ If a partner is allocated excess business interest, the partner treats that interest as paid or accrued “in the next succeeding taxable year in which the partner is allocated excess taxable income,” to the extent of that income.¹²⁹ A partner’s share of excess taxable income increases her ATI only to the extent that income has not offset excess business interest.¹³⁰

The partner reduces her basis in her partnership interest (*i.e.*, her outside basis) by the amount of any allocated excess business interest.¹³¹ If a partner disposes of her partnership interest, the partner increases her outside basis by the excess, if any, of (i) the amount of her basis reduction for excess business interest over (ii) the portion of its excess business

¹²⁷ § 163(j)(4)(B)(i)(I) (as added by § 13301(a) of the TCJA).

¹²⁸ § 163(j)(4)(B)(i)(II) (as added by § 13301(a) of the TCJA). Again, non-separately stated taxable income may be allocated differently than non-separately stated taxable loss, making this determination uncertain.

¹²⁹ § 163(j)(4)(B)(ii)(I); *see also* § 163(j)(4)(B)(ii)(II) (providing that any remaining excess business interest is carried over to the next succeeding taxable year in which the partner is allocated excess taxable income).

¹³⁰ § 163(j)(4)(B)(ii) (last sentence). Note that the last sentence of § 163(j)(4)(B)(ii) should refer to paragraph (4)(A), not paragraph (1)(A).

¹³¹ § 163(j)(4)(B)(iii)(I). As under § 704(d), the outside basis cannot be reduced below zero. Unlike under § 704(d), if the partner is unable to reduce her outside basis by the full amount of the excess business interest, it appears that the partner is not required to reduce her outside basis when the partner can later use that excess business interest. *See* H.R. REP. NO. 115-466, at 391 (2017) (Conf. Rep.) (stating that “the partner’s deduction in a future year for interest carried forward does not reduce the partner’s basis in the partnership interest”); *cf.* Treas. Reg. § 1.704-1(d)(1) (as amended in 2017) (providing for a reduction in outside basis when a loss suspended under § 704(d) is allowed); Treas. Reg. § 1.704-1(d)(4), Ex. (1) (illustrating the reduction). Perhaps that oversight will be the subject of a technical correction.

interest treated as paid or accrued.¹³² Neither the transferor nor transferee can deduct the excess business interest to the extent of that basis increase.¹³³

Because the special rules for S corporation and their shareholders have a stronger single-entity flavor than the partnership rules, they are simpler. Like a partnership, an S corporation first deducts allowable business interest in computing its non-separately stated taxable income or loss.¹³⁴

As with a partner, an S corporation shareholder then determines her ATI by generally disregarding all S corporation items.¹³⁵ Again as with a partner, the S corporation shareholder increases her ATI by her

¹³² § 163(j)(4)(iii)(II) (as added by § 13301(a) of the TCJA). Note that this amount differs from the partner's share of the excess business interest not yet treated as paid or accrued, because the partner's excess business interest may have exceeded her reduction in outside basis for the reason noted in the preceding footnote.

¹³³ *Id.* It is not clear how the transferor or transferee treats any remaining excess business interest (*i.e.*, the portion of that interest that did not result in a reduction in the partner's outside basis).

¹³⁴ § 163(j)(4)(A)(i); *see* § 163(j)(4)(D) (providing that rules similar to the rules of § 163(j)(4)(A) and (C) apply to any S corporation and its shareholders). Note that an S corporation's business interest for a taxable year is allowable to the extent it does not exceed the sum of 30% of the S corporation's ATI, its business interest income, and its floor plan financing interest for the year. *See* § 163(j)(1).

Note as well that an S corporation shareholder must be allocated allowable business interest in proportion to the stock that she owns. § 1366(a) (providing for a pro rata allocation); *see also* § 1361(b)(1)(D) (providing that an S corporation cannot have more than one class of stock); § 1361(b)(4) (disregarding differences in voting rights for purposes of § 1361(b)(1)(D)).

¹³⁵ § 163(j)(4)(A)(ii)(I) (as amended by § 13301(a) of the TCJA); *see* § 163(j)(4)(D) (as amended by § 13301(a) of the TCJA). An S corporation shareholder, however, adjusts her basis in her S corporation stock by taking the distributive share of S corporation items into account. § 1366(a).

distributive share, if any, of the S corporation's "excess taxable income,"¹³⁶ determined by the S corporation in the same manner as by a partnership.¹³⁷

However, in a significant departure from the partnership approach, if an S corporation cannot deduct a portion of its business interest under § 163(j) for a taxable year, the corporation treats that portion as business interest paid or accrued in the next year,¹³⁸ determining its allowable business interest in the succeeding year by taking that carryover into account.

C. Excess Business Losses

Under § 461(j), a taxpayer other than a C corporation cannot deduct an excess business loss for a taxable year,¹³⁹ but that excess business loss is carried forward and treated as a part of the taxpayer's net operating loss carryover to the following year.¹⁴⁰ A taxpayer's excess business loss

¹³⁶ § 163(j)(4)(A)(ii)(II) (as amended by § 13301(a) of the TCJA) (providing that a partner's ATI is increased by the partner's share of the partnership's excess taxable income); § 163(j)(4)(C) (as amended by § 13301(a) of the TCJA) (defining excess taxable income); § 163(j)(4)(D) (providing that rules similar to § 163(j)(4)(A) and (C) apply to S corporations and their shareholders).

¹³⁷ § 163(j)(4)(D).

¹³⁸ § 163(j)(2); *see* § 163(j)(4)(D) (providing that rules similar to § 163(j)(4)(A) and (C) apply to any S corporation and its shareholders, but not rules similar to § 163(j)(4)(B), the special rule for carryforwards that applies just for partnerships); *see also* H.R. REP. NO. 115-466, at 391 (2017) (Conf. Rep.) (confirming that rules like those under § 163(j)(4)(B) do not apply to S corporations and their shareholders).

¹³⁹ § 461(j)(1) (as added by § 11012(a) of the TCJA) (also providing that § 461(j), relating to excess farm losses, does not apply). This provision is effective for any taxable years beginning after December 31, 2017 and ending before January 1, 2026. *Id.*; *see also* § 11012(b) of the TCJA.

¹⁴⁰ § 461(j)(2) (as added by § 11012(a) of the TCJA) (providing that an excess business loss for a taxable year is treated as "a" net operating loss carryover to the following year); *see also* H.R. REP. NO. 115-466, at 239 (2017) (Conf. Rep.) (stating that a taxpayer's excess

for a taxable year is the excess, if any, of (i) the taxpayer's aggregate deductions for the year attributable to the taxpayer's trades or businesses, over (ii) \$250,000 (or twice that amount in the case of a joint return) plus the taxpayer's aggregate gross income or gain for the year attributable to those trades or businesses.¹⁴¹

For a partnership or S corporation and their owners, § 461(j) is applied at the partner or shareholder level.¹⁴² Such an owner applies § 461(j) for a taxable year by taking into account her allocable share of the entity's tax items for the entity's taxable year that ends during or at the same time as the owner's year.¹⁴³

D. Net Operating Loss Carryovers

A taxpayer can carry a net operating loss (an "NOL") for a taxable year to other years as provided in § 172.¹⁴⁴ Before the changes made by the TCJA, a taxpayer could generally carry an NOL back two years and forward 20 years, and the NOL offset taxable income in the order of the

business loss for a taxable year is treated as part of her net operating loss carryover to the following year).

¹⁴¹ § 461(j)(3)(A) (as added by § 11012(a) of the TCJA) (adding that the excess business loss is "determined without regard to whether or not such deductions are disallowed for such taxable year under [§ 461(j)(1)]"). Those deductions are determined after applying § 469 (*i.e.*, the passive activity rules). § 461(j)(6) (as added by § 11012(a) of the TCJA). Note that the \$250,000 amount is adjusted for inflation for any taxable year beginning after December 31, 2018. § 461(j)(3)(B) (as added by § 11012(a) of the TCJA).

¹⁴² § 461(j)(4)(A) (as added by § 11012(a) of the TCJA).

¹⁴³ § 461(j)(4)(B) (as added by § 11012(a) of the TCJA) (adding that the entity items taken into account are those "from trades or businesses attributable to the partnership or S corporation"); *see* H.R. REP. NO. 115-466, at 239 (2017) (Conf. Rep.); *see also* § 706(a) (providing that a partner takes into account his or her distributive share of partnership tax items for the partnership taxable year that ends during or at the same time as the partner's taxable year); § 1366(a)(1) (providing a comparable rule for S corporation shareholders).

¹⁴⁴ *See* § 172(c) (providing that a net operating loss is the excess of deductions over gross income, computed with the modifications specified in § 172(d)); § 172(d) (generally disallowing non-business deductions for non-corporate taxpayers).

taxable years to which the NOL could be carried.¹⁴⁵ The NOL deduction for a taxable year equaled the sum of the NOL carryforwards and carrybacks to the year.¹⁴⁶

As modified by the TCJA, in general, § 172 allows an indefinite carryforward of an NOL but prohibits any NOL carryback.¹⁴⁷ Further, the NOL deduction for a taxable year cannot exceed 80% of the taxable income for the year, computed without regard to the NOL carryover.¹⁴⁸

¹⁴⁵ § 172(b)(1)(A) (before its amendment by the TCJA for the general rule); § 172(b)(2) (for the ordering rule); *see also* § 172(b)(1)(C), (E), (F) (extending the carryback period for certain losses); § 172(b)(1)(D) (preventing the carryback of a corporate equity reduction loss for any loss limitation year to a taxable year preceding the taxable year in which the corporate equity reduction transaction occurred).

¹⁴⁶ § 172(a).

¹⁴⁷ § 172(b)(1)(A) (as modified by § 13302 of the TCJA) (providing that an NOL may be carried “to each taxable year following the taxable year of the loss”); *see also* § 172(b)(1)(B) (as modified by § 13302 of the TCJA) (allowing a two-year carryback for farming losses); § 172(b)(1)(C) (as modified by § 13302 of the TCJA) (providing a two-year carryback and 20-year carryforward for an NOL of an insurance company other than a life insurance company). These carryforward and carryback rules apply to NOLs arising in taxable years ending after December 31, 2017. § 13302(e)(2) of the TCJA. *But see* Net Operating Loss Provision May Need Fix From Congress, 2018 TNT 18-3 (Jan. 26, 2018) (noting that the provision was intended to apply to taxable years beginning after December 31, 2017; the effective date in the statute makes a difference for fiscal-year taxpayers). Note that because NOLs can be carried forward indefinitely, § 382 will generally no longer prevent the full utilization of an NOL following an ownership change. *But see* § 382(j)(5)(D) (providing for a § 382 limitation of zero if there is a second ownership change of a loss corporation within two years after an ownership change to which § 382(j)(5)(A) applied).

Note as well that before this change, a purchasing corporation might make a § 338(g) (rather than § 338(h)(10)) election for a target corporation if the target would recognize a loss on the deemed asset sale that could be utilized in a carryback year. Eliminating the carryback period removes that incentive for a § 338(g) election.

¹⁴⁸ § 172(a) (as amended by § 13302(a) of the TCJA). Thus, the NOL deduction for a taxable year equals the smaller of (i) that 80% amount and (ii) the total of the NOL carrybacks and carryforwards to the year. This limitation on the use of NOLs applies to

The amended NOL rules may disadvantage taxpayers that have a business cycle greater than one year by postponing the use of a portion of their losses. Consider the following example:

Corporations A and B are both formed in 2018. Corporation A has a two-year business cycle, it has a \$1,000 taxable loss in 2018, incurring no tax, and taxable income (disregarding the \$1,000 NOL carried from 2018) of \$1,100 in 2019. Because of the 80% limitation under § 172, Corporation A can use only \$880 of its \$1,000 NOL in 2019, and therefore has \$220 of taxable income in 2019, incurring a \$46.20 tax (*i.e.*, 21% of \$220). Its remaining \$120 portion of the \$1,000 NOL is carried to succeeding years.¹⁴⁹

In contrast, corporation B has \$0 of taxable income in 2018, incurring no tax, and \$100 of taxable income in 2019, incurring just a \$21 tax. Although both corporations have the same aggregate taxable income for 2018 and 2019, because of the timing of Corporation A's income and loss, it incurs an extra \$25.20 of tax by the end of 2019. Even if it can absorb its remaining \$120 NOL in future years, it suffers a time-value cost because of the loss deferral.

The business interest and NOL limitations make it more likely that a corporation facing business setbacks will fail.¹⁵⁰ Under prior law, the

losses arising in taxable years beginning after December 31, 2017. § 13302(e)(1) of the TCJA. Thus, pre-2018 losses carried over to post-2017 years are not subject to the 80% limitation. The policy rationale for the 80% limitation is not altogether clear. *Cf.* H.R. REP. NO. 115-409, at 252 (2017) (Conf. Rep.) (to support a 90% limitation, the House Ways and Means Committee stated that “[t]he Committee also believes that taxpayers should pay some income tax in years in which the taxpayer has taxable income (determined without regard to the NOL deduction). Therefore, the Committee believes that the NOL deduction should be limited to 90 percent of taxable income (determined without regard to the deduction)”).

¹⁴⁹ If corporation A continued the pattern of a \$1,000 taxable loss in one year followed by \$1,100 of taxable income in the next year, it would utilize only \$880 of its NOL carryover every two years, never using any of the excess loss (*i.e.*, in operation, its excess loss would be permanently disallowed).

¹⁵⁰ Other changes may also hurt failing corporations, including the repeal of the deduction for domestic production activities. *See* § 13305(a) of the TCJA (repealing

NOL carryback could cushion a business setback for a formally profitable corporation, a benefit withdrawn by the TCJA. Further, because a deduction for business interest cannot exceed 30% of a taxpayer's ATI, a financially troubled corporation risks being ensnared by this limitation and may have to pay tax even though it suffers an economic loss, a loss that could have been deducted under prior law. In short, these changes may lead to a death spiral for a financially troubled corporation.

E. Executive Compensation -- § 162(m)

Under § 162(a), an employer generally can deduct reasonable compensation paid to an employee, although § 162(m) limits the deduction for compensation paid by a public corporation to certain highly compensated executives. Although the exception was intended to reduce runaway executive compensation, before its amendment by the TCJA, it may have had the perverse effect of increasing it, because performance-based compensation often escaped its limitations, an exception that led to a torrent of executive stock options and stock appreciation rights ("SARs").

Under § 162(m), a publicly held corporation cannot deduct "applicable employee remuneration" for a "covered employee" to the extent it exceeds \$1 million for any taxable year.¹⁵¹ Although applicable employee remuneration generally included all compensation, before the amendment made by the TCJA, it excluded compensation payable on a

§ 199); *see also* § 13305(c) of the TCJA (providing that the repeal is effective for taxable years beginning after December 31, 2017).

¹⁵¹ § 162(m)(1) (more precisely limiting the deduction of applicable employee remuneration); § 162(m)(4)(A) (generally defining applicable employee remuneration for any covered employee for a taxable year as "the aggregate amount allowable as a deduction . . . for such taxable year . . . for remuneration for services performed by such employee (whether or not during the taxable year)").

commission basis and “performance-based compensation,”¹⁵² most prominently stock options and SARs.¹⁵³

Before the TCJA, a covered employee for any taxable year included the corporation’s chief executive officer and its four highest paid officers for that year (other than the chief executive officer) whose total compensation had to reported to shareholders under the Securities Exchange Act of 1934 (the “1934 Act”).¹⁵⁴ In 2006, the Securities and Exchange Commission (the “SEC”) amended the reporting rules for officer compensation, limiting the reporting to the compensation of the principal executive officer, principal financial officer, and the three most highly compensated officers other than the principal executive and principal financial officers.¹⁵⁵ In response, the IRS limited covered

¹⁵² § 162(m)(4)(B), (C) (before its amendment by the TCJA). Remuneration excludes any benefit provided to or for the benefit of the employee if it was reasonable to believe when the benefit was provided that the employee could exclude it from gross income (*e.g.*, payments to a qualified pension or profit-sharing plan). § 162(m)(4)(E)(ii).

¹⁵³ Performance-based compensation had to meet the following requirements:

- (i) It had to be paid solely on account of attaining one or more performance goals;
- (ii) The performance goals had to be determined by a compensation committee of the board of directors composed solely of at least two or more outside directors;
- (iii) Before payment, the material terms of the remuneration, including the performance goals, had to be disclosed to shareholders and approved by a majority shareholder vote; and
- (iv) Before payment, the compensation committee had to certify that the performance goals and any other material terms were satisfied.

§ 162(m)(3)(C) (before its amendment by the TCJA). Those performance requirements generally would have been met for a stock option or SAR with an exercise price not less than value when issued, because the compensation attributable to such an interest was based solely on the increased value of the corporation’s stock. *See* H.R. REP. NO. 115-466, at 489 (2017) (Conf. Rep.) (making this point).

¹⁵⁴ § 162(m)(3) (before its amendment by the TCJA).

¹⁵⁵ *See* H.R. REP. NO. 115-466, at 487 (2017) (Conf. Rep.) (noting this change).

employees to the principal executive officer and the three most highly compensated officers other than the principal executive officer.¹⁵⁶

The TCJA widened the reach of § 162(m) by expanding the categories of compensation and groups of employees and employers covered by the provision.¹⁵⁷ First, it no longer excepted commissions and performance-based compensation from applicable employee remuneration.¹⁵⁸

Second, it broadened the employees covered by the provision, tracking the SEC's 2006 change to the reporting rules. Covered employees now include (i) an employee who is the corporation's principal executive officer or principal financial officer at any time during the taxable year and (ii) the three highest compensated employees (other than the principal executive officer or principal financial officer) as reported under the 1934 Act.¹⁵⁹ A person is also a covered employee if he or she (or a predecessor) met the definition in the preceding sentence for any taxable year beginning after December 31, 2016.¹⁶⁰

Finally, the definition of publicly traded corporations (*i.e.*, the employers subject to the § 162(m) limitation) was also expanded. It now

¹⁵⁶ I.R.S. Notice 2007-49, 2007-25 I.R.B. 1429.

¹⁵⁷ The amendments to § 162(m) are generally effective for taxable years beginning after December 31, 2017 but they do not apply to remuneration provided pursuant to a written binding agreement in effect on November 2, 2017 and not modified in any material respect after that date. § 13601(e) of the TCJA; *see also* H.R. REP. NO. 115-466, at 490–91 (2017) (Conf. Rep.) (further describing the transition rule).

¹⁵⁸ § 13601(a)(1) of the TCJA.

¹⁵⁹ § 162(m)(3)(A)–(B) (as amended by § 13601(b) of the TCJA).

