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7 New Small-Business Tax Rules You Haven't Heard Of

The new tax law spawned a lot of stories about pass-through business income, but it also establishes several other rules for small businesses.

By **William H. Byrnes, Robert Bloink** | February 16, 2018

The Tax Cuts and Jobs Act of 2017 made a lot of headlines for the new deduction for pass-through business income, but it also establishes several other new rules for small businesses that haven't received as much attention. The Q&As below, excerpted from Tax Facts, explore some of those changes.

1. Can pass-through business owners continue to deduct interest on indebtedness under the 2017 Tax Act?

Businesses that operate as pass-through entities (partnerships, S corporations, sole proprietorships) are generally permitted to deduct interest expenses incurred in operating the business. The 2017 Tax Act generally limits the interest expense deduction to the sum of (1) business interest income, (2) 30 percent of the business' adjusted taxable income and (3) floor plan financing interest. Businesses with average annual gross receipts of $25 million or less

for the three-taxable year period that ends with the previous tax year are exempt from this new limitation (i.e., businesses that meet the gross receipts test of IRC Section 448(c)).

These rules are applied at the partnership level, and the deduction for business interest must be taken into account in determining the non-separately stated taxable income or loss of the partnership. Under the 2017 Tax Act, the limit on the amount that is allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income.

Code section 163(j)(4)(C) defines "excess taxable income" as the amount that bears the same ratio to the partnership's adjusted taxable income as:

> (x) the excess (if any) of the amount that (1) 30 percent of the adjusted taxable income of the partnership over (2) the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership, bears to
>
> (y) 30 percent of the adjusted taxable income of the partnership.

Excess taxable income must be allocated in the same manner as non-separately stated income and loss. A partner's adjusted basis in his or her partnership interest must be reduced (not below zero) by the excess business interest that is allocated to the partner. The new law provides that similar rules will apply to S corporations and their shareholders.

As expressed in the Senate amendment to the 2017 Tax Act, the intent of this calculation was to allow a partner to deduct additional interest expense that the partner may have paid to the extent that the partnership could have deducted more business interest.

"Business interest" means interest paid on indebtedness that is properly

allocated to a trade or business, but excluding investment interest.

"Business interest income" means the amount of interest income that is included in the entity's income and properly allocated to a trade or business, excluding investment interest income.

"Trade or business" specifically excludes the trade or business of being an employee, any electing real property trades or businesses, electing farming businesses, furnishing or selling electrical, water or sewage disposal services, and gas or steam distribution and transportation.

"Adjusted taxable income" for purposes of these rules means taxable income computed without regard to non-business items of income, gain deduction and loss, business interest and business interest income, the net operating loss deduction under Section 172, the deduction for pass-through entities under IRC Section 199A and any deductions for depreciation, amortization or depletion.

2. Can a partnership carry forward disallowed business interest?

The 2017 Tax Act created a special rule to allow partnerships to carry forward certain disallowed business interest (the rule does not apply to S corporations or other pass-through entities, although the new law specifies that similar rules will apply). The general rules governing carrying forward disallowed business interest do not apply to partnerships.

Instead, disallowed business interest is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership. According to Code section 163(j)(4)(B) the partner is entitled to deduct his or her share of excess business interest in any future year, but only:

1. against excess taxable income (see above) attributed to the partner by the partnership, and

2. when the excess taxable income is related to the activities that created the excess business interest carryforward.

Such a deduction also requires a corresponding reduction in excess taxable income. Further, if excess business interest is attributed to a partner, his or her basis in the partnership interest is reduced (not below zero) by the amount of the allocation even though the carryforward does not permit a partner's deduction in the year of the basis reduction. The partner's deduction in a future year for the carried forward interest will *not* require another basis adjustment.

If the partner disposes of the partnership interest after a basis adjustment occurred, immediately before the disposition the partner's basis will be increased by the amount that any basis reduction exceeds the amount of excess interest expense that has been deducted by the partner.

3. Did tax reform impact the net operating loss (NOL) carryforward and carryback rules for taxpayers that are not corporations?

Under the 2017 Tax Act, excess business losses (see below) of a non-corporate taxpayer are not allowed for the taxable year. These losses are carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward in subsequent taxable years.

NOL carryovers generally are allowed for a taxable year up to the lesser of the carryover amount or 90 percent (80 percent for taxable years beginning after December 31, 2022) of taxable income determined without regard to the deduction for NOLs.

An "excess business loss" is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross

income or gain of the taxpayer plus a threshold amount. The annual threshold amount is $250,000 (or twice the otherwise applicable threshold amount for married taxpayers filing a joint return). This amount is indexed for inflation.

In the case of a pass-through entity (such as a partnership or S corporation), these rules apply at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation for the taxable year of the partner or S corporation shareholder. These rules apply after the application of the passive loss rules.

These provisions are effective for tax years beginning after December 31, 2017 and before January 1, 2026.

Further, for taxable years beginning after December 31, 2017 and before January 1, 2026, the limitation relating to excess farm losses does not apply.

4. Were the rules governing electing small-business trusts (ESBTs) changed under tax reform?

The 2017 Tax Act expands the definition of a qualifying beneficiary under an electing small-business trust (ESBT) to include nonresident aliens. This provision is effective beginning January 1, 2018.

For tax years beginning after December 31, 2017, charitable deductions of an ESBT will be determined according to the rules that apply to individuals (rather than using the rules applicable to trusts and estates) except that deductions that are allowed for expenses paid in administering the trust that would not have been incurred but for the trust arrangement are allowed in determining adjusted gross income.

5. What are the new rules governing the substantial built-in loss of a partnership

Generally, a partnership must adjust the basis of partnership property following a transfer of a partnership interest if the partnership has suffered a substantial built-in loss immediately following the transfer. Under prior law, a substantial built-in loss existed if the adjusted basis in the partnership's property exceeded the fair market value of the property by more than $250,000.

The 2017 Tax Act expanded the definition of substantial built-in loss to include situations where, immediately after the transfer, the transferee would be allocated a net loss of more than $250,000 upon a hypothetical disposition by the partnership of all the partnership's assets in a taxable transaction for cash equal to the fair market value of the assets.

6. Was the basis limitation on a partner's losses impacted by tax reform?

For tax years beginning after 2017, the basis limitation on the deductibility of a partner's losses applies to a partner's distributive share of charitable contributions and foreign taxes. Under prior law, those items were exempt from the limitation. This does not apply to the excess of fair market value over adjusted basis on charitable contributions of appreciated property.

7. Was the technical termination of a partnership rule impacted by tax reform?

Under the 2017 Tax Act, the technical termination rule was repealed. Therefore, a partnership will be treated as though it is continuing even if more than 50 percent of the total capital and profits interest of the partnership are sold or exchanged. This provision applies for tax years beginning after 2017.

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