¹⁶⁰ § 162(m)(3)(C) (as amended by § 13601(b) of the TCJA). Thus, if an individual was a covered employee for any taxable year beginning after December 31, 2016, she remains a covered employee for deferred compensation received from the employer after retirement. Further, a deduction may be limited for “compensation paid to a beneficiary after the employee’s death, or to a former spouse pursuant to a domestic relations order.” H.R. REP. NO. 115-466, at 489–90.

includes not only all domestic publicly traded corporations and all foreign companies publicly traded through American depository receipts (commonly called “ADRs”) but also certain non-publicly traded corporations, such as certain large private C or S corporations.¹⁶¹

IV. S CORPORATION TAX CHANGES

The TCJA added several provisions that apply exclusively to S corporations and their shareholders. It added a provision to extend the time that income adjustments under § 481 are taken into account on the conversion of an “eligible terminated” S corporation to a C corporation. It also extended the time that cash distributions could be considered paid out of the accumulated adjustment account following those conversions. Finally, it allowed an electing small business trust to be an S corporation shareholder even if it had a nonresident alien as a potential current beneficiary.

A. Section 481 Adjustments

When an S corporation that used the cash method of accounting converts to a C corporation, it may be required to switch to the accrual method and make adjustments under § 481 to prevent tax items from being duplicated or omitted from taxable income.¹⁶² Before the TCJA was enacted, generally, net adjustments that decreased taxable income were taken into account in the year of the change, while net adjustments that increased taxable income were taken into account during the four-year period beginning with the taxable year of the change.¹⁶³

¹⁶¹ H.R. REP. NO. 115-466, at 490; *see also* § 13601(c) of the TCJA (amending § 162(m)(2) to define publicly traded corporations to include not only corporations the securities of which are required to be registered under section 12 of the 1934 Act but also corporations that are required to file reports under section 15(d) of that act (*e.g.*, those that have issued debt securities to the public in a registered offering)).

¹⁶² *See* § 448(a)(1) (generally requiring a C corporation to use the accrual method of accounting); *cf.* § 448(b) (for certain exceptions, including for corporations that meet the \$25 million gross receipts test); *see also supra* notes 63–65 (discussing the \$25 million gross receipts test).

¹⁶³ Treas. Reg. § 1.481-1(c)(2) (2013) (providing that § 481 adjustments for a voluntary change in the method of accounting generally must be taken into account in the year of

Under the TCJA, if an “eligible terminated” S corporation revokes its S election, it takes net adjustments that increase taxable income into account over a six-year, rather than four-year, period.¹⁶⁴ An eligible terminated S corporation is a C corporation that meets the following three requirements:

(i) It was an S corporation on the day before the date of the TCJA’s enactment (*i.e.*, December 21, 2017);

(ii) It revokes its S election during the two-year period beginning on the date of the TCJA’s enactment (*i.e.*, December 22, 2017); and

(iii) On both the date of the enactment and date of revocation, the same persons own stock in the corporation in identical proportions.¹⁶⁵

the change, although the Commissioner has the authority to prescribe different rules); Rev. Proc. 2015-13, 2015-5 I.R.B. 419 at § 7.03(1) (generally providing that net adjustments that increase taxable income are taken into account over four taxable years (*i.e.*, the year of the change and the next three years)).

¹⁶⁴ § 481(d)(1) (as added by § 13543(a) of the TCJA) (more precisely providing that adjustments required by § 481(a)(2) are “taken into account ratably during the 6-taxable year period beginning with the year of the change”); § 1361(d)(1)–(2) (describing how an S election may be electively revoked). Thus, this extension does not apply if the corporation’s S election terminates other than by revocation (*i.e.*, if the election terminates because the S corporation ceases to be a small business corporation). *See* § 1362(d)(2) (providing that a corporation’s S election terminates when it ceases to be a small business corporation); § 1361(b)(1) (defining a small business corporation as a corporation (other than an ineligible corporation) that does not have more than one class of stock, more than 100 shareholders, and shareholders other than individual citizens and residents and certain types of trusts and tax-exempt organizations).

¹⁶⁵ § 461(d)(2) (as added by § 13543(a) of the TCJA).

When those requirements are met, the corporation uses the extended six-year period to account for its § 481 adjustments.¹⁶⁶

B. Post-termination Distributions

When a C corporation with accumulated earnings and profits (“e&p”) becomes an S corporation, its distributions out of pre-S corporation e&p are taxed as dividends while distributions out of its accumulated adjustments account (its “AAA”) are taxed as a return of basis.¹⁶⁷ When a corporation’s S election terminates, a similar issue arises

¹⁶⁶ Note that § 481(d)(1) provides for a six-year adjustment period whether the § 481 adjustments triggered by the revocation increase or decrease taxable income. A change from the cash to the accrual method typically will result in § 481 adjustments that increase taxable income by accelerating income or deferring deductions. *See* Treas. Reg. § 1.451-1(a) (1999) (providing that under the accrual method, an amount is included in gross income when “all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy,” while under the cash method, an amount is included in gross income when “actually or constructively received”); § 451(b) (as amended by § 13221(a) of the TCJA) (providing that in accounting for an item of gross income for an accrual-method taxpayer, the all events test will be met no later than when the item is taken into account as revenue in the taxpayer’s applicable financial statement); Treas. Reg. § 1.461-1(a)(1) (1999) (providing that under the cash method, an amount generally cannot be deducted until paid); Treas. Reg. § 1.461-1(a)(2) (1999) (providing that under the accrual method, a liability generally is taken into account in the year in which all events have occurred that establish the fact of the liability, the liability can be determined with reasonable accuracy, and economic performance has occurred).

¹⁶⁷ *See* § 1368(c) (for a three-tiered scheme to characterize distributions by an S corporation with accumulated e&p). Broadly speaking, an S corporation’s AAA equals its earnings (reduced by its tax-exempt income) while an S corporation. The AAA is determined in a manner similar to the stock basis adjustments under § 1367 with two exceptions. § 1368(e)(1)(A); *see also* § 1367(a) (providing that stock basis is increased for income items and reduced for non-taxable distributions, losses, deductions, and non-capitalizable, nondeductible expenses). First, unlike stock basis, the account may be reduced below \$0. Second, the account is not adjusted for tax-exempt income (and related expenses). § 1368(e)(1)(A) (providing that no adjustment is made for tax-exempt income and related expense); Treas. Reg. § 1.1368-2(a)(2)–(3) (2000). Thus, a corporation’s AAA reflects its undistributed earnings while an S corporation, except that tax-exempt income is not taken into account. Because a corporation’s AAA reflects only the corporation’s items while it was an S corporation, its AAA is not affected by any post-termination tax items.

because its distribution of pre-termination S corporation earnings should be treated as a basis recovery while post-termination distributions out of e&p should be taxed as dividends. The TCJA preserved one post-termination rule § 1371(e), while adding another § 1371(f).

Under § 1371(e)(1), if an S corporation converts to a C corporation, its post-termination distributions to shareholders may be tax-free to the extent of the corporation's AAA and reduce the shareholders' stock basis.¹⁶⁸ However, to qualify for this treatment, the distribution must be paid in cash during the post-termination transition period.¹⁶⁹ Broadly speaking, the post-termination transition period is generally the one-year period after the S election terminates.¹⁷⁰

The TCJA added § 1371(f), which extends the time that post-termination payments may be deemed paid out of a corporation's AAA. As with a § 1361(e) distribution, a § 1371(f) distribution must be paid in cash.¹⁷¹ Further, it must be paid by an eligible terminated S corporation

¹⁶⁸ See § 1371(e)(1); § 1371(e)(2) (for an election to not apply § 1371(e)(1)). Note that these distributions are tax-free to a shareholder only to the extent of the shareholder's stock basis.

¹⁶⁹ § 1371(e)(1).

¹⁷⁰ More precisely, as a general rule, the "post-termination transition period" begins on the first day that the corporation is no longer an S corporation and ends at the later of (i) one year after that date or (ii) the due date for the federal income tax return (including extensions) for the corporation's final taxable year as an S corporation. § 1377(b)(1)(A). The post-termination transition period may also include two 120-day periods. See § 1377(b)(1)(B) (including in the post-termination transition period the 120-day period beginning on the date of any audit determination that follows the termination but adjusts an item of income, loss, or deduction for the corporation while it had S status); § 1377(b)(1)(C) (also including the 120-day period beginning on the date of a determination that the corporation's S election had terminated for a previous taxable year); see also § 1377(b)(2) (defining determination).

¹⁷¹ § 1371(f) (as added by § 13543(b) of the TCJA).

to its shareholders after the post-termination transition period ends.¹⁷² Although the provision's wording is somewhat cryptic, it appears that the portion of a distribution deemed paid out of the AAA is determined as follows: The distribution is allocated proportionately between the AAA and accumulated e&p at the time of the distribution.¹⁷³ Presumably, to the

¹⁷² *Id.*; see *supra* note 165 and accompanying text (for the definition of an eligible terminated S corporation). It is not entirely clear what § 1371(f) means when it provides that it applies to distributions after “the” post-termination transition period, because there may be three post-termination periods, the “general” period and two 120-day periods. See *supra* note 170 (describing those periods). Presumably, Congress intended that § 1371(f) should apply to distributions made after the “general” post-termination period ends other than during either 120-day period.

The alternative makes little sense—for § 1371 to apply only after the last post-termination period ends. First, until the statute of limitations period ends for all S corporation years, it may be uncertain whether either 120-day period will arise. If neither does (likely the typical case) but the alternative rule is adopted, distributions could retrospectively be treated as § 1371(f) distributions, but the statute of limitations for the retrospective period may have already closed. No doubt, well-advised shareholders would file returns assuming that the general post-termination transition period would be the last. If it turns out not to be, it would create a significant administrative burden for them to file amended returns (and many might “forget” to do so). In any case, if one of those 120-day periods arises, it is not clear why § 1371(f) should not apply to distributions made after the general post-termination period ends and before the 120-day period begins. For those reasons, regulations or other administrative guidance should provide that § 1371(f) applies after the general post-termination period ends, except during either 120-day period.

¹⁷³ § 1371(f) (as added by § 13543(b) of the TCJA) (stating that “the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of such accumulated adjustments account bears to the amount of such accumulated earnings and profits”); see also Treas. Reg. § 1.316-2(b) (1960) (last sentence) (if the amount of accumulated e&p cannot be shown (*e.g.*, through a closing of the books) at the time of the distribution, the current e&p for the distribution year is prorated to the date of the distribution).

If the amount of the distribution exceeds the sum of the AAA and accumulated e&p at the time of the distribution, the amount allocated to the AAA should equal its balance. If the distribution amount is less than that sum, the distribution should be allocated proportionately between the AAA and accumulated e&p. For example, if the corporation makes a \$1,000 distribution when the AAA is \$500 and accumulated e&p is \$1,500, \$250 (\$1,000 times \$500/\$2,000) should be allocated to the AAA and the

extent allocable to the AAA, a distribution may be tax-free to the shareholders and would reduce their stock basis to that extent.¹⁷⁴

All other post-termination distributions are accounted for under § 301, the section generally applicable to distributions from C corporations. Thus, except to the extent either § 1371(e)(1) or (f) applies, if a corporation makes a distribution to its shareholders after its S election terminates, the distribution is subject to § 301 even if the corporation's AAA has not been fully depleted.

C. Eligible Shareholders

Among other things, an S corporation cannot have a corporation, partnership, or nonresident alien as a shareholder.¹⁷⁵ Permitted S corporation shareholders include individuals (other than nonresident aliens), certain exempt organizations, and certain trusts, such as electing small business trusts (“ESBTs”).¹⁷⁶

A trust is an ESBT if (i) each beneficiary is an individual or one of several types of exempt organizations, (ii) no interest in the trust was acquired by purchase, and (iii) an election under § 1361(e)(3) is made for the trust.¹⁷⁷ Before January 1, 2018, such a trust was a permitted

remaining \$750 (\$1,000 times \$1,500/\$2,000) to the accumulated e&p. If a portion of a distribution is allocated to the AAA, the AAA should be reduced by that amount.

¹⁷⁴ More precisely, a former S shareholder should treat the distribution to the extent considered paid out of the AAA first as a recovery of stock basis and then as gain from the sale or exchange of property. *See* § 1368(b)(1), (c)(1).

¹⁷⁵ If one of those persons is treated as a shareholder of an S corporation, it ceases to qualify as a small business corporation and its S election terminates on the date of cessation. § 1362(d)(2).

¹⁷⁶ *See* § 1361(b)(1)(B) (for permitted shareholders); § 1361(c)(2) (describing certain trusts that are permitted shareholders); § 1361(c)(6) (for certain exempt organizations that are permitted shareholders).

¹⁷⁷ § 1361(e)(1)(A). In addition, an ESBT cannot be a qualified subchapter S trust, a trust exempt from tax, a charitable remainder annuity trust, or a charitable remainder unitrust.

shareholder of an S corporation, unless it had a “potential income beneficiary” who was a non-resident alien,¹⁷⁸ but the TCJA changed that rule. Effective January 1, 2018, a corporation may qualify as an S corporation even if one of its shareholders is an ESBT that has one or more non-resident aliens who are potential income beneficiaries.¹⁷⁹

Note that the portion of an ESBT that consists of stock of one or more S corporations is treated as a separate trust.¹⁸⁰ The separate trust

§ 1361(e)(1)(B); *see also* § 1361(e)(1)(C) (defining purchase as any acquisition if the basis of property acquired is determined under § 1012).

¹⁷⁸ *See* § 1361(c)(2)(B)(v) (before its amendment by the TCJA) (providing that each potential current beneficiary of an ESBT was treated as a shareholder for purposes of § 1361(b)(1)); § 1361(b)(1)(C) (providing that a small business corporation cannot have a nonresident alien as a shareholder); § 1362(a)(1) (providing that an S corporation must be a small business corporation); *see also* § 1361(e)(2) (providing as a general rule that a potential current beneficiary of an ESBT “with respect to any period” is “any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust”).

¹⁷⁹ § 13541(a) of the TCJA (adding the following sentence at the end of § 1361(c)(2)(B)(v): “This clause shall not apply for purposes of” § 1361(b)(1)(C); that provision prohibits a non-resident alien from being a shareholder of a small business corporation); *see also* § 13541(b) (for the January 1, 2018 effective date). Thus, under § 1361(c)(2)(B)(v), as amended by § 13541 of the TCJA, if a nonresident alien is a potential current beneficiary of an ESBT that owns stock in an S corporation, that nonresident alien is treated as a shareholder of the corporation for all purposes of § 1361(b)(1) other than paragraph (C). In relevant part, therefore, the nonresident alien is still treated as a shareholder in measuring whether the S corporation meets the 100-shareholder limit under § 1361(b)(1)(A).

¹⁸⁰ § 641(c)(1).

takes into account its allocable share of S corporation income and pays tax on that income.¹⁸¹ No portion of the income is taxed to the trust.¹⁸²

¹⁸¹ See § 641(c)(1)(B), (c)(2). Before the TCJA was enacted, a trust's tax was imposed by § 1(e) but § 641(c) modified how § 1(e) applied to an ESBT. As modified, to compute the tax imposed by § 1(e) on an ESBT's taxable income relating to its S corporation stock, the applicable tax rate generally was computed at § 1(e)'s highest marginal rate. See § 641(c)(2)(A) (providing that "[e]xcept as provided in section 1(h), the amount of tax imposed by section 1(e) shall be determined by using the highest rate of tax set forth in section 1(e)"); § 641(c)(2)(C) (among other things, providing that an ESBT's taxable income related to any S corporation stock includes the trust's allocable share of S corporation items determined under § 1366, any gain or loss from the sale of S corporation stock, and any interest expense on indebtedness used to acquire the S corporation stock); § 1(e) (providing for a highest marginal rate of 39.6%, equal to the highest marginal rate for individuals under § 1(a)-(d)); see also § 1(i)(2) (modifying rates under § 1(e) but retaining the top marginal rate); § 1411(a)(2) (with limitations, imposing an additional tax of 3.8% on its undistributed net investment income of trusts). The highest marginal rate under § 1(e) was also the highest marginal rate for an individual.

Congress likely intended to continue taxing the "S corporation" income of an ESBT at the highest individual rate, but a technical glitch in the TCJA appears to change that result. See H.R. REP. NO. 115-466, at 518 (2017) (Conf. Rep.) (describing the law before the enactment of the TCJA as providing that such a trust "generally [was] taxed on its share of an S corporation's income at the highest rate of tax imposed on individual taxpayers"; the legislative history did not suggest that the TCJA changed that result). For taxable years beginning after December 31, 2017 and before January 1, 2026, new § 1(j), rather than § 1(e), imposes tax on trusts, including ESBTs. See § 11001(a) of the TCJA (adding § 1(j)(1)(E), which provides a tax table for trusts "in lieu of the table contained in" § 1(e)); H.R. REP. NO. 115-466, at 199 (2017) (Conf. Rep.) (stating that the new rate schedules temporarily replace the existing rate schedules). Because § 641(c) does not modify how new § 1(j) applies, § 641 will no longer change how an ESBT's tax is computed (Section 641 modifies how § 1(e), not § 1(j), applies). Thus, the tax on an ESBT's S corporation income may be imposed at graduated rates under § 1(j), something likely not intended by Congress.

Note that the TCJA also limited the charitable deduction for the portion of an ESBT that consists of stock in one or more S corporations. Before the TCJA was enacted, generally an ESBT was allowed a charitable deduction without limitation for the amount of its gross income paid for a charitable purpose. See § 642(c); see also H.R. REP. NO. 115-466, at 518 (2017) (Conf. Rep.) (describing that rule). As modified by the TCJA,

V. PARTNERSHIP TAX CHANGES

A. Amendment to § 743

When a person buys a partnership interest, the purchaser takes a cost basis in the acquired interest (the partner's "outside" basis), but the partnership does not adjust its asset bases (the "inside" basis) unless the partnership has made a § 754 election or has a substantial built-in loss.¹⁸³ Without that adjustment, if the partnership sells an asset, the purchaser may be allocated gain or loss even if the value of the partnership asset remains unchanged since the purchase.

If the adjustment is made, the purchasing partner's share of inside basis matches (or at least approaches) the cost basis that the partner would take if she acquired a share of partnership assets directly and contributed that share to the partnership. Those adjustments are advantageous if the purchaser would otherwise recognize a gain, but are less pleasurable if the purchaser would otherwise recognize a loss.

Section 743(a) requires those adjustments if the partnership has made a § 754 election or has a substantial built-in loss. A partnership has a substantial built-in loss if the aggregate adjusted basis of its property exceeds the property's aggregate value by more than \$250,000.¹⁸⁴ Under the TCJA, a partnership also has a substantial built-in loss if the transferee partner would be allocated a loss of more than \$250,000 if the partnership assets were sold for cash equal to their fair market value immediately after the transfer.¹⁸⁵ Thus, because of the change made by the act, substantial

the charitable contribution deduction for that portion of the ESBT is subject to the limitations that apply to individuals, although any excess contribution can be carried forward for five years. *See* § 13542 of the TCJA (adding § 641(c)(2)(E)); *see also* H.R. REP. NO. 115-466, at 518 (2017) (Conf. Rep.) (describing that change).

¹⁸² *See* § 641(c)(2) (last sentence) (stating that no item described in § 641(c)(2) is apportioned to any beneficiary).

¹⁸³ *See* § 743(a).

¹⁸⁴ *See* § 743(d)(1)(A) (as amended by § 13502(a)(1)(A) of the TCJA).

¹⁸⁵ *See* § 743(d)(1)(B) (as amended by § 13502(a)(1)(A) of the TCJA); *see also* H.R. REP. NO. 115-466, at 512 (2017) (Conf. Rep.). This change applies to transfers of partnership interests after December 31, 2017. § 13502(b) of the TCJA. Although the statute does

built-in losses must be measured both at the partnership and transferee partner levels.¹⁸⁶

B. *Loss Limitation under § 704(d)*

Under § 704(d), a partner's distributive share of partnership loss is allowed only to the extent of the partner's outside basis (before reduction for partnership loss). Any disallowed loss is suspended and is taken into account at the end of the first subsequent taxable year that the partner has a positive outside basis (before accounting for partnership loss for the year).¹⁸⁷ The suspended loss is allowed to the extent of that outside basis.¹⁸⁸

In computing the basis limitation under § 704(d), the regulations disregard deductions for charitable contributions and foreign taxes even though a partner reduces her outside basis to account for those

not expressly state that the allocable loss is determined on a net basis, the legislative history suggests that it should be. *See* H.R. REP. NO. 115-466, at 513 (2017) (Conf. Rep.) (applying the rule by stating that a partner had a “net” built-in-loss of \$300,000). Regulations or administrative guidance should confirm that point.

¹⁸⁶ *See* H.R. REP. NO. 115-466, at 513 (2017) (Conf. Rep.) (making this point).

¹⁸⁷ Treas. Reg. § 1.704-1(d)(1) (as amended in 2017). Under § 705(a), a partner's outside basis is increased by her distributive share of partnership income and reduced by her share of partnership losses and non-capitalizable, non-deductible expenditures. Note that a partner reduces her outside basis to account for the partnership's charitable contributions, but the reduction may be less than the partner's share of the charitable contribution deduction if the partnership has contributed appreciated property. *See* Rev. Rul. 96-11, 1996-1 C.B. 140 (concluding that if a partnership makes a charitable contribution of property with a value greater than its adjusted basis, a partner reduces her outside basis by her distributive share of the adjusted basis of the contributed property).

¹⁸⁸ Treas. Reg. § 1.704-1(d)(1); *see also* Treas. Reg. § 1.704-1(d)(2) (aggregating the loss carryforwards with current losses and providing that a proportionate amount of each loss and deduction is taken into account).

deductions.¹⁸⁹ The TCJA changes that result, requiring a partner to compute her basis limitation under § 704(d) by accounting for her distributive share of deductions for charitable contributions and foreign taxes.¹⁹⁰ However, if the partnership makes a charitable contribution of non-cash property with a value exceeding its adjusted basis, a partner determines her § 704(d) limitation by disregarding her share of that excess.¹⁹¹

The new rule is comparable to § 1366(d)(4), a rule that applies to S corporation shareholders, and the new rule should apply in a similar fashion. For example, suppose that Fred and Mort are partners in a partnership, each is allocated one-half of all partnership items, and each has a \$35 outside basis in the partnership. For a taxable year, the partnership makes a charitable contribution of property with a \$100 basis and \$350 value, has \$20 of non-separately stated taxable income, and has a \$50 long-term capital loss. Subject to § 704(d), each partner shares in \$175 of the charitable contribution deduction, \$10 of the ordinary income, and \$25 of the capital loss.

To compute each partner's basis limitation under § 704(d), each partner increases his outside basis from \$35 to \$45, accounting for his one-half share of the partnership's ordinary income for the year.¹⁹² Each partner is allowed a \$125 share of the charitable contribution deduction (*i.e.*, the amount attributable to the built-in gain in the contributed asset), because § 704(d) does not apply to (and hence does not limit) that

¹⁸⁹ Treas. Reg. § 1.704-1(d)(2) (not taking into account deductions under § 702(a)(4) and (6)).

¹⁹⁰ § 704(d)(3)(A) (as added by § 13503(a)(3)(A) of the TCJA).

¹⁹¹ § 704(d)(3)(B) (as added by § 13503(a)(3)(A) of the TCJA) (providing that rule); *see also* H.R. REP. NO. 115-466, at 515 (2017) (Conf. Rep.) (describing the new rule); *cf.* § 1366(d)(4) (for a comparable rule for S corporation shareholders). The changes made to § 704(d) are effective for partnership taxable years beginning after December 31, 2017. § 13503(b) of the TCJA.

¹⁹² Treas. Reg. § 1.704-1(d)(2) (as amended in 2017) (providing that in computing the § 704(d) limitation, each partner first adjusts her outside basis to account for items under § 705(a)(1) and (2) other than partnership losses and deductions); *cf.* § 1366(d)(1)(A) (for a comparable rule for S corporation shareholders).

allowance.¹⁹³ However, § 704(d) may limit the allowance of each partner's one-half share of the remaining \$100 charitable contribution deduction and the \$50 long-term capital loss. Because each partner shares in \$75 of the aggregate loss and deduction and that aggregate amount exceeds his \$45 outside basis, under § 704(d), each partner is allowed only a proportionate amount of each component of that amount.¹⁹⁴ Thus, Fred and Mort are each allowed \$30 of the remaining charitable contribution deduction (*i.e.*, \$45 times \$50/\$75) and \$15 of the long-term capital loss (*i.e.*, \$45 times \$25/\$75).¹⁹⁵ Under § 704(d), each partner suspends and carries over \$20 of the charitable contribution deduction and \$10 of the capital loss.¹⁹⁶

C. *Technical Termination of a Partnership*

A partnership is treated as terminated if “no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.”¹⁹⁷ Special rules also apply to

¹⁹³ § 704(d)(3)(B) (as added by § 13503(a)(3)(A) of the TCJA); *cf.* § 1366(d)(4) (for a comparable rule for S corporation shareholders). Note that neither partner reduces his outside basis to account for his \$125 share of this portion of the charitable contribution deduction. *See* Rev. Rul. 96-11, 1996-1 C.B. 140 (providing that result).

¹⁹⁴ § 704(d)(3) (as amended by § 13503(a) of the TCJA); Treas. Reg. § 1.704-1(d)(2) (providing that a proportionate amount of each loss and deduction is taken into account); *cf.* Treas. Reg. § 1.1366-2(a)(5) (for a comparable rule for S corporation shareholders).

¹⁹⁵ In total, therefore, each partner is allowed a \$155 charitable contribution deduction (*i.e.*, a \$125 unlimited portion plus a \$30 limited portion of the deduction) and a \$15 capital loss. Each partner's outside basis is reduced by only \$45, however. *See* § 705(a)(2); Rev. Rul. 96-11, 1996-1 C.B. 140.

¹⁹⁶ *See* Rev. Rul. 2008-16, 2008-1 C.B. 585 (discussing a similar example for an S corporation).

¹⁹⁷ § 708(b)(1) (before its amendment by the TCJA).

the merger or consolidation of several partnerships or the division of one partnership.¹⁹⁸

For partnership taxable years beginning before 2018, a partnership was also treated as terminated if underwent a “technical termination,” that is if within a 12-month period, there was a “sale or exchange of 50% or more of the total interest in partnership capital and profits.”¹⁹⁹ Eliminating a trap for the unwary, the TCJA removed the technical termination rule, effective for partnership taxable years beginning after December 31, 2017.²⁰⁰

D. Carried Interest

In § 13309 of the TCJA, Congress targeted the use of carried interests in partnerships investing in securities, real estate, commodities and the like. Typically, a carried interest is a profits interest in the partnership received by an investment manager in exchange for services provided to the partnership. If the partnership profit allocated to the investment manager is long-term capital gain, the investment manager arguably enjoys compensation income taxed at preferential rates, a concern addressed by § 13309 of the TCJA.

Those investment partnerships are often structured as follows: passive investors receive limited partnership interests, while an investment manager receives management fees together with a profits interest (*i.e.*, the carried interest).²⁰¹ The investors expect that the partnership assets will appreciate in value, in significant part because of the investment manager’s services. Optimally, the sale of those assets generates long-term capital

¹⁹⁸ § 708(b)(2); *see also* Treas. Reg. § 1.708-1(c), (d) (describing those rules).

¹⁹⁹ Treas. Reg. § 1.708-1(b)(2). With a technical termination, the partnership’s taxable year closed, the partnership-level elections generally ceased to apply, but partners generally did not recognize gain or loss. *See* Treas. Reg. § 1.708-1(b)(3), (4) (treating the terminating partnership as contributing its assets and liabilities to a new partnership and immediately distributing the new partnership interests to the purchasing and remaining partners).

²⁰⁰ *See* § 13504 of the TCJA.

²⁰¹ The investment manager may also contribute capital to the partnership in exchange for a capital interest.

gain, which is allocated among the partners, including the investment manager. Under the law in effect before the TCJA, the investment manager would therefore report long-term capital gain taxed at preferential rates, gain that in large part might be tied to the manager's services.²⁰² This tax "loophole" became a political stalking horse, and in § 13309 of the TCJA, Congress added § 1061, a provision to address carried interests, recharacterizing as short-term capital gain certain amounts that would otherwise be treated as long-term capital gain.²⁰³

As a general rule under § 1061, if a taxpayer holds an applicable partnership interest at any time during a taxable year, the taxpayer determines net long-term capital gain with respect to the interest by using a three-year, rather than one-year, holding period.²⁰⁴ To the extent

²⁰² The House justified the new provision, asserting that "[l]ong-term capital gain allocated to individual partners may represent compensation for their services as fund managers." H.R. REP. NO. 115-409, at 277 (2017).

²⁰³ See § 1061 (as added by § 13309 of the TCJA); § 1061(c) (as added by § 13309 of the TCJA) (providing that the provision applies to taxable years beginning after December 31, 2017). *But see* Howard E. Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 183 (July 16, 2007) (counseling caution in addressing carried interests).

²⁰⁴ More precisely, the taxpayer treats as short-term capital gain the excess, if any, of (i) her net long-term capital gain with respect to the interest for the year, over (ii) her net long-term capital gain with respect to the interest, computed using a three-year (rather than one-year) holding period. See § 1061(a) (as amended by § 13309 of the TCJA) (adding that this provision applies "notwithstanding section 83 or any election in effect under section 83(b)"). See Sowell et al., *supra* note 96, at 29596 (noting that the reference to "taxpayer" raises the question about whether § 1061 applies only to partners that are subject to federal income tax). Note that this provision does not recharacterize § 1231 amounts, because it applies only to gain or loss from the sale of a capital asset. See § 1061(a)(2) (as amended by § 13309 of the TCJA) (recharacterizing net long-term capital gain by using a three-year holding period in § 1222(3) and (4)); § 1222(3) and (4) (defining long-term capital gain or loss as gain or loss from the sale or exchange of a capital asset); *cf.* § 1231(b) (describing assets to which § 1231 applies, which in large part include depreciable or real property used in a trade or business and held for more than one year); § 1221(a)(2) (providing that a capital asset does not include depreciable or real property used in a trade or business); see also Sowell et al., *supra* note 96, at 294 (reaching this

provided in regulations or other administrative guidance, this general rule does not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors.²⁰⁵

Thus, § 1061 can apply to a taxpayer only if the taxpayer holds an “applicable partnership interest.” In general, an applicable partnership interest is a partnership interest that “is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business.”²⁰⁶

An “applicable trade or business” is an “activity conducted on a regular, continuous, and substantial basis” that at least in part includes raising or returning capital and either of the following two activities: (i) investing in or disposing of specified assets (or identifying those assets for

conclusion but noting that the result may be changed by future guidance); Blake D. Rubin, Andrea Macintosh Whiteway, and Maximilian Pakaluk, *Real Estate Owners: Don't Get Carried Away by the New Carried Interest Rule*, 159 TAX NOTES 45, 50 (Apr. 2, 2018) (noting that technical reading). That exclusion makes at least some sense because § 1231 assets are not likely to increase in value because of an investment manager's services. *But see* Kurt R. Magette, *Carried Interest in a Tax Partnership; Reflection, Reaction, and Regs*, 159 TAX NOTES 491, 493 (Apr. 23, 2018) (stating that guidance will likely provide that if the three-year holding period is not met, § 1061 will recharacterize relevant § 1231 gains and losses otherwise treated as long-term capital gains and losses).

²⁰⁵ § 1061(b) (as amended by § 13309(a)(2) of the TCJA). A third-party investor is a person who does not hold a partnership interest in connection with an applicable trade or business for that person and who has not actively engaged in (and is not related to a person so engaged in) providing substantial services to the partnership or any applicable trade or business. *See* § 1061(c)(5) (as amended by § 13309(a)(2) of the TCJA). Note that the statute does not define when one person is related to another for this purpose, but the legislative history uses the definition of related person found in § 1061(d)(2). *See* H.R. REP. NO. 115-466, at 420 (2017) (Conf. Rep.).

²⁰⁶ § 1061(c)(1) (as amended by § 13309(a)(2) of the TCJA) (adding that an applicable partnership interest does not include an interest held by a person who is employed by and only provides services to an entity that conducts a trade or business but not an applicable trade or business). Curiously, § 1061 does not define “related person” for this purpose. § 1061(d)(2) (as amended by § 13309(a)(2) of the TCJA) (defining related person but for purposes of § 1061(d)).

that purpose) or (ii) developing specified assets.²⁰⁷ “Specified assets” are securities (as defined in § 475(c)(2) without regard to its last sentence), commodities (as defined in § 475(e)(2)), real estate held for rental or investment, cash or cash equivalents, options, or derivative contracts with respect to any of the foregoing specified assets.²⁰⁸

Applicable partnership interests do not include any partnership interest held directly or indirectly by a corporation,²⁰⁹ an exception that literally applies whether the interest is held by a C or S corporation.²¹⁰

²⁰⁷ § 1061(c)(2) (as amended by § 13309(a)(2) of the TCJA); *see also* H.R. REP. NO. 115-466, at 421 (2017) (Conf. Rep.) (stating that “[d]eveloping specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider”; adding that “[s]ervices performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule”).

²⁰⁸ § 1061(c)(3) (as amended by § 13309(a)(2) of the TCJA) (also providing that specified assets include a partnership interest to the extent of the partnership’s proportionate interest in any of the specified assets described in the text). Securities are defined in § 475(c)(2) and include (i) stock, (ii) interests in widely held or publicly traded partnerships or trusts, (iii) evidences of indebtedness, (iv) interest rate, currency, or equity notional principal contracts, and (v) certain derivatives. § 475(c)(2). Commodities include (i) actively traded commodities, (ii) notional principal contracts in any commodity described in (i), (iii) evidences of an interest in, or derivative instruments in, any commodity described in (i) or (ii), and (iv) certain commodity hedges. § 475(e)(2).

²⁰⁹ § 1061(c)(4)(A) (as amended by § 13309(a) of the TCJA). For example, an applicable partnership interest does not include a joint venture between two corporations. *See also* H.R. REP. NO. 115-466, at 420 (2017) (Conf. Rep.) (illustrating this point by describing a joint venture between two corporations to develop and market a pharmaceutical product).

²¹⁰ *But see* § 1061(f) (as amended by § 13309(a) of the TCJA) (giving Treasury authority to issue regulations or other guidance as necessary or appropriate to carry out the purposes of § 1061); H.R. REP. NO. 115-466, at 422 (2017) (Conf. Rep.) (stating that the Treasury guidance should prevent the abuse of § 1061 through, for example, “the allocation of income to tax-indifferent parties” and the guidance should also provide for the application of the section to “tiered structures of entities”); *see infra* note 222 (noting

Applicable partnership interests also do not include a capital interest in the partnership where the partner's right to share in partnership capital is commensurate with (i) the amount of capital contributed to the partnership upon receipt of the interest or (ii) the value of the interest subject to tax under § 83 upon the receipt or vesting of the interest.²¹¹

Thus, a taxpayer determines net long-term capital gain “with respect to” an applicable partnership interest using a three-year holding period, but neither the statute nor legislative history defines when a taxpayer has gain “with respect to” such an interest. Certainly, that gain should encompass the gain allocable to the taxpayer on her applicable partnership interest, because excluding that gain would effectively neuter the provision.²¹²

that forthcoming guidance will provide that § 1061 cannot be avoided by holding a partnership interest through an S corporation).

²¹¹ § 1061(c)(4)(B) (as amended by § 13309(a) of the TCJA). *See* Magette, *supra* note 204, at 492-93 (suggesting that guidance define what constitutes a capital interest for this purpose and noting concerns with crafting that definition); Sowell et al., *supra* note 96, at 297 (noting that it may be difficult to determine the amount of income associated with contributed capital and exempt from reclassification under § 1061); Rubin et al., *supra* note 204, at 47 (discussing this issue). Note that a partner can hold a profits interest that is an applicable partnership interest and a capital interest that is not. *See also* H.R. REP. NO. 115-466, at 420 (2017) (Conf. Rep.) (stating that “[i]t is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership”); *id* at 420-21 (stating that “if the partnership agreement provides that the partner’s share of partnership capital is commensurate with the amount of capital he or she contributed . . . the partnership interest is not an applicable partnership interest *to that extent*”) (emphasis added).

²¹² The taxpayer should apply this three-year rule as long as the partnership interest is an applicable partnership interest. For example, if a taxpayer has held an applicable partnership interest for four years when the partnership acquires an asset, the three-year holding period for the asset should start when the asset is acquired. *See* Nathan Richman, *Carried Interest Holding Period Has Attorneys Calling for Answers*, 158 TAX NOTES 722 (Feb. 5, 2018) (raising this issue but using an example where the taxpayer has held the partnership interest for two years); Rubin et al., *supra* note 204, at 48 (discussing this issue); *see also* § 1061(d) (as amended by § 13309(a) of the TCJA) (complementing this rule). More to the point, if the taxpayer provides substantial services in connection with a specified asset, the three-year clock for the asset should begin when the partnership

The affected gain should include more than that allocable gain, however, because had Congress intended to so limit § 1061's reach, it could have expressly limited § 1061 to just that gain. For example, it should apply to gain recognized by a partner on the transfer of an applicable partnership interest if the partner's holding period for the interest does not exceed three years.²¹³

Suppose that the partner has held an applicable partnership interest for more than three years but the partnership has held an asset for less than three years, an asset with respect to which the partner has provided substantial services. If the partnership sold that asset and recognized a capital gain, the partner's allocable share of that gain should

acquires it. Otherwise, a taxpayer could avoid § 1061 by providing services to a partnership in which she has held a profits interest for more than three years.

It is less clear how § 1061 should apply if a service partner has held the profits interest for less than three years but is allocated capital gain on an asset that the partnership has held for more than three years. *See* Richman, at 722 (raising this issue). Arguably that gain should also be recharacterized but it is difficult to reach that result under the statute. *Id.*

²¹³ *See* § 1061(d)(1)(B) (as amended by § 13309(a) of the TCJA) (indicating that an amount may be treated as short-term capital gain under the general rule on the transfer of an applicable partnership interest). If the partnership holds assets not held for portfolio investment on behalf of third party investors, administrative guidance may provide that only a portion of the partner's gain is recharacterized under § 1061(a). *See* § 1061(b) (as amended by § 13309(a) of the TCJA) (authorizing Treasury to issue guidance providing that the recharacterization rule does not apply to any asset not held for portfolio investment on behalf of third-party investors).

In fact, the reach of the general rule may be even broader. For example, it may apply if a partnership distributes a specified asset to the taxpayer in a non-liquidating distribution and the taxpayer then sells the asset at a gain. Under a broad reading of the general rule, that gain may be treated as gain "with respect to" an applicable partnership interest, because the partner will tack the partnership's holding period for the asset and often succeed to the partnership's basis in the asset. *Cf.* § 735(b) (providing that a partner tacks the partnership's holding period for property distributed by the partnership to the partner); § 732(a)(1) (providing as a general rule that the partner's basis in an asset received in a non-liquidating distribution equals the partnership's adjusted basis).

be recharacterized under § 1061. Without a special rule, however, the partner could avoid § 1061 by selling the partnership interest. Section 1061(d) addresses that concern, adding a “look-through” rule that operates like § 751 and applies when a person transfers an applicable partnership interest, directly or indirectly, to a related person.²¹⁴ A related person is –

- (i) a member of the taxpayer’s family (as defined in § 318(a)); or
- (ii) a person who performed a service during the calendar year of the transfer or any of the three preceding years if the service was performed in any applicable trade or business in or for which the taxpayer performed a service.²¹⁵

Although the wording of the look-through rule is somewhat obscure, the taxpayer apparently treats as short-term capital gain an amount equal to the excess, if any, of—

- (i) the taxpayer’s allocable share of the long-term capital gain that would be recharacterized under the general rule if the partnership had sold all of

²¹⁴ Thus, this anti-avoidance rule can be avoided if the person simply transfers the applicable partnership interest to a person other than a related person. *But see* Magette, *supra* note 204, at 492 (noting that under a conservative approach, carried interests would not be redeemed until the relevant asset has been held for more than three years).

Note that this anti-avoidance rule, if read literally, could require gain to be recognized on what otherwise would be a non-recognition transfer, such as a gift. *See* Sowell et al., *supra* note 96, at 298 (making this point).

²¹⁵ § 1061(d)(2) (as amended by § 13309(a) of the TCJA) (providing that if the person is related to the taxpayer because of the provision of services, the services must be performed in the “current” calendar year or preceding three calendar years; presumably the “current” calendar year is the year of the transfer, not 2017, the year that the TCJA was enacted); *see also* § 318(a)(1)(A) (defining the members of a taxpayer’s family as her spouse, children, grandchildren, and parents).

its assets for their fair market value immediately before the transfer,²¹⁶ over

(ii) any amount that the taxpayer otherwise treats as short-term capital gain under the general rule on the transfer of the applicable partnership interest.²¹⁷

Thus, the look-through rule prevents related persons from avoiding the general rule through a transfer of an applicable partnership interest when the partnership has a § 754 election in place.²¹⁸ For example, suppose that an investment manager has owned a carried interest in a partnership for more than three years, and the partnership, which has a § 754 election in place, owns highly-appreciated, specified assets held for less than three years. Rather than having the partnership sell those assets, the investment manager transfers her carried interest to her son, recognizing a significant capital gain on the sale, a gain attributable to those appreciated assets. However, because the transferor has owned the transferred interest for more than three years, the general rule of § 1061(a)

²¹⁶ § 1061(d)(1)(A) (as amended by § 13309(a) of the TCJA) (expressly providing that this allocable share equals “so much of the taxpayer’s long-term capital gains with respect to [the taxpayer’s transferred applicable partnership] interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest”). Although not reflected in the statutory language, the legislative history would apply this rule by looking to *net* long-term capital gain attributable to the sale or exchange of an asset, a sensible limitation that regulations should adopt. *See* H.R. REP. NO. 115-466, at 422 (2017) (Conf. Rep.). Further, consistent with § 1061(b), regulations may also provide that this special rule is implemented by disregarding any asset not held for portfolio investment on behalf of third party investors.

²¹⁷ § 1061(d)(1)(B) (as amended by § 13309(a) of the TCJA). Note that this reduction is most likely relevant when the partner has a split holding period in her partnership interest. *See* Treas. Reg. § 1.1223-3(a)(1)–(2) (discussing circumstances where a split holding period may arise, including when portions of an interest are acquired at different times or in exchange for property with different holding periods).

²¹⁸ Note, however, that the rule applies whether the partnership has a § 754 election in place or not.

does not apply to recharacterize her gain as short-term capital gain. Further, because the partnership has a § 754 election in effect, the son is entitled to special positive basis adjustments that eliminate the built-in gain on the specified assets allocable to the transferred interest. Absent the look-through rule in § 1061(d), the investment manager would recognize a long-term capital gain on the transfer. The look-through rule converts all or a portion of that gain to short-term capital gain.

That rule does not address all possible avenues to circumvent the general rule of § 1061, and Congress authorized Treasury to issue regulatory or other administrative guidance “as is necessary and appropriate to carry out the purposes of” § 1061.²¹⁹ That guidance is intended to help prevent “the abuse of the purposes of [§ 1061], including through the allocation of income to tax-indifferent parties” and to describe how § 1061 applies to “tiered structures of entities.”²²⁰

Subject to that guidance, § 1061 might easily be circumvented through the simple device of investment managers holding their carried interests through S corporations. Section 1061 can apply only if a taxpayer holds an applicable partnership interest and § 1061(c)(4)(A) expressly states that an interest held through a corporation is not an applicable partnership interest. Because the character of an S corporation’s tax items pass thru to its owners,²²¹ if § 1061 did not apply when an investment manager held a carried interest through an S corporation, the manager might readily avoid § 1061 simply by interposing an S corporation. Despite the express language of § 1061(c)(4)(A), regulations or other administrative guidance will almost certainly provide that because of the pass-thru nature of S corporations, a partnership interest held through an S corporation can still be an applicable partnership interest.²²²

²¹⁹ § 1061(f) (as amended by § 13309(a) of the TCJA).

²²⁰ H.R. REP. NO. 115-466, at 422 (2017) (Conf. Rep.).

²²¹ § 1366(b).

²²² *See* Guidance Under Section 1061, Partnership Interests Held in Connection with Performance of Services, Notice 2018-18 (Mar. 1, 2018), <https://www.irs.gov/pub/irs-drop/n-18-18.pdf> (announcing that Treasury will issue regulations that will apply to taxable years beginning after December 31, 2017 and will provide that an S corporation

In addition, § 1061 could be skirted by avoiding the use of a partnership. For example, if the specified asset is the stock of a corporation, the investment manager and third-party investors could acquire the stock using a corporation, rather than a partnership.²²³ Through a later sale or redemption of the stock of the acquiring corporation, the investment manager could recognize long-term capital gain if the manager held the stock for more than one year.

There is at least one disadvantage of using a corporation rather than a partnership to acquire the target stock, however. When the investment manager receives the stock interest in exchange for services, she would have compensation income equal to the value of the stock received.²²⁴ In contrast, the manager typically does not have compensation

is not a corporation for purposes of § 1061(c)(4)(A)); *Regs Will Clarify Limitations On Carried Interest For S Corps*, 2018 TNT TAX NOTES TODAY 42-17 (Mar. 2, 2018) (reprinting Notice 2018-18); *see also* William Hoffman, *IRS To Close Carried Interest Loophole Prompted By New Law*, 158 TAX NOTES 1089 (Feb. 19, 2018) (reporting that Secretary of the Treasury Mnuchin stated on February 14, 2018 that the IRS will issue guidance in the succeeding two weeks that will prevent the three-year holding period from being avoided by holding a carried interest through an S corporation).

²²³ In fact, the acquisition vehicle could be a state-law partnership that elects to be treated as a corporation for federal income tax purposes. *See* Treas. Reg. § 301.7701-3(a), (c)(1)(i) (2006).

²²⁴ Because the investment manager would have that compensation income and in addition receive management fees, the IRS might not press to apply the assignment of income doctrine or § 482 to increase the manager's compensation income. *Cf.* *Foglesong v. Comm'r*, 691 F.2d 848, 852 (7th Cir. 1982) (concluding that § 482 did not apply when an individual worked exclusively for a corporation because only one business was involved); *see also* *Sargent v. Comm'r*, 929 F.2d 1252, 1260 (8th Cir. 1991) (concluding that neither § 482 nor the assignment of income doctrine applied to allocate or assign income to a hockey player who owned all stock in and was an employee of a corporation that contracted to provide his services to a professional hockey club). *But see* Rev. Rul. 88-38, 1988-1 C.B. 246 (stating that the IRS would not follow *Foglesong*).

income on the receipt of a carried interest, because the interest is deemed to have a \$0 value when received.²²⁵

VI. DEDUCTION FOR QUALIFIED BUSINESS INCOME

A. Introduction

In the Tax Reform Act of 1986, Congress effected a systemic change in the corporate tax regime: Not only did the act sound the death knell of the *General Utilities* doctrine, it also eliminated an individual's capital gains preference and provided a higher maximum tax rate for C corporations than individuals.²²⁶ Those changes tilted the scales heavily in favor of sole proprietorships and pass-thru entities as tax vehicles of choice.

Gradually, Congress moderated the tax penalty borne by C corporations. In 1990, it reintroduced the capital gains preference for non-corporate taxpayers, and in 2003, it added a tax preference for qualified dividend income.²²⁷ These changes reduced the tax burden for individual C corporation shareholders on stock sales and dividend distributions.

²²⁵ See Rev. Proc. 93-27, 1993-2 C.B. 343 (providing that the receipt of a profits interest for services provided to the partnership generally is not a taxable event for the partner or partnership).

²²⁶ Tax Reform Act of 1986, Pub. L. No. 99-514, § 101(a), 100 Stat. 2085, 2096 (1986) (providing a maximum individual tax rate of 28%); *id.* § 301(a), 100 Stat. at 2216 (repealing the individual tax preference for capital gains); *id.* § 610(a), 100 Stat. at 2249 (providing a maximum corporate tax rate of 34%); *id.* § 631, 100 Stat. at 2269–2273 (modifying § 311, § 336, § 337, and § 338); see *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 204 (1935) (concluding that a corporation did not recognize gain on its distribution of appreciated property); see also Eric Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839 (1988) (noting how these three changes upset the equilibrium between the corporate and individual tax regimes).

²²⁷ See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 760–61; Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-808, § 11101(c), 104 Stats. 1388-401–405.

The TCJA reduced the maximum tax rate for corporations to just 21%, 16% below the maximum individual rate, a change that in isolation could make a C corporation the favored tax form (or at least a much more palatable form) for small businesses. However, the act also added § 199A, which offered taxpayers other than corporations a deduction for qualified business income, a deduction that will generally keep sole proprietorships and pass-thru entities as the preferred tax vehicles for many small businesses.²²⁸ Congress justified this deduction “[t]o treat corporate and non-corporate business income more similarly.”²²⁹

²²⁸ See Donald B. Susswein, *Understanding the New Passthrough Rules*, 2018 TNT TAX NOTES TODAY 24-7 (Feb. 05, 2018) (for a good summary of the policy and mechanics of § 199A); Magda Abdo-Gomez, *Navigating the New Deduction for Qualified Business Income*, 158 TAX NOTES 1627 (Mar. 19, 2018) (also discussing § 199A). If an entity is a corporation and its stock is publicly traded, it must be a C corporation. See Treas. Reg. § 301.7701-2(b)(1)(i)–(ii) (providing that an entity organized as a corporation is treated as a corporation for federal income tax purposes); § 1361(b)(1) (providing, among other requirements, that an S corporation must have no more than 100 shareholders and cannot have a non-resident alien, corporation, or partnership as a shareholder). Generally, a publicly traded partnership must also be treated as a corporation for federal income tax purposes. See § 7704.

²²⁹ H.R. REP. NO. 115-409, at 129 (2017). The taxable income of sole proprietorships and pass-thru entities is subject to one level of tax. *But see* §§ 1374, 1375 (for circumstances where an S corporation is subject to an entity-level tax). If those entities are highly profitable and their owners can fully benefit from the deduction for qualified business income, the owner’s taxable income from those entities would be reduced by up to 20% and bear an effective tax rate approaching 29.6% (*i.e.*, 80% of 37%).

In contrast, the earnings of a C corporation are subject to both a shareholder-level and corporate-level tax. Under the TCJA, a C corporation’s taxable income is subject to a 21% tax. A shareholder is taxed on those earnings, if at all, directly when the earnings are distributed or indirectly when she sells her corporate stock. If a shareholder is taxed on those earnings, the shareholder often enjoys preferential rates. Further, that tax is often deferred, giving the shareholder a time-value benefit, because corporations often retain, rather than distribute earnings. Note as well that many C corporation shareholders are tax indifferent (*e.g.*, tax-exempt pension and profits sharing plans). Because of those factors, following the changes made by the TCJA, the effective tax rates

B. Operating Rules

Although § 199A is quite complex, its operating rule sounds deceptively simple. Generally, a § 199A deduction for a taxable year equals the smaller of (i) the taxpayer's combined qualified business income amount for the year or (ii) 20% of the taxpayer's taxable income (reduced by net capital gain) for the year.²³⁰ The computation is more involved if the taxpayer has qualified cooperative dividends for the year.²³¹ In either case, the deductible amount cannot exceed the taxpayer's taxable income (reduced by net capital gain) for the year.²³² Note that a taxpayer does not

on the taxable income of profitable C corporations or other tax entities in the aggregate may be comparable.

²³⁰ § 199A(a) (as added by § 11011 of the TCJA); § 199A(e)(1) (as added by § 11011 of the TCJA) (providing that for purposes of § 199A, taxable income is computed without regard to the § 199A deduction); *see also* § 11011(e) of the TCJA (providing § 199A generally applies to taxable years beginning after December 31, 2017); § 199A(i) (as added by § 11011 of the TCJA) (stating that § 199A does not apply to taxable years beginning after December 31, 2025).

For this purpose, net capital gain is defined in § 1(h)(11)(A). § 199A(a)(1)(B)(ii) (as added by § 11011 of the TCJA). Thus, it includes net capital gain, as defined in § 1222, plus qualified dividend income, as defined in § 1(h)(11)(B)(i). *See also* § 1222(11) (defining net capital gain as the excess of net long-term capital gain over net short-term capital loss); § 1222(7) (defining net long-term capital gain as the excess of long-term capital gains over long-term capital losses); § 1222(6) (defining net short-term capital loss as the excess of short-term capital losses over short-term capital gains); § 1231(a)(1) (treating § 1231 gains and losses as long-term capital gains and losses when those gains exceed those losses for a taxable year).

²³¹ In that case, the deduction is computed in two steps. First, the taxpayer determines the amount described in the text, except that taxable income is reduced not only by net capital gain but also by the qualified cooperative dividends. § 199A(a)(1) (as added by § 11011 of the TCJA). Second, the taxpayer adds to that amount the smaller of its taxable income (reduced by net capital gains) for the year or 20% of qualified cooperative dividends for the year. *Id.* at (a)(2). A qualified cooperative dividend includes any patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any similar amount (see § 1388(a), (c), and (f)) that is includible in gross income and received from a tax-exempt or taxable cooperative (*i.e.*, an organization governed by the rules of subchapter T of the Code or described in § 1381) or an entity described in § 501(c)(12). *Id.* at (e)(4).

²³² *Id.* at (a) (flush language). It is not clear when this taxable income limitation applies.

take the § 199A deduction in computing adjusted gross income but can nonetheless take the deduction even if she does not itemize deductions.²³³

To apply the operating rule of § 199A, a person must navigate not only its definition of the “combined qualified business income amount” but also a series of corollary definitions. Special rules also apply to partnerships and S corporations, as well as certain agricultural and horticultural cooperatives.²³⁴ This web of definitions and special rules creates both complexity and possible confusion, extending an open invitation to tax mischief.

Generally, a taxpayer’s § 199A deduction equals her “combined qualified business income amount.”²³⁵ Thus, the keystone for § 199A is

²³³ § 11011 of the TCJA (amending § 62(a) to provide that the § 199A deduction is not a deduction taken in computing adjusted gross income, amending § 63(b) to allow the § 199A deduction to non-itemizers, amending § 63(d) to provide that the § 199A deduction is not an itemized deduction and therefore not subject to limits on itemized deductions).

²³⁴ See § 199A(g)(1) (as added by § 11011 of the TCJA) (for a deduction allowed to specified agricultural or horticultural cooperatives generally equal to the smaller of (i) 20% of the excess of its gross income over its qualified cooperative dividends for the taxable year or (ii) the greater of 50% of (A) the W-2 wages paid by the cooperative with respect to its trade or business or (B) 25% of those wages plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property of the cooperative); *id.* at (g)(2) (providing that the deduction under § 199A(g)(1) “shall not exceed the taxable income of the specified agricultural or horticultural [cooperative] for the taxable year”); *id.* at (g)(3) (describing a “specified” horticultural or agricultural cooperative as one to which part I of subchapter T applies that is engaged in (i) the manufacturing, production, growth or extraction in significant part of any agricultural or horticultural product, (ii) the marketing of such products which its patrons have so manufactured, produced, grown, or extracted, or (iii) the provision of supplies, equipment, or services to farmers or to organizations described in (i) or (ii)); *see also* H.R. REP. NO. 115-466, at 224 (2017) (Conf. Rep.) (describing this special rule for specified cooperatives); § 199A(f)(1)(C) (for special rules that apply to trades or businesses in Puerto Rico)..

²³⁵ § 199A(a) (as added by § 11011 of the TCJA) (also limiting the deduction to 20% of taxable income (reduced by net capital gain) and providing adjustments for qualified cooperative dividends).

computing that amount, which for a taxable year, equals (i) the sum of the deductible amounts for each trade or business carried on by the taxpayer, plus (ii) 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the year.²³⁶

A typical taxpayer has no qualified REIT dividends, no qualified publicly traded partnership income, and no qualified cooperative dividends. Consequently, her combined qualified business income amount simply equals the sum of her “deductible amounts for each trade or business” carried on by the taxpayer.²³⁷

Subject to a special rule for lower-income taxpayers, the deductible amount for each qualified trade or business equals the smaller of the following two amounts:

²³⁶ § 199A(b)(1) (as added by § 11011 of the TCJA); *see* § 199A(b)(5) (as added by § 11011 of the TCJA) (providing that the Secretary shall provide for the application of § 199A(b) in the case of a short taxable year or where the taxpayer acquires or disposes of a major portion of a trade or business during the year); *see also* Susswein, *supra* note 228 (stating that the benefits provided passive investors in businesses with substantial investments in tangible, depreciable property may justify the favorable treatment under § 199A of qualified REIT dividends, qualified publicly traded partnership income, and income of certain cooperatives).

A qualified REIT dividend is any dividend from a real estate investment trust received during the year that is not a capital gain dividend (*see* § 857(b)(3)) or qualified dividend income (*see* § 1(h)(11)). § 199A(e)(3) (as added by the TCJA).

Qualified publicly traded partnership income for any qualified trade or business of the taxpayer is the sum of (i) the net amount of the taxpayer’s allocable share of each qualified item of income, gain, deduction, and loss (as defined in § 199A(c)(3) after application of § 199A(c)(4)) from a publicly traded partnership that is not treated as a corporation, plus (ii) any gain recognized by the taxpayer on its disposition of an interest in such a partnership to the extent treated under § 751(a) as gain from the sale or exchange property other than a capital asset. *Id.* at (e)(5). Note that on the sale of a partnership interest, the seller may recognize ordinary loss under § 751(a). It is not clear why qualified publicly traded partnership income is not reduced by that ordinary loss.

²³⁷ § 199A(b) (as added by § 11011 the TCJA). Thus, that taxpayer’s § 199A deduction equals the smaller of that sum or 20% of the taxpayer’s taxable income (reduced by net capital gain). *Id.* at (a).

- (i) 20% of the taxpayer's qualified business income with respect to the qualified trade or business; or
- (ii) The greater of (A) 50% of the W-2 wages with respect to the qualified trade or business or (B) the sum of 25 percent of those wages plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.²³⁸

For convenience, the amounts specified in (i) and (ii) are referred to as the “First Deductibility Factor” and the “Second Deductibility Factor,” respectively.

For a lower-income taxpayer, the deductible amount for each qualified trade or business equals just the First Deductibility Factor (not the smaller of the two factors).²³⁹ A lower-income taxpayer is one whose taxable income for the taxable year does not exceed a threshold amount of \$157,500 (or \$315,000 for a taxpayer filing a joint return).²⁴⁰ A phase-out rule applies for a taxpayer whose taxable income does not exceed the

²³⁸ § 199A(b)(2) (as added by § 11011 of the TCJA). See Sowell et al., *supra* note 96, at 291 (noting that there is a question about whether a basis adjustment under § 743(b) for qualified property can give rise to unadjusted basis for purposes of § 199A(b)(2)(B)(ii)).

²³⁹ § 199A(b)(2)(A) (as added by § 11011 of the TCJA) (for the First Deductibility Factor); § 199A(b)(3)(A) (as added by § 11011 of the TCJA) (providing only that factor applies if the threshold requirement is met). Thus, for a typical lower-income taxpayer, her § 199A deduction equals the smaller of (i) 20% of the taxpayer's taxable income (reduced by net capital gain), or (ii) the aggregate amount of her First Deductibility Factors. § 199A(a) (as added by § 11011 of the TCJA).

²⁴⁰ § 199A(b)(3)(A) (as added by § 11011 of the TCJA); see also § 199A(e)(2) (as added by § 11011 of the TCJA) (defining the threshold amounts and providing that those amounts will be adjusted for inflation for any taxable year beginning after 2018).

threshold amount by more than \$50,000 (or \$100,000 for a taxpayer filing a joint return).²⁴¹

C. Examples

To compute the First and Second Deductibility Factors, a taxpayer must understand the definitions of several relevant phrases, which are considered in detail in the next section. To help follow the examples in this section, they may be described briefly as follows:

(i) A “qualified trade or business” is any trade or business other than (A) performing services as an employee, (B) being an investment management or trading or dealing in securities and the like, and (C) for taxpayers other than lower-income taxpayers, certain trades or businesses for which the principal asset is the reputation or skill of one or more of its employees or owners (such as legal or health services).²⁴²

(ii) “Qualified business income” is the net amount of income, gain, loss, and deduction connected with a qualified trade or business other than generally investment items.²⁴³

(iii) “W-2 wages are all employee compensation wages and elective deferrals reported on the form W-2.”²⁴⁴

²⁴¹ § 199A(b)(3)(B)(i)(I) (as added by § 11011 of the TCJA) (not providing an inflation adjustment for the \$50,000 and \$100,000 amounts). For such a taxpayer, the deductible amount for a qualified trade or business equals First Deductibility Factor reduced by the following: (A) the excess, if any, of the First Deductibility Factor over the Second Deductibility Factor, multiplied by (B) the excess of the taxpayer’s taxable income over the threshold amount, divided by (C) the threshold amount. § 199A(b)(3)(B)(ii) (as added by § 11011 of the TCJA). Thus, if the First Deductibility Factor does not exceed the second, the taxpayer simply takes the first factor into account.

²⁴² See *infra* notes 261-270 and accompanying text (for a more detailed definition).

²⁴³ See *infra* notes 268-272 and accompanying text (for a more detailed definition which also notes that the items must be effectively connected with the conduct of a trade or business within the United States).

²⁴⁴ See *infra* notes 273-275 and accompanying text (for a more detailed definition).

(iv) “Qualified property” is depreciable tangible personal property used to produce qualified business income for the period that includes at least the first ten years after the property is placed in service.²⁴⁵

The following examples illustrate the basic operation of § 199A and uncover some of its apparent policies. Assume in reading the examples that they contain all relevant facts needed to apply § 199A and that unless otherwise stated, all gross income and deductions are taken into account in computing qualified business income.²⁴⁶

Example – The impact of wages

Fred operates a sole proprietorship that conducts a qualified trade or business. In a taxable year, the business generates \$1 million of gross income and has a \$400,000 deduction for W-2 wages.

Because Fred’s qualified business income is \$600,000 (*i.e.*, \$1 million of gross income minus \$400,000 of deductions), the First Deductibility Factor equals \$120,000 (*i.e.*, 20% of \$600,000).²⁴⁷ Because the sole proprietorship has no qualified property, the Second Deductibility Factor equals \$200,000 (50% of the W-2

²⁴⁵ See *infra* notes 276-285 and accompanying text (for a more detailed definition).

²⁴⁶ In none of the examples or their variations does the taxpayer have any net capital gain or any net loss. Thus, in none of the cases is the § 199A deduction limited to 20% of taxable income (reduced by net capital gain), and in each case the deduction equals the taxpayer’s combined qualified business income. See § 199A(a) (as added by § 11011 of the TCJA). Under the relatively simple facts of each example or variation, that combined amount equals the smaller of the First or Second Deductibility Factor (or for a lower-income taxpayer, just the First Deductibility Factor).

²⁴⁷ § 199A(b)(2)(A) (as added by § 11011 of the TCJA); see also § 199A(c) (as added by § 11011 of the TCJA) (providing that qualified business income is the *net* amount of qualified items of income, gain, loss, and deduction with respect to any qualified trade or business).

wages of \$400,000).²⁴⁸ Thus, the deductible amount for Fred's business equals \$120,000, the smaller of those two factors,²⁴⁹ which also equals the combined qualified business amount and Fred's § 199A deduction.²⁵⁰

Suppose that the facts are the same as in the preceding example, except that the deduction for W-2 wages is only \$150,000. Then, Fred's qualified business income is \$850,000 (*i.e.*, \$1,000,000 of gross income minus \$150,000 of deductions), the First Deductibility Factor is \$170,000 (*i.e.*, 20% of \$850,000), and the Second Deductibility Factor is \$75,000 (50% of the W-2 wages of \$150,000).²⁵¹ The deductible amount for Fred is the smaller of those two factors or \$75,000, which also equals the combined qualified business amount and Fred's § 199A deduction.²⁵²

Suppose instead that the gross income and W-2 wages are one-tenth of the amounts in the preceding paragraph. Then, Fred's qualified business income is \$85,000, the First Deductibility Factor is \$17,000, and the Second Deductibility Factor is \$7,500. Because Fred's taxable income does not exceed \$157,500 (*i.e.*, the threshold amount), even though the First Deductibility Factor exceeds the second, his deductible amount equals the first factor,²⁵³ which also equals the combined qualified business amount and Fred's § 199A deduction.

Example – The impact of depreciable tangible property

Fred owns an office building that he purchased two years ago for \$9,000,000, with \$1,200,000 of the cost properly allocable to the

²⁴⁸ § 199A(b)(2)(B)(i) (as added by § 11011 of the TCJA). Note that the sole proprietorship has no qualified property so that the amount determined in § 199(b)(2)(B)(ii) (25% of W-2 wages) can be no greater than the amount determined in § 199A(b)(2)(B)(i) (50% of W-2 wages).

²⁴⁹ § 199A(b)(2) (as added by § 11011 of the TCJA).

²⁵⁰ § 199A(b)(1) (as added by § 11011 of the TCJA) (for the combined qualified business amount); § 199A(a) (as added by § 11011 of the TCJA) (for the § 199A deduction).

²⁵¹ *See supra* notes 247-248 (for the relevant cites).

²⁵² *See supra* notes 249-250 (for the relevant cites).

²⁵³ § 199A(b)(3)(A) (as added by § 11011 of the TCJA).

land and \$7,800,000 properly allocable to the building.²⁵⁴ He has hired several employees to maintain the property and collect rent. This year, the office building has generated \$900,000 in rental income, and Fred has paid W-2 wages of \$100,000 and taken a depreciation deduction of \$200,000.

Because Fred has qualified business income with respect to the rental business of \$600,000 (\$900,000 of rental income minus \$300,000 of deductions), the First Deductibility Factor equals \$120,000 (*i.e.*, 20% of \$600,000).²⁵⁵ The Second Deductibility Factor is \$220,000, which is the greater of (i) \$50,000 (*i.e.*, 50% of the W-2 wages of \$100,000) or (ii) \$220,000 (*i.e.*, the sum of \$25,000 (25% of the W-2 wages of \$100,000) plus \$195,000 (2.5% of \$7,800,000, the unadjusted basis of the office building, which is qualified property)).²⁵⁶ Thus, Fred's § 199A deduction, as well as the deductible amount and the combined qualified business amount, equal the smaller of the two factors or \$120,000.

Suppose that the facts are the same as in the preceding example, except that Fred's rental income for the year is \$1.5 million, rather than \$900,000. Therefore, his qualified business income is \$1.2 million, rather than \$600,000, the First Deductibility Factor is \$240,000 (*i.e.*, 20% of \$1.2 million), while the Second Deductibility Factor is still \$220,000, computed in the same way as provided in the preceding example. Accordingly, Fred's § 199A deduction equals the smaller of the two factors or \$220,000.

²⁵⁴ Assume that Fred's rental of the apartment building is a trade or business and therefore a qualified trade or business. Note that it may be unclear in certain cases whether renting property is a trade or business or simply an investment.

²⁵⁵ § 199A(b)(2)(A) (as added by § 11011 of the TCJA); *see also* § 199A(c) (as added by § 11011 of the TCJA) (providing that qualified business income is the *net* amount of qualified items of income, gain, loss, and deduction with respect to any qualified trade or business).

²⁵⁶ § 199A(b)(2)(B) (as added by § 11011 of the TCJA) (for the Second Deductibility Factor); § 199A(b)(6) (as added by § 11011 of the TCJA) (defining qualified property).

Suppose finally that the facts are the same as in the preceding paragraph, except that Fred hires a management company to perform the maintenance and collect the rent, paying \$100,000 to the management company. Even if the management company uses its employees to perform those services, Fred has paid no W-2 wages.²⁵⁷ Consequently, the Second Deductibility Factor and Fred's § 199A deduction are just \$195,000 (*i.e.*, 2.5% of \$7.8 million).

The examples suggest several key themes. First, the deduction under § 199A may be affected by the structure of a business. For example, the § 199A deduction may be smaller if a business uses independent contractors rather than employees.²⁵⁸

Further, except for lower-income taxpayers, the § 199A deduction for a qualified trade or business is limited by the Second Deductibility Factor, a factor that looks to the greater of two amounts. The first amount is tied to the business's deductible W-2 wages. Thus, the § 199A deduction may depend significantly on wages paid, providing some incentive to hire additional employees.²⁵⁹ However, that incentive is somewhat undercut, because the second amount is based significantly on the cost to the business of its depreciable, tangible assets, which together with bonus depreciation may encourage some businesses to automate, investing in equipment rather than labor.²⁶⁰ Time will tell how those incentives

²⁵⁷ § 199A(b)(4)(A) (as added by § 11011 of the TCJA) (defining W-2 wages ultimately by looking to wages as defined in § 3401(a), which with exceptions are remuneration for services performed by an employee for an employer); Susswein, *supra* note 228 (raising the concern noted in the text and illustrating it in Example 6 in the article).

²⁵⁸ See § 199A(b)(4)(A) (as added by § 11011 of the TCJA); § 6051(a)(3); § 3401(a). However, independent contractors may benefit from § 199A and, depending on their relative bargaining power, may agree to share some of that benefit under § 199A with the business owners.

²⁵⁹ Susswein, *supra* note 228 (suggesting that Congress intended, in part, to promote the payment of wages, rather than outsourcing or automation, among other things).

²⁶⁰ The second amount equals 25% of W-2 wages plus 2.5% of the unadjusted basis of tangible depreciable property, and that basis amount is taken into account for the longer of ten years or the property's recovery period under § 168. § 199A(b)(2)(B)(ii) (as added by § 11011 of the TCJA) (for the second amount); § 199A(b)(6) (as added by § 11011 of the TCJA) (defining qualified property). Effectively through this second amount, a

balance, but if an unincorporated business either invests heavily in tangible depreciable property or pays substantial wages, its owners may enjoy a robust § 199A deduction.²⁶¹

Finally, the § 199A deduction for a lower-income taxpayer will be relatively greater, because she will compute the deduction by looking just to qualified business income, disregarding W-2 wages and the cost basis of depreciable tangible property. The prospect of the § 199A deduction may encourage more lower-income taxpayers to form their own small businesses, potentially increasing jobs.

D. Definitions

In review, a typical taxpayer's § 199A deduction for a taxable year equals the smaller of (i) her combined qualified income amount for the year or (ii) 20% of the excess of her taxable income over her net capital gain for the year.²⁶² Her combined qualified income amount generally equals the sum of the deductible amounts for each qualified trade or business carried on by the taxpayer.²⁶³ As a general rule, the deductible

taxpayer can deduct the cost of property more than once. For depreciable tangible property with a recovery period of no more than ten years (*i.e.*, most property), the taxpayer may enjoy a deduction equal to 125% of the property's cost (*i.e.*, the full depreciation deduction plus a § 199A benefit of ten times 2.5%). For depreciable, nonresidential real property, the taxpayer may enjoy a benefit equal to 197.5% of its cost (*i.e.*, the full depreciation deduction plus a § 199A benefit of 39 times 2.5%). The last point illustrates a subtle way that § 199A may favor real estate investments.

²⁶¹ See Susswein, *supra* note 228 (making this point).

²⁶² See § 199A(a)(1) (as added by § 11011 of the TCJA) (adding that the § 199A deduction is limited to taxable income reduced by net capital gain for the year). If a taxpayer has qualified cooperative dividends, the computation is more involved. See also § 199A(a)(2) (as added by § 11011 of the TCJA).

²⁶³ § 199A(b)(1)(A) (as added by § 11011 of the TCJA). That amount is also increased by 20% of the sum of her qualified REIT dividends and her qualified publicly traded partnership income for the year. § 199A(b)(1)(B) (as added by § 11011 of the TCJA).

amount for each qualified trade or business equals the smaller of the First or Second Deductibility Factor for the trade or business.²⁶⁴

To compute those factors, the taxpayer must unpack and apply a web of definitions. Unfortunately, the devil is in the details and some of that devilish detail follows, as the article explores in some depth definitions critical to understanding the First and Second Deductibility Factors.

1. Qualified Trade or Business

For both factors, the taxpayer must consider the definition of a “qualified trade or business,” which is any trade or business other than the trade or business of performing services as an employee or generally a “specified service” trade or business.²⁶⁵ Specified service trades or businesses include those involving “the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.”²⁶⁶ Except for lower-income taxpayers, those trades or businesses also include many trades or businesses for which the principal asset is the reputation or skill of one or

²⁶⁴ § 199A(b)(2) (as added by § 11011 of the TCJA). *But see* § 199A(b)(3)(A) (as added by § 11011 of the TCJA) (providing that a lower-income taxpayer takes into account only the First Deductibility Factor for a trade or business).

²⁶⁵ § 199A(d)(1) (as added by § 11011 of the TCJA). Thus, an employee may be treated worse than a self-employed person, and § 199A encourages a person to provide services other than in her capacity as an employee. The section will therefore prompt some current employees to try to change their status to independent contractors, likely provoking disputes with the IRS. Without further guidance, those disputes may make planning under § 199A uncertain, because it may be difficult to distinguish between employees and independent contractors in close cases. For purposes of § 199A, the key issues will be “whether the individual is providing services with sufficient regularity to be engaged in a trade or business and whether the individual” is acting as an employee or independent contractor. Susswein, *supra* note 228. The IRS would be well-served to provide prompt guidance on both issues.

²⁶⁶ § 199A(d)(2)(B) (as added by § 11011 of the TCJA). Securities are defined in § 475(c)(2) and commodities in § 475(e)(2). *Id.*; *see supra* note 208 (for a summary of those definitions).

more of its employees or owners (a “§ 1202(e)(3)(A) business”).²⁶⁷ For this purpose, § 1202(e)(3)(A) businesses are ones

involving the performance of services in the fields of health, law, . . . accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees [or owners].²⁶⁸

A lower-income taxpayer is one whose taxable income for the taxable year does not exceed a threshold amount of \$157,500 (or \$315,000 for a taxpayer filing a joint return). That taxpayer may treat a § 1202(e)(3)(A)

²⁶⁷ § 199A(d)(2)(A) (as added by § 11011 of the TCJA).

²⁶⁸ § 1202(e)(3)(A); *see also* § 199A(d)(2)(A) (as added by § 11011 of the TCJA) (providing that § 1202(e)(3)(A) is “applied without regard to the words ‘engineering, architecture,’ and by substituting “employees or owners” for “employees” therein). Congress apparently intended to exclude engineering or architectural services from “specified service” trades or businesses. H.R. REP. NO. 105-466, at 223 (2017) (Conf. Rep.). Despite that intent, § 199A could be read to include an engineering and architectural service if the principal asset of that trade or business was the reputation or skill of one or more of its employees or owners. *See* Susswein, *supra* note 228 (making this point); Abdo-Gomez, *supra* note 228 (also making this point). The IRS should issue guidance to resolve this issue.

Note that health services include medical services provided by physicians, nurses, dentists and other healthcare professionals but do not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. H.R. REP. NO. 115-466, at 216, n. 44 (2017) (Conf. Rep.); *see also id.* at 216, n. 45 (providing that those performing in the field of performing arts include actors, singers, musicians, entertainers, and similar artists but do not include those who broadcast or otherwise disseminate the performance of those services to the public); *id.* at 216, n. 46 (providing that consulting means “the provision of advice and counsel” but does not include sales or brokerage services).

business as a qualified trade or business.²⁶⁹ This benefit is phased out for a taxpayer whose taxable income does not exceed the threshold amount by more than \$50,000 (or \$100,000 for a taxpayer filing a joint return).²⁷⁰

2. Qualified Business Income

To compute the First Deductibility Factor for a qualified trade or business, the taxpayer must also consider the definitions of “qualified business income” and “qualified items of income, gain, deduction, and loss.” Recall that the first factor equals “20 percent of the taxpayer’s qualified business income with respect to the qualified trade or business.”²⁷¹

For any taxable year, qualified business income for a qualified trade or business is the net amount of “qualified items of income, gain, deduction, and loss” connected with that trade or business.²⁷² Those

²⁶⁹ § 199A(d)(3) (as added by § 11011 of the TCJA); *see also* § 199A(e)(2) (as added by § 11011 of the TCJA) (defining the threshold amounts and providing that those amounts will be adjusted for inflation for any taxable year beginning after 2018). *See also* Abdo-Gomez, *supra* note 228 (noting that taxpayers may take steps to qualify as lower-income taxpayers).

²⁷⁰ § 199A(d)(3) (as added by § 11011 of the TCJA). Such a taxpayer treats a § 1202(e)(3)(A) business as a qualified trade or business, but takes into account only the “applicable percentage” of the following amounts for that business: qualified items of income, gain, deduction, or loss; W-2 wages; and unadjusted basis immediately after the acquisition of qualified property. § 199A(d)(3)(A) (as added by § 11011 of the TCJA). Note that those amounts are relevant in computing the deductible amount for each trade or business (§ 199A(b)(2)) and qualified business income (§ 199A(c)). The applicable percentage for a taxable year is 100% reduced (but not below zero) by a percentage equivalent to the following fraction: (i) the excess of the taxpayer’s taxable income for the year over the threshold amount, divided by (ii) \$50,000 (or \$100,000 for a taxpayer filing a joint return). § 199A(d)(3)(B) (as added by § 11011 of the TCJA).

²⁷¹ § 199A(b)(2)(A) (as added by § 11011 of the TCJA).

²⁷² § 199A(c)(1) (as added by § 11011 of the TCJA) (referring to qualified items “with respect to” any qualified trade or business of the taxpayer and noting that those items exclude any qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income). If that net amount is less than zero, it is treated as a loss from a qualified trade or business in the succeeding taxable year. § 199A(c)(2) (as added by § 11011 of the TCJA).

qualified items are items of income, gain, deduction, and loss that are effectively connected with the conduct of a trade or business in the United States and included or allowed in determining taxable income for the year.²⁷³

Qualified items (and qualified business income) exclude any investment income, gain, deductions, or loss *not* connected to a qualified trade or business.²⁷⁴ Further, even if such an investment item is connected to such a trade or business, it often is not a qualified item (and therefore not taken into account in computing qualified business income).²⁷⁵ Qualified business income also excludes the following:

²⁷³ § 199A(c)(3)(A) (as added by § 11011 of the TCJA) (providing that the “effectively connected” determination is made by looking to § 864(c) and substituting “qualified trade or business (within the meaning of section 199A)” for “nonresident alien individual or a foreign corporation” or for “a foreign corporation” each place either phrase appears).

²⁷⁴ *See* § 199A(c)(3)(A)(i) (as added by § 11011 of the TCJA); *see also* H.R. REP. NO. 115-466, at 215 (2017) (Conf. Rep.).

²⁷⁵ § 199A(c)(3)(B) (as added by § 11011 of the TCJA). Broadly speaking, the following items are excluded:

- (i) any item taken into account in determining long-term or short-term capital gain or loss;
- (ii) any dividend or income equivalent to a dividend;
- (iii) any interest income not properly allocable to a trade or business;
- (iv) net gains from commodities transactions other than those entered into in normal conduct of a trade or business;
- (v) net foreign currency gains from § 988 transactions except for those directly related to the needs of the business;
- (vi) with some modifications, net income from notional principal contracts;

- (i) reasonable compensation paid to the taxpayer by a qualified trade or business of the taxpayer for services rendered for that business;
- (ii) any guaranteed payment (described in § 707(c)) made to a partner for services rendered to the trade or business; and
- (iii) to the extent provided in regulations, any payment described in § 707(a) made to a partner for services rendered to the trade or business.²⁷⁶

An employee's wages cannot be qualified business income, not only because those wages are paid to the employee by the trade or business for which the employee rendered services, but also because performing services as an employee is not a qualified trade or business.²⁷⁷ In contrast,

-
- (vii) any amount received from an annuity but not received in connection with a trade or business; and
 - (viii) any item of deduction or loss properly allocable to one of the seven categories above.

Id.; see also H.R. REP. NO. 114-466, at 215 (2017) (Conf. Rep.) (describing those items). Thus, if a taxpayer has net § 1231 gain for a taxable year, her § 1231 amounts are treated as long-term capital gain or loss and apparently excluded from qualified business income even if they are connected to a qualified trade or business. If she does not have a net § 1231 gain for the year, her § 1231 items connected to a qualified trade or business are apparently included in qualified business income. Note that this determination has no necessarily correlation to the net § 1231 gain or loss tied to any qualified trade or business.

²⁷⁶ § 199A(c)(4) (as added by § 11011 the TCJA); see § 707(a) (applying when a partner engages in a transaction with a partnership other than in her capacity as a partner). Treas. Reg. § 1.707-1(a) (providing that transactions described in § 707(a) include services provide by a partner to a partnership where the partner engages in the transaction other than in her capacity as a partner). In addition, qualified business income excludes any qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income. § 199A(c)(1) (as added by § 11011 of the TCJA).

²⁷⁷ § 199A(c)(4)(A) (as added by § 11011 of the TCJA) (providing that qualified business income does not include reasonable compensation paid to a taxpayer by a trade or business for which the taxpayer provides services); § 199A(d)(1)(B) (as added by § 11011

if an independent contractor conducts a qualified trade or business, her gross income from the business should be qualified business income because the income would be paid to her by the service recipient, not her trade or business.²⁷⁸

Thus, reasonable compensation paid to a shareholder/employee of an S corporation also does not qualify as qualified business income.²⁷⁹ The result should be the same if a distribution paid to an S corporation shareholder is recharacterized as reasonable compensation.²⁸⁰

In addition, a payment by a partnership to a partner is not qualified business income if it is a guaranteed payment for services with respect to any qualified trade or business or, to the extent provided by regulations, made to a partner in a capacity other than as a partner.²⁸¹ In sharp contrast, absent further guidance, if a partner provides services in her capacity as a partner to the partnership's qualified trade or business and is allocated

of the TCJA) (providing that a qualified trade or business does not include performing services as an employee).

²⁷⁸ See § 199A(c)(4)(A) (as added by § 11011 of the TCJA).

²⁷⁹ *Id.*; H.R. REP. NO. 115-466, at 215 (2017) (Conf. Rep.) (in describing the Senate bill, providing that “[q]ualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer”).

²⁸⁰ H.R. REP. NO. 115-466, at 215 (2017) (Conf. Rep.); see Susswein, *supra* note 228 (making this point); see also *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990) (concluding that distributions from an S corporation to shareholder who provided substantial services to the corporation should be characterized as wages for employment tax purposes); *Joseph Radtke, S.C. v. United States*, 895 F.2d 1196 (7th Cir. 1990) (to the same effect); *Veterinary Surgical Consulting P.C. v. Comm’r*, 117 T.C. 141, 152 (2001) (to the same effect); *Yeagle Drywall Co. v. Comm’r*, T.C. Memo 2001-284, 82 T.C.M. 814 (CCH) (2001) (to the same effect); Rev. Rul. 74-44, 1974 C.B. 287 (to the same effect).

²⁸¹ § 199A(c)(4)(B)–(C) (as added by § 11011 of the TCJA); § 707(c) (providing that guaranteed payments include payments to a partner for services to the extent determined without regard to the partnership's income); § 707(a) (applying when a partner engages in a transaction with a partnership other than in her capacity as a partner).

qualified items attributable to that trade or business, those items should form part of the taxpayer's qualified business income.²⁸²

3. W-2 Wages

To compute the Second Deductibility Factor, the taxpayer must apply the definitions not only for “qualified trade or business,” but also for “W-2 wages,” and “qualified property.” Recall that the second factor equals the greater of (A) 50% of the W-2 wages for the qualified trade or business or (B) the sum of 25% of those wages plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.²⁸³

W-2 wages for a year are all employee wages and elective deferrals reported on the form W-2.²⁸⁴ Those wages exclude any amount not

²⁸² The allocation would be governed by § 702 and § 704, not § 707(a) or (c), because it would be to a partner providing services to the partnership in her capacity as a partner, and it would not be tied to partnership income (and therefore would not be determined without regard to that income). Although the government has not done so in the past, it could treat a portion of such an allocation as reasonable compensation. See Susswein, *supra* note 228 (raising this issue). However, in the view of a high ranking Treasury official, it will not do so unless “someone above [him] makes that decision.” Matthew Madara, *ABA Section of Taxation Meeting: No Plans to Apply Reasonable Compensation Beyond S Corps*, 158 TAX NOTES 1123 (Feb. 19, 2018). The representative cautioned, however, that guidance may address cases where employees are made partners to take advantage of the § 199A deduction. *Id.* (adding that “[w]hat we’re really trying to do is address situations where you changed your facts from what they would have otherwise been simply to get the deduction”).

²⁸³ § 199A(b)(2) (as added by § 11011 of the TCJA).

²⁸⁴ § 199A(b)(4) (as added by § 11011 of the TCJA) (defining wages as including the amounts described in § 6051(a)(3) and (8)); § 6051(a)(3) (referring to wages as defined in § 3401(a)); § 199A(a)(8) (as added by § 11011 of the TCJA) (referring to elective deferrals (as defined in § 402(g)(3)) and compensation deferred under § 457 including designated Roth contributions as defined in § 402A). H.R. REP. NO. 115-466, at 217 (2017) (Conf. Rep.) (noting that the W-2 wages must be “paid by a qualified trade or business with respect to the employment of its employees during the calendar year ending during the taxable year of the taxpayer”). Thus, W-2 wages are those subject to wage withholding and elective deferrals include those under a § 401(k), § 403(b), or § 457 plan as well as designated Roth contributions under a § 401(k) or § 403(b) plan. See § 6051(a)(3) and (8); § 402(g)(3).

properly allocable to a qualified trade or business.²⁸⁵ Further, they exclude any amount that is not included in a timely return filed with the Social Security Administration.²⁸⁶

4. Qualified Property

With respect to a qualified trade or business, qualified property for a taxable year is tangible, depreciable property held by, and available for use in, the qualified trade or business and used at some point during the year in the production of qualified business income.²⁸⁷ In addition, the depreciable period for the property cannot have ended before the end of

²⁸⁵ § 199A(b)(4)(B) (as added by § 11011 of the TCJA).

²⁸⁶ § 199A(b)(4)(C) (as added by § 11011 of the TCJA) (adding that the return must be filed on or before the sixtieth day after the due date (including extensions) for the return); *see* § 6071(c) (providing that the due date to file a Form W-2 or Form W-3 with the Social Security Administration is generally the January 31 following the calendar year to which the return relates); *see also* § 6081(a) (granting the Secretary the authority to grant a reasonable extension of time to file any return); Form 8809, Application for Extension of Time To File Information Returns, IRS.GOV, <https://www.irs.gov/pub/irs-pdf/f8809.pdf> (last visited Mar. 6, 2018) (using this form, an employer may automatically extend the time to file a Form W-2 up to 30 days and for cause extend that time for an additional 30 days). Thus, W-2 wages may include reasonable compensation paid by an S corporation to a shareholder/employee. Those wages do not, however, include guaranteed payments to partners for services, because those payments are subject to self-employment tax. *See* Treas. Reg. § 1.1402(a)-1(a)(1) (providing that net earnings from self-employment include gross income derived by an individual from any trade or business carried on by the individual); Treas. Reg. § 1.1402(b) (providing that gross income derived by an individual from a trade or business includes guaranteed payments for services from a partnership engaged in a trade or business); *see also* Treas. Reg. § 1.707-1(c) (providing that guaranteed payments are considered to be made to a non-partner only for purposes of § 61(a) and § 162(a)); Rev. Rul. 69-184, 1969-1 C.B. 256 (concluding that remuneration received by a partner from a partnership is not wages); Rev. Rul. 56-675, 1956-2 C.B. 459, 460 (concluding that guaranteed payments for services are subject to self-employment tax).

²⁸⁷ § 199A(b)(6)(A) (as added by § 11011 of the TCJA).

the year.²⁸⁸ For this purpose, the depreciable period for property begins on the date that the property is first placed in service by the taxpayer and ends on the later of (i) ten years after that date or (ii) the last day of the last full year in the § 168 recovery period for the property.²⁸⁹

E. Partnerships and S Corporations

For a partnership or S corporation, § 199A is applied at the partner or shareholder level.²⁹⁰ Thus, a partnership or S corporation's qualified trade or business is treated as a qualified trade or business of its partner or shareholder. For each qualified trade or business of a partnership or S corporation, a partner or shareholder takes into account her allocable share of each qualified item of income, gain, deduction, and loss.²⁹¹ Further, a partner or shareholder takes into account her allocable share of W-2 wages and unadjusted basis immediately after the acquisition of qualified property for the taxpayer year.²⁹² Her allocable share for W-2 wages is determined in the same manner as her allocable share of wage expenses, while her allocable share of the unadjusted basis amount is determined in the same manner as her allocable share of depreciation deductions on the property.²⁹³

F. Anti-abuse Rules

Finally, § 199A(h) contains what are labelled “anti-abuse” rules, although those rules are targeted, not broad. First, § 199A(h) calls for rules to prevent the manipulation of the depreciable period of qualified property

²⁸⁸ § 199A(b)(6)(A)(iii) (as added by § 11011 of the TCJA).

²⁸⁹ § 199A(b)(6)(B) (as added by § 11011 of the TCJA) (adding that the recovery period is determined without regard to § 168(g) (*i.e.*, the alternative depreciation system)).

²⁹⁰ § 199A(f)(1)(A)(i) (as added by § 11011 of the TCJA).

²⁹¹ § 199A(f)(1)(A)(ii) (as added by § 11011 of the TCJA).

²⁹² § 199A(f)(1)(A)(iii) (as added by § 11011 of the TCJA).

²⁹³ § 199A(f)(1)(A) (as added by § 11011 of the TCJA) (flush language) (adding that an S corporation shareholder's allocable share of an item is her pro rate share of the item). Regulations should address how to allocate wages and the adjusted basis of qualified property for partnerships with multiple classes of interests, waterfalls, and so on. *See* Susswein, *supra* note 228 (making this point).

through transactions between related parties.²⁹⁴ Second, it directs Treasury to prescribe rules to determine the basis of qualified property acquired in like-kind exchanges or involuntary conversions.²⁹⁵ However, § 199A(h) fails to grant Treasury express authority to issue regulations to prevent the abuse of § 199A through a technical or literal application of its provisions, something that more aggressive taxpayers may be tempted to do.

G. *Some Planning Opportunities*

Because of that potential freedom, § 199A may encourage taxpayers to rearrange their affairs to fit within its literal provisions. For example, § 199A may encourage more skilled workers and artisans to become self-employed. Unlike an employee, a self-employed plumber, electrician, carpenter, or other skilled worker or artisan may be entitled to a § 199A deduction for amounts received for her services. If, as is likely, the artisan is a lower-income taxpayer, her business as a self-employed artisan will be a qualified trade or business.²⁹⁶ Then, she typically will be entitled to a § 199A deduction equal to 20% of her taxable income from that business (*i.e.*, her qualified business income).²⁹⁷ In contrast, an artisan/employee will be denied a § 199A deduction related to any wages

²⁹⁴ § 199A(h)(1) (as added by § 11011 of the TCJA) (calling for rules similar to those under § 179(d)(2)); *see* § 179(d)(2) (providing that § 179 property does not include property acquired by a person related to the transferor under § 267 or 707(a)(2), property acquired by one member of a controlled group from another member, and property acquired in a transferred-basis transaction or in a transfer from a decedent to which § 1014(a) applies).

²⁹⁵ § 199A(h)(2) (as added by § 11011 of the TCJA).

²⁹⁶ That business will be a qualified trade or business, because for a lower-income taxpayer, a qualified trade or business is any trade or business other than performing services as an employee or one that involves the performance of services consisting of investment management, trading or dealing in securities and the like. *See* § 199A(d) (as added by § 11011 of the TCJA); *see also supra* notes 265-270 (for a more detailed discussion of the applicable law).

²⁹⁷ *See supra* notes 228-238 (for a discussion of the relevant law).

received because performing services as an employee is not a qualified trade or business, and the wages are therefore not qualified business income.²⁹⁸

Consider the following more adventurous hypothetical. Suppose that a law school faculty at a major public university considers forming a partnership to provide teaching and other services to the law school.²⁹⁹ Happily for purposes of § 199A (but sadly for other purposes), the faculty are all lower-income taxpayers. Because the university administration is both flexible and creative,³⁰⁰ they approve a plan where the partners, in their capacity as partners, provide teaching services at the law school and also govern the law school, and the university pays the partnership for those services. Under the plan, the partners (the full-time faculty) are allocated profit shares from the partnership under § 702(a) and § 704(a) and paid an amount equal to the allocable profit. The partnership's teaching and governance services, provided through the partners, should constitute a qualified trade or business for each partner.³⁰¹ Consequently,

²⁹⁸ § 199A(c)(4)(A) (as added by § 11011 of the TCJA) (providing that qualified business income does not include reasonable compensation); *id.* at (d)(1)(B) (as added by § 11011 of the TCJA) (providing that performing services as an employee is not a qualified trade or business); § 199A(b)(2) (as added by § 11011 of the TCJA) (providing for a deduction equal in relevant part to 20% of qualified business income); § 199A(c)(1) (as added by § 11011 of the TCJA) (providing that qualified business income is the net amount of certain tax items related to a qualified trade or business). Although the legislative history does not explain why § 199A distinguishes between employees and independent contractors, the distinction may be justified as a device to aid job creation. With the tax break, an independent contractor is better positioned to expand her business and hire more employees.

²⁹⁹ If a law school faculty is not a sympathetic enough group (and it likely is not), consider a partnership arrangement to benefit lawyers who are public defenders or who work for Legal Aid.

³⁰⁰ The university administration might approve this arrangement, because it would increase the after-tax income of the faculty partners at no additional cost to the university (other than the time expended to consider the arrangement).

³⁰¹ The partnership's business will be a qualified trade or business, because for a lower-income taxpayer (*i.e.*, each partner), a qualified trade or business is any trade or business other than performing services as an employee or one that involves the performance of services consisting of investment management, trading or dealing in securities and the

the partnership's profits, which can be traced to the university's payments for those services, could be qualified business income in their entirety.³⁰²

like. See § 199A(d) (as added by § 11011 of the TCJA); see *supra* notes 265–270 (for a more detailed discussion of the applicable law).

³⁰² § 199A(c)(1) (as added by § 11011 of the TCJA) (providing that qualified business income includes the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business); § 199A(c)(3) (as added by § 11011 of the TCJA) (providing that qualified items of income, gain, deduction, and loss includes items effectively connected with a trade or business within the United States that are included or allowed in determining taxable income).

A partner's income for services will not be qualified business income if the distribution to the partner is described in either § 707(a) or (c). § 199A(b)(4)(B), (C) (as added by § 11011 of the TCJA). A payment is described in § 707(a) if it is made by the partnership to a partner in a non-partner capacity. Because each partner will provide services to the partnership in her capacity as a partner, she will not receive payments from the partnership in a non-partner capacity and those payments will therefore not be described in § 707(a).

Although a much closer case, a payment by the partnership to a partner should also not be a guaranteed payment, at least if the partnership is respected. Under § 707(c), a guaranteed payment is one made by a partnership without regard to partnership income. Under the partnership structure, the partnership's income will be tied inexorably to university funding, and the payments to each partner must be some percentage of that income. Thus, the payments received by each partner must be made with regard to partnership income and should not be considered guaranteed payments.

That result, however, is not assured. Under the proposed arrangement, the payments to the partners will be certain, because the partnership will have gross income but no deductions, and that certainty in a sense makes the payments "guaranteed." In fact, the payments may be set for a school year before it begins if the university commits to fund payments for faculty services in advance. The IRS may argue that faculty services cannot meaningfully be separated from the other operations of the law school (*i.e.*, the work of the administration and staff, the maintenance of the law school building, and the like), that the partnership necessarily must incorporate faculty services and the law school's other essential operations, and therefore that the payments received by the faculty are made without regard to the taxable income of the partnership as a whole.

To counter that argument, the partnership could assume responsibility for more operations of the law school, so that the partnership distributions to the partners would not be certain. For example, the partnership could agree to hire and pay adjunct faculty,

If so characterized, each partner would be able to deduct an amount equal to 20% of her allocable share of income from the partnership.³⁰³

That result is vulnerable to attack, however. The partnership payments could be treated as guaranteed payments, which would not be qualified business income.³⁰⁴ The partnership might also be viewed as a sham with the faculty receiving payment directly from the university as employees, and those wage payments would not constitute qualified business income. As a related argument, the partnership anti-abuse rule might apply to prevent the faculty from circumventing § 199A. As applied, the partnership could be treated as an aggregate of its partners and the partners treated as providing services directly to the law school as employees, receiving wages that would not be qualified business income.³⁰⁵ Finally, regulations or other guidance may be published that would provide that the partner's allocable share of partnership income was not qualified income because employees formed the partnership to exploit § 199A.³⁰⁶

Even if the law faculty is able to exploit § 199A by forming a partnership, the arrangement raises a number of collateral issues, including how employment taxes, payments of medical insurance premiums, and possible group term life insurance and cafeteria plan benefits may be taken into account and how a faculty member's tenure may be preserved.³⁰⁷

so that its overall profit would depend on how efficiently and extensively adjunct faculty were utilized. The partnership could assume other aspects of the law school's operation as well, making the taxable income of the partnership even less certain. Of course, as that uncertainty increases, the partnership's appeal ebbs.

³⁰³ § 199A(a) (as added by § 11011 of the TCJA). This conclusion assumes that the partner does not have a net taxable loss, disregarding her allocable share of partnership income.

³⁰⁴ See *supra* note 302 (for an argument that the partnership payments are guaranteed payments).

³⁰⁵ Treas. Reg. § 1.701-2(e) (providing that the Commissioner can treat a partnership as an aggregate of its partners to carry out the purpose of any provision of the Code).

³⁰⁶ See *supra* note 282 (reporting that such guidance may be forthcoming).

³⁰⁷ For convenience, as the context requires, a reference in the text to employment tax is to employment taxes paid by employers and employees, self-employment taxes paid by the self-employed and partners in a partnership, or to both. See § 1401 (for the self-

Tenure could be preserved through the university assuring partnership funding for all previously tenured faculty (or partners who later meet tenure standards) who are active partners in the partnership.³⁰⁸

Neither the overall amount of employment taxes nor their tax effect should depend on whether a faculty member is a partner or employee. If the faculty member is an employee, her wages would bear employment taxes of up to 15.3%, although the faculty member and university would each be liable for half of that amount.³⁰⁹ As an employee, the faculty member would include in gross income only her share of the employment tax but that share would be nondeductible.³¹⁰ If the faculty member was a partner, the total employment tax would be unchanged, but the faculty member would be liable for the entire tax.³¹¹ If the partnership structure is adopted, the university should increase the amount paid to the

employment taxes); § 3101 (for employment tax imposed on employees); § 3111 (for employment tax imposed on employers).

³⁰⁸ Those partners could include those who are teaching or on a research sabbatical.

³⁰⁹ See § 3101(a), (b)(1) (for an aggregate 7.65% tax imposed on the employee); § 3201(a) (imposing tax at the same rate on the employer); see also § 3101(b)(2) (imposing an additional 0.9% tax on employees with wages in excess of certain threshold amounts).

³¹⁰ § 3102(a) (providing that an employer collects the employee's share of employment tax by deducting it from the employee's wages). No Code provision provides for a deduction of the employee's share of federal employment taxes.

³¹¹ The tax would be imposed on the partner's allocable share of non-separately stated taxable income. § 1402(a) (flush language); Treas. Reg. § 1.1402(a)-1(a)(2) (1974); see also § 1401(a), (b)(1) (imposing employment taxes of up to 15.3% on self-employment income); *id.* at (b)(2) (imposing an additional 0.9% tax on the income of persons with sufficient self-employment income); *cf.* § 1402(a)(13) (excluding the allocable share of a limited partner (other than certain guaranteed payments) from net earnings from self-employment); Prop. Treas. Reg. § 1.1402(a)-2(h)(2), 63 Fed. Reg. 1702, 1704 (Jan. 13, 1997) (providing that a partner is not treated as a limited partner under § 1402(a)(3) if, for example, she participates in the partnership's trade or business more than 500 hours during the partnership's taxable year).

partnership for services by its foregone share of employment tax.³¹² A partner would then be allocated her share of that extra amount, but because she could deduct one-half of any employment tax paid, the partner would include in taxable income the same net amount related to employment tax as under the employment arrangement.³¹³

The treatment of any premiums paid for health insurance and any insurance benefits received would also be comparable for employees and partners. An employee would exclude from gross income the cost of any employer-provided coverage under a health insurance plan.³¹⁴ Further, to the extent the employee benefits from insurance payments for medical care, she would exclude those benefits from gross income.³¹⁵ Under the partnership structure, a partner would be treated consistently. First, the partner would also have no taxable income because of the partnership's payment of health insurance premiums on the partner's behalf.³¹⁶ In

³¹² Thus, the amount that the university paid for each faculty member would be the same whether the direct employment or partnership structure were used. With the direct employment structure, the university would pay a salary to the faculty member and pay the employer's share of the employment tax to the IRS. With the partnership structure, the university would pay the same amount for each faculty member but it would pay it all directly to the partnership and each partner would pay the entire employment tax.

³¹³ § 164(f) (allowing a self-employed person to deduct one-half of her employment taxes).

³¹⁴ § 106(a).

³¹⁵ § 105(b).

³¹⁶ See Rev. Rul. 91-26, 1991-1 C.B. 184 (Situation 1). If the premiums paid by the partnership are payable without regard to partnership income (which seems likely), they would be treated as guaranteed payments made to the partners, included in their gross income and not treated as qualified business income for purposes of § 199A. *Id.*; § 707(c). Those payments should be treated as ordinary and necessary business expenses and deductible by the partnership. Although each partner must include the allocable portion of premiums in gross income, the partner should be entitled to a deduction equal to that premium amount. § 162(j)(1) (allowing a deduction for insurance for medical care for the taxpayer, her spouse, and her dependents or any child who has not reached age 27 by the end of the taxable year); see also *id.* at (j)(2)(A) (limiting the § 162(j) deduction to the taxpayer's earned income from the trade or business with respect to which the medical care coverage is established).

addition, the partner would exclude from gross income any economic benefit from insurance payments for medical care.³¹⁷

Note, however, that in several ways a partner may be treated worse than an employee. For example, a partner could not participate in the partnership's cafeteria plan or group term life insurance plan, while an employee could.³¹⁸ Despite those disadvantages, if a faculty member is entitled to a § 199A deduction in the law school hypothetical, the partnership structure may significantly advantage a faculty member who becomes a partner rather than an employee.

VII. SOME FINAL THOUGHTS

This part of the paper considers how the TCJA affects choice of entity. Although the act may affect the appropriate choice in certain cases, the choice depends vitally on the facts, just like before the act. Nor does the act change the fundamental approach in making that choice. Because of the “check-the-box” regulations, the approach generally involves two steps – an analysis first of the best business form and then of the best tax status.³¹⁹ By enabling a sequential analysis first of business form and then

The partnership may instead account for its payment of the health insurance premiums on behalf of a partner as a distribution to the partner to which § 731 applies. In that case, the partnership will not be entitled to a deduction, increasing the partnership's non-separately stated taxable income (or decreasing the loss) allocated to the partners. The partner should be treated as if she paid the premium and therefore should be entitled to a deduction equal to the amount of the payment under § 162(f).

³¹⁷ § 104(a)(3) (excluding from gross income amounts received through health insurance for personal injuries or sickness).

³¹⁸ Under both types of plans a participant must be an employee. § 79(a); § 125(d)(1).

³¹⁹ See Treas. Reg. § 301.7701-1, -2, and -3 (for the “check the box” regulations). More precisely, the approach may require a tripartite analysis, beginning first with whether to operate a business directly or through an entity. If the business is operated directly, its owners take its tax items into account, and they avoid the administrative costs of operating an entity.

of tax status, the regulations made the choice of business form generally independent of tax considerations.

In significant part, a business may operate through a general partnership, limited partnership, limited liability company, limited liability partnership, or corporation.³²⁰ In deciding among those business forms, owners should consider the form's administrative cost, its flexibility in allocating income, deductions, and loss among owners, and its feasible management structures (*e.g.*, collective or centralized management). They should also consider the importance of limited liability protection for its owners, free transferability of ownership interests, and continuity of life. The TCJA affects neither those factors nor the analysis of the advantages and disadvantages of various business forms.

If the ownership interests in an entity are publicly traded, the entity will be typically organized as a corporation.³²¹ Further, because of the publicly trading, such an entity must be treated as a C corporation for federal income tax purposes.³²² If an entity's interests are not publicly

Despite those possible advantages, it is often advantageous to operate a business through an entity. First, it is typically easier to transfer an entity interest than partial interests in the business assets. Second, customers can deal with one legal person (*i.e.*, the entity), rather than multiple owners, and the owners may maintain their anonymity. Third, depending on the business form, an entity's ownership interests may be more flexibly crafted (*e.g.*, creative partnership allocations) than direct interests in the business assets. Fourth, certain business forms offer limited liability to their owners. Finally, by using an entity, an owner may indirectly transfer an asset that could not be transferred directly. Because of those possible advantages for entities, the text does not generally discuss the direct ownership of business assets.

³²⁰ For this purpose, the textual reference to a corporation includes an entity that its enabling statute describes as being incorporated or refers to as a corporation, body corporate, body politic, joint-stock company, or joint-stock association. *See* Treas. Reg. § 301.7701-2(b)(1), (3).

³²¹ Note that some partnerships are also publicly traded, and those partnerships are generally treated as corporations for federal income tax purposes. § 7704(a) (for the general rule); § 7704(c) (for exceptions).

³²² It likely will not qualify as an S corporation, because it will be considered to have more than 100 shareholders. § 1361(b)(1)(A) (for the 100-shareholder limit). *But see* § 1361(d)(1) (treating members of a family as one shareholder in applying the 100-shareholder limit and expansively defining family for that purpose).

traded, but it is still treated as a corporation for federal income tax purposes, it is treated as a C corporation, unless it qualifies for and elects to be an S corporation.³²³

Other domestic business entities generally may choose their tax status, but their choice depends on whether they have one or more owners. By default for federal income tax purposes, an entity with multiple owners is treated as a partnership,³²⁴ while an entity with just one owner is disregarded as an entity separate from its owner.³²⁵ In either case, the entity may change that default status, electing to be treated as a corporation for federal income tax purpose.³²⁶ If it makes that election, it will be treated as a C corporation unless it qualifies for and elects to be treated as an S corporation.

The choice among tax status depends on a host of factors, most of which were unchanged by the TCJA. They include how the entity and owners treat (i) entity formation, (ii) liquidating and non-liquidating distributions, (iii) sales of ownership interests in the entity, (iv) combinations of entities, and (v) a person's provision of services, or

³²³ Insurance companies, a state-chartered business entity conducting federal insured banking activities, and certain publicly traded partnerships must also be treated as corporations for federal income tax purposes. *See* § 7704 (publicly traded partnerships); Treas. Reg. § 301.7701-2(b)(4) (insurance companies); Treas. Reg. § 301.7701-2(b)(5) (banks). Recall that the earnings of a C corporation are subject to a corporate-level tax and, when distributed, a shareholder-level tax, while the earnings of an S corporation, a pass-thru entity, are generally subject to only a shareholder-level tax.

³²⁴ Treas. Reg. § 301.7701-3(b)(1)(i).

³²⁵ Treas. Reg. § 301.7701-3(b)(1)(ii). If the entity is disregarded for federal income tax purposes, its tax items are treated as tax items of its owner for those purposes (*e.g.*, for an individual as if the business was operated as a sole proprietorship or for a corporation as if the business was operated as a corporate division). *See* Treas. Reg. § 301.7701-3(a).

³²⁶ *See* Treas. Reg. § 301.7701-3(c)(1)(i).

contribution of property, to the entity in exchange for an ownership interest.³²⁷

Despite the importance of those factors, planners often focus on whether the entity's income bears one or two levels of tax, what effective tax rates are imposed at each level, when the taxes may be imposed, and whether any special benefits may inure to a particular tax status. The TCJA affected that focus in several important ways. It replaced graduated rates for C corporations with a flat 21% rate³²⁸ and generally lowered rates for individuals.³²⁹ It also added a deduction for qualified business income for taxpayers other than C corporations.³³⁰ Those changes bear critically on the analysis of the best tax status.³³¹

The change in tax rates makes it less likely that a lower-income individual should incorporate her business as a C corporation. If her highest marginal rate is less than 21%, she would be foolish to use a C corporation, since the corporation would be taxed at a flat 21% rate³³² and the shareholder would also be taxed on any corporate distribution of earnings.³³³ Even if the shareholder's highest marginal rate is 22% or 24%, she should hesitate to incorporate her business in a C corporation, because

³²⁷ There are many other factors that may be taken into account, including the possible application of the passive activity or at-risk rules or the possible imposition of the accumulated earnings or personal holding company tax. *See* § 465 (for the at-risk rules); § 469 (for the passive activity rules); *see supra* notes 14–23 and accompanying text (for a discussion of the personal holding company tax); *supra* notes 24–33 and accompanying text (for a discussion of the accumulated earnings tax). It is also imperative to consider the impact of state, local, and foreign taxes. For convenience, the discussion in the text disregards that impact.

³²⁸ *See supra* notes 2–12 and accompanying text (for a discussion of this change).

³²⁹ *See* § 1(j) (as added by § 11001 of the TCJA).

³³⁰ *See supra* notes 239–318 and accompanying text (for a discussion of this change).

³³¹ *See supra* notes 32–33 and accompanying text (for one example of how a high-taxed elderly individual may exploit the new corporate rate); *see also* Willard B. Taylor, *Tax Cuts and Jobs Act – A Missed Opportunity*, 159 TAX NOTES 183 (Apr. 9, 2018) (discussing choice of entity)..

³³² *See* § 11(b) (as amended by § 13001 of the TCJA) (for the corporate rate); § 1(j) (as amended by § 11001 of the TCJA) (for the individual rates).

³³³ *See* § 301(c)(1).

the present value of the corporate-level and shareholder-level taxes on corporate earnings will likely exceed that marginal rate and are even more likely to exceed her average tax rate.

For higher-income individuals, the TCJA sends mixed signals on incorporation. Although it eliminated graduated rates for C corporations, it reduced the tax rate for highly profitable corporations from 35% to 21%. However, it also reduced the highest marginal rate for individuals and introduced a deduction for qualified business income, a deduction that may reduce the effective tax rate on an individual's business income, whether earned directly or through a pass-thru entity. Because the effect of this hodgepodge depends vitally on future events, including how long any shareholder tax on corporate earnings is deferred, it may be difficult to predict with certainty whether a higher-income taxpayer should incorporate business assets in a C corporation.

Before the TCJA was enacted, the analysis was in some ways simpler. A higher-income taxpayer might have an incentive to transfer business assets to a C corporation, because the corporation's income could be taxed at graduated rates. In fact, the higher the taxpayer's marginal rate, the greater the incentive to make that transfer. Suppose, for example, that Fred operated a business that earned \$50,000 of taxable income each year,³³⁴ a business that he planned to sell in two years. Assume that he was taxed on his business income at a marginal rate of 39.6%, then the highest marginal individual tax rate.³³⁵ If Fred operated the business as a sole proprietorship, he would pay a tax of \$39,600 (\$100,000 times 39.6%) and net a \$60,400 profit after taxes (\$100,000 earnings less \$39,600 tax).

Suppose instead that Fred contributed the assets to a newly formed C corporation, C Inc., solely in exchange for all C stock.³³⁶ Before

³³⁴ For convenience, assume that at all relevant times, the business assets have a basis equal to fair market value and that value stays the same.

³³⁵ See § 1(a)-(d), (i).

³³⁶ Under § 351(a), Fred would recognize no gain or loss on the contribution and under § 358(a) would take a basis in the stock equal to the aggregate basis of the contributed

the enactment of the TCJA, C Inc. would pay tax on the business income at a 15% rate (because it would earn no more than \$50,000 each year).³³⁷ Thus, over the two years, it would incur a \$15,000 tax (*i.e.*, \$100,000 times 15%), and its value would increase by \$85,000 (*i.e.*, the excess of the \$100,000 earnings over the \$15,000 tax). If Fred then sold the C stock for its fair market value, he would recognize an \$85,000 gain. Because that gain would be subject to an aggregate 23.8% tax,³³⁸ Fred would pay a \$20,230 tax (\$85,000 times 23.8%), netting a \$64,770 profit after tax. Accordingly, by using C Inc., Fred would net an additional \$4,370 (*i.e.*, \$64,770 less \$60,400).³³⁹

The TCJA removes even that modest benefit. Under the act, C Inc. would be taxed at a flat 21% rate, Fred would be taxed at a marginal rate of just 37%, and he may be entitled to a deduction for qualified business income if he operates the business directly.³⁴⁰ By operating the business directly, Fred would net no less than \$63,000 after taxes (*i.e.*, \$100,000 earnings minus a \$37,000 tax (37% of \$100,000)), but he would net even more to the extent his business earnings constituted qualified business income. To that extent, Fred could deduct up to 20% of the

property (which equals its aggregate value). Assume that Fred could justify the incorporation for valid non-tax business reasons. *Cf.* § 269(a) (providing that if a person acquires control of a corporation with the principal purpose to avoid or evade federal income tax by securing an allowance that she would not otherwise enjoy, the Secretary may disallow that allowance). For convenience, assume that Fred took a fair market value basis in his C stock and C Inc. took fair market value bases in the contributed assets.

³³⁷ § 11(b)(1)(A) (before the enactment of the TCJA). This conclusion assumes that C Inc. was not a member of a controlled group that shared one set of graduated rates. *Cf.* § 1561(a)(1) (before its amendment by the TCJA).

³³⁸ § 1(h)(1)(D) (for the 20% tax on net capital gain); § 1411(a)(1) (for a 3.8% tax imposed on net investment income of higher-income taxpayers).

³³⁹ In addition, Fred (through C, Inc.) would be able to invest the tax savings from the first year but the after-tax earnings on that investment are disregarded. Note that the example also does not account for the added administrative costs of using the corporate form, costs that in this example would likely exceed any after-tax earnings from investing the tax savings.

³⁴⁰ § 11(b) (as amended by § 13001 of the TCJA); § 1(j) (as added by § 11001 of the TCJA); § 199A (as added by § 11011 of the TCJA).

earnings,³⁴¹ increasing his net after-tax return by up to \$7,400 (*i.e.*, 20% of \$100,000 times 37%). If Fred instead operated the business through C Inc., the corporation would pay a \$21,000 tax on its \$100,000 of taxable income and Fred would recognize just a \$79,000 gain on his sale of the C stock. Because that gain would be subject to an \$18,802 tax (*i.e.*, 23.8% of \$79,000), Fred would net just a \$60,198 profit after tax, or between \$2,202 and \$9,602 less than if he had operated the business directly.

The preceding example illustrates the likely results under the TCJA in many, but not all, cases. For a higher-income individual, the deduction for qualified business income often could weigh heavily against using a C corporation (which cannot take that deduction). However, the longer the individual planned to own and operate a business, the more attractive a C corporation could become. Further, if the individual could limit or avoid tax on an eventual sale of her stock, that benefit might help tip the scales in favor of the C corporation. For example, if the individual planned to hold the C corporation's stock until her death, her estate, heirs or beneficiaries could sell the stock with little or no tax, increasing the appeal of a C corporation.³⁴²

Sometimes investors prefer C corporations for non-tax reasons. Consider, for example, venture capital investors. Before the enactment of the TCJA, they typically used C corporations as investment vehicles principally for non-tax business reasons.³⁴³ Because the TCJA does not

³⁴¹ § 199A(a)(1), (b)(2)(A) (as added by § 11011 of the TCJA).

³⁴² See § 1014(a) (providing that property acquired from a decedent takes a basis equals to its value at or near the time of the decedent's death).

³⁴³ Gregg Polsky, *Explaining Choice-of-Entity Decisions by Silicon Valley Start-Ups*, (University of Georgia School of Law Research Paper Series No. 2018-11, 2018), <https://ssrn.com/abstract=3123793> (arguing that Silicon Valley prefers corporations for start-ups because flow-through structures are more complex and administratively burdensome and the tax benefits of a flow-through structure that may arise upon exit are diminished if the exit occurs through an initial public offering or sale to a public company); Meri Weis, *Why Venture Capitalists Prefer Delaware C-Corps*, HARVARD BUSINESS SERVICES, INC. (Sept. 4, 2017) <https://www.delawareinc.com/blog/why-venture->

affect the non-tax reasons for that choice and because the TCJA reduced the tax rate for highly profitable C corporations, venture capital investors will likely continue to favor C corporations as their investment vehicle of choice.³⁴⁴

In many cases, however, a C corporation will not be the tax entity of choice. Investors may then choose between an S corporation on the one hand and a partnership or sole proprietorship on the other hand.³⁴⁵ If an owner performs services in her business, her use of an S corporation

capitalists-prefer-delaware-c-corps/ (stating that venture capitalists prefer C corporations as investment vehicles because corporate stock is more liquid than interests in limited liability companies, they offer more consistency on management responsibilities, and they prefer holding preferred stock interests to reduce their investment risk).

Some advisers suggest, however, that the corporation held by the venture capital investor should invest in a limited liability company (an “LLC”) treated as a partnership, making the venture capital investment more attractive to the founders who were seeking the venture financing and can become members of the LLC. Ryan D. Harris & Thomas P. Ward, *Venture Funds: Don't Fear the LLC*, VC EXPERTS, https://www.mwe.com/~media/files/thought-leadership/publications/2013/04/venture-funds-dont-fear-the-llc/files/venture_funds_dont_fear_the_llc/fileattachment/venture_funds_dont_fear_the_llc.pdf. (last visited Mar. 5, 2018). Their suggestion highlights another point about choice of entity—it may be advantageous for some investors to own their interests in a partnership (or LLC) directly and for others to own those interests through a corporation.

³⁴⁴ Note that if a venture capital firm is a partnership for federal income tax purposes and intends to invest in a business, it may prefer to have those assets held in a C corporation, rather than a pass-thru entity, to exploit § 1202 and § 1045. Only a C corporation can qualify as a small business corporation under § 1202. *See* § 1202(c)(1) (providing that a small business corporation must be a C corporation); § 1202(c)(2) (providing that a small business corporation must meet the active business requirement); § 1202(e)(1)(A) (providing that the active business requirement is not met unless during the relevant period the corporation uses at least 80% by value of its assets in a qualified trade or business). If the corporation so qualifies and certain other requirements are met, the partners of the venture capital firm may exclude a portion of any gain on the firm’s sale of the corporation’s stock. *See* § 1202(a)(1) (for the exclusion); § 1202(g) (for special rules that apply to § 1202 stock held by pass-thru entities). Further, if the firm uses the sales proceeds to buy the stock of another small business corporation within 60 days after the sale, it may avoid recognizing the gain in its entirety. *See* § 1045(a).

³⁴⁵ A single investor may choose between an S corporation, holding the assets directly, or holding the assets through a disregarded entity, such as a single-member LLC.

may lower employment taxes, but it may also lower the deduction for qualified business income, a disadvantage that may outweigh any employment-tax benefit.³⁴⁶

Example – Sole proprietorship or S corporation

Fred and Mary are both attorneys who are sole practitioners with no employees. Fred operates his law practice as a sole proprietorship, while Mary operates her practice through an S corporation. Assume that each is married (but not to each other), they each file joint returns but do not itemize, each of their spouses has wage income exactly equal to the couple's standard deduction, and the only other items reported on those returns are from their legal practices. In 2018, each law firm generates \$300,000 of taxable income before accounting for any deduction for compensation paid, qualified business income, or employment taxes.

³⁴⁶ Wages paid to a shareholder-employee of an S corporation are subject to employment taxes. *See* § 3401 (defining wages); § 3101 (for the employee's share of employment taxes); § 3111 (for the employer's share of employment taxes). However, income allocated to a shareholder-employee by the S corporation under § 1366 is not subject to employment taxes (because it is not wage income) or self-employment taxes. *See* Rev. Rul. 59-221, 1959-1 C.B. 225 (concluding that income allocated to a shareholder under the predecessor to § 1366 did not constitute net earnings from self-employment); *cf.* § 1402(a) (expressly providing, with some exceptions, that net earnings from self-employment include a partner's distributive share of non-separately stated taxable income under § 702(a)(8) from any trade or business carried on by the partnership; there is no corresponding inclusion rule for the pass-thru of items under § 1366 to S corporation shareholders). Thus, shareholders of an S corporation avoid self-employment taxes on their allocable share of non-separately computed income from any trade or business held by the S corporation. That benefit has enticed many business owners to operate their businesses through S corporations rather than partnerships.

Fred has \$300,000 of self-employment income.³⁴⁷ The entire amount is subject to self-employment tax of \$25,071.60.³⁴⁸ Of that amount, Fred can deduct \$12,310.80, so that his joint taxable income equals \$287,689.20 before any deduction for qualified business income.³⁴⁹ Because that taxable income amount is less than \$315,000, Fred's law business is a qualified business, his qualified business income is \$287,687.20, and his § 199A deduction equals 20% of that amount or \$57,537.84. Thus, Fred and his spouse report taxable income of \$230,151.36 (*i.e.*, the excess of \$287,689.20 over \$57,537.84) and incur a \$43,815.33 tax.³⁵⁰ After accounting for the self-employment and income taxes, Fred and his spouse net \$231,113.07.

Mary's treatment depends on how much of her income is treated as compensation income. Suppose that the S corporation pays its net earnings to her for the year (\$300,000 reduced by its share of any employment tax paid), but it designates only \$150,000 of the payment as Mary's compensation. If the IRS does not recharacterize any of the remaining payment as compensation, the

³⁴⁷ Of course, he receives no compensation income from his practice, because he cannot pay compensation to himself.

³⁴⁸ That amount equals 2.9% of \$300,000, plus 12.4% of \$128,400, plus 0.9% of \$50,000 (*i.e.*, the excess of \$300,000 over \$250,000). § 1401(a) (imposing a 12.4% tax on self-employment income for old-age, survivors, and disability insurance); § 1402(a) (defining net earnings from self-employment); § 1402(b)(1) (excluding for purposes of § 1402(a), any self-employment income over the contribution and benefit base as determined under section 230 of the Social Security Act); *Contribution and Benefit Base*, SOCIAL SECURITY ADMINISTRATION, <https://www.ssa.gov/oact/cola/cbb.html> (last visited Mar. 6, 2018) (stating that the contribution and benefits base for 2018 is \$128,400); § 1401(b)(1) (imposing a 2.9% tax on self-employment income for hospital insurance); § 1401(b)(2) (imposing an additional 0.9% tax on self-employment income over \$250,000 in the case of a joint return). Note that if Fred were providing services to a partnership, his partnership allocations or guaranteed payments would also be subject to self-employment tax. *See supra* notes 286 and 311 (for relevant cites).

³⁴⁹ The deduction equals one-half of the excess of Fred's self-employment taxes over the tax determined under § 1401(b)(2). *See* § 164(f)(1) (providing that deduction).

³⁵⁰ § 1(j)(2)(A) (as added by § 11001 of the TCJA) (imposing a tax on \$230,151.36 equal to \$28,179 plus 24% of \$65,151.36, which is the excess of \$230,151.36 over \$165,000).

consequences are as follows: The employment taxes imposed on Mary's compensation income will equal \$20,271.60.³⁵¹ Assume that under § 162(a), the S corporation can deduct its one-half share of those employment taxes plus Mary's compensation. Therefore, the corporation has taxable income of \$139,864.20, entirely allocable to Mary. Because Mary's joint taxable income before accounting for any § 199A deduction will be less than \$315,000, Mary treats the S corporation's law business as a qualified business and her allocable share of its income as qualified business income. Thus, her § 199A deduction equals \$17,972.84 (20% of \$139,864.20), her joint taxable income equals \$261,891.36,³⁵² and she incurs a \$51,432.93 tax.³⁵³ After accounting for the employment and income taxes, Mary and her spouse net \$228,295.47 or \$2,817.60 less than Fred and his spouse.

The news for Mary and her poor spouse may get even worse. The IRS may recharacterize more of her payment from the S corporation as reasonable compensation, because the earnings of the S corporation appear to be attributable principally if not entirely to her services.³⁵⁴ Suppose that the IRS successfully recharacterizes an additional \$120,000 as reasonable compensation, so that Mary is treated as receiving \$270,000 of compensation from the S corporation. Because of that recharacterization, Mary and the corporation would owe additional

³⁵¹ That amount equals 12.4% of \$128,400 (for the employer's and employee's share of employment tax for old-age, survivors, and disability insurance) plus 2.9% of \$150,000 (for the employer's and employee's share of employment tax for hospital insurance). *See* § 3101 (for the employee's share); § 3111 (for the employer's share). Because the corporation pays half of that amount, it pays \$289,864.20 to Mary (*i.e.*, \$300,000 minus one-half of \$20,271.60).

³⁵² That amount equals \$150,000, Mary's wages, plus \$139,864.20, her income allocation from the S corporation, minus \$17,972.84, the § 199A deduction.

³⁵³ § 1(j)(2)(A) (as added by § 11001 of the TCJA) (imposing a tax on \$261,891.36 equal to \$28,179 plus 24% of \$96,891.36, which is the excess of \$261,891.36 over \$165,000).

³⁵⁴ *See supra* note 280 (for relevant authorities).

employment taxes of \$1,920 and \$1,740, respectively.³⁵⁵ Further, the recharacterization reduces the qualified business income allocated to Mary by \$120,000,³⁵⁶ thereby reducing Mary's § 199A deduction and increasing her taxable income by \$24,000 (*i.e.*, 20% of \$120,000).³⁵⁷ Thus, the taxable income for Mary and her spouse in the payment year increases to \$285,891.36, and their tax increases by \$5,760 to \$57,432.93. Thus, after accounting for the employment and income taxes, Mary and her spouse net just \$218,637.47 or \$12,477.60 less than Fred and his spouse.

Before the enactment of the TCJA, if the IRS recharacterized a payment by an S corporation as reasonable compensation, the

³⁵⁵ Both Mary and the corporation are liable for additional employment tax related to hospital insurance, with Mary's additional tax being \$1,920 (1.45% of \$120,000 plus 0.9% of the excess of \$270,000 over \$250,000) and the corporation's additional tax being \$1,740 (*i.e.*, 1.45% of \$120,000). § 3101(b) (for the employee's tax); § 3111(b) (for the employer's tax).

³⁵⁶ *But see* Martin A. Sullivan, *A Spreadsheet to Calculate the New Passthrough Deduction*, 159 TAX NOTES 7, 14 (Apr. 2, 2018) (illustrating how a wage increase for owner/employees of an S corporation could increase the § 199A deduction for the owner/employees). Assuming, as is likely, that the recharacterization occurs in a taxable year after the payment year, the corporation will not reduce its taxable income to account for its additional employment tax. Whether the S corporation is a cash or accrual method taxpayer, it will deduct the additional tax only in the year that it is paid. *See* Treas. Reg. § 1.461-1(a)(1) (providing that a cash method taxpayer takes an allowable deduction into account as a general rule in the year paid); *id.* at (a)(2) (providing that an accrual method taxpayer takes a liability into account no earlier than when economic performance occurs); Treas. Reg. § 1.461-4(g)(6)(i) (providing as a general rule that economic performance occurs for a tax as the tax is paid).

Note that it is unlikely that the recharacterized compensation will be treated as W-2 wages under § 199A, because it is unlikely that the S corporation will have filed the relevant return including that amount with the Social Security Administration by 60 days after the due date (including extensions) for the return. *See* § 199A(b)(4)(C) (as added by § 11011 of the TCJA) (for that requirement).

³⁵⁷ The deduction for qualified business income will equal 20% of the taxable income of the S corporation (before taking the deduction into account). § 199A(e)(1) (as added by § 11011 of the TCJA). Because that taxable income will equal just \$19,864.20 (\$300,000 earnings minus \$10,135.80 (for employment tax paid) minus \$270,000 (for compensation paid), the deduction will be just \$3,972.84 (20% of \$19,864.20), or \$24,000 less than if the compensation were only \$150,000.

recharacterization typically would increase just the employment tax.³⁵⁸ Because of the TCJA, as the preceding example illustrates, the recharacterization may now also increase the income tax. Those heightened stakes invite the IRS to more closely scrutinize payments by S corporations to an employee-shareholder, particularly a 100% shareholder.

Despite the preceding example, an S corporation may be the favored tax vehicle in a variety of circumstances. For instance, if the business owners are not employees, they may prefer an S corporation over a partnership to eliminate their employment tax burden but still preserve any § 199A deduction.³⁵⁹ In some cases, the owners may even be able to increase their § 199A deduction by using an S corporation, for example, for a capital-intensive business in which the owners receive W-2 wages.³⁶⁰

The examples in this portion of the paper illustrate just a few of the multiplicity of choice-of-entity cases. However, the examples demonstrate that in choosing the appropriate business form and tax status

³⁵⁸ The added employment tax would reduce the S corporation's taxable income (and therefore the taxable income and tax of its shareholders), but likely for a taxable year following the payment year. *See supra* note 356.

³⁵⁹ None of the income allocated to the shareholders under § 1366 would be subject to employment or self-employment tax. *See supra* note 346 (for the relevant authorities). In contrast, if the business were operated through a partnership, at least the general partners would be subject to self-employment tax on their allocable share of non-separately stated taxable income under § 702(a)(8) attributable to a trade or business. § 1402(a) (expressly providing, with some exceptions, that net earnings from self-employment include a partner's distributive share of non-separately stated taxable income under § 702(a)(8) from any trade or business carried on by the partnership). *See also supra* note 286 (describing why § 707(c) guaranteed payments for services are subject to self-employment tax).

³⁶⁰ *See* § 199A(b)(2)(B) (as added by § 11011 of the TCJA) (describing the Second Deductibility Factor, which increases as W-2 wages increase). Increasing the Second Deductibility Factor may increase the deductible amount for the corresponding trade or business (§ 199A(b)(2)), thereby increasing the combined qualified business income amount (§ 199A(b)(1)), and possibly increasing the deduction for qualified business income (§ 199A(a)). § 199A (as added by § 11011 of the TCJA)

for a business, it is dangerous to rely on rules of thumb, particularly because the TCJA added variables, the effect of which cannot be anticipated with certainty. Instead, that choice must be made by uncovering and carefully considering all relevant facts.