

## Partnerships and S corporations

The Build Back Better Act contains various tax proposals that would affect partnerships, S corporations and their owners. Planning opportunities and other considerations for these taxpayers include the following:

- Taxpayers with unused passive activity losses attributable to partnership or S corporation interests may want to consider disposing of the interest to utilize the loss in 2021.
- Taxpayers other than corporations may be entitled to a deduction of up to 20% of their qualified business income (within certain limitations based on the taxpayer's taxable income, whether the taxpayer is engaged in a service-type trade or business, the amount of W-2 wages paid by the business and the unadjusted basis of certain property held by the business). Planning opportunities may be available to maximize this deduction.
- Certain requirements must be met for losses of pass-through entities to be deductible by a partner or S corporation shareholder. In addition, an individual's excess business losses are subject to overall limitations. There may be steps that pass-through owners can take before the end of 2021 to maximize their loss deductions. The Build Back Better Act would make the excess business loss limitation permanent (the limitation is currently scheduled to expire for taxable years beginning on or after January 1, 2026) and change the manner in which the carryover of excess business losses may be used in subsequent years.
- Under current rules, the abandonment or worthlessness of a partnership interest may generate an ordinary deduction (instead of a capital loss) in cases where no partnership liabilities are allocated to the interest. Under the Build Back Better Act, the abandonment or worthlessness of a partnership interest would generate a capital loss regardless of partnership liability allocations, effective for taxable years beginning after December 31, 2021. Taxpayers should consider an abandonment of a partnership interest in 2021 to be able to claim an ordinary deduction.
- Following enactment of the TCJA, deductibility of expenses incurred by investment funds are treated as "investment expenses"—and therefore are limited at the individual investor level—if the fund does not operate an active trade or business (i.e., if the fund's only activities are investment activities). To avoid the investment expense limitation, consideration should be given as to whether a particular fund's activities are so closely connected to the operations of its portfolio companies that the fund itself should be viewed as operating an active trade or business.
- Under current rules, gains allocated to carried interests in investment funds are treated as long-term capital gains only if the investment property has been held for more than three years. Investment funds should consider holding the property for more than three years prior to sale to qualify for reduced long-term capital gains rates. Although the Build Back Better Act currently does not propose changes to the carried interest rules, an earlier draft of the bill would have extended the current three-year property holding period to five years. Additionally, there are multiple bills in the Senate that, if enacted, would seek to tax all carry allocations at ordinary income rates.

- Under the Build Back Better Act, essentially all pass-through income of high-income owners that is not subject to self-employment tax would be subject to the 3.8% Net Investment Income Tax (NIIT). This means that pass-through income and gains on sales of assets allocable to partnership and S corporation owners would incur NIIT, even if the owner actively participates in the business. Additionally, taxpayers that currently utilize a state law limited partnership to avoid self-employment taxes on the distributive shares of active “limited partners” would instead be subject to the 3.8% NIIT. If enacted, this proposal would be effective for taxable years beginning after December 31, 2021. Taxpayers should consider accelerating income and planned dispositions of business assets into 2021 to avoid the possible additional tax.
- The Build Back Better Act proposes to modify the rules with respect to business interest expense incurred by partnerships and S corporations effective for taxable years beginning after December 31, 2022. Under the proposed bill, the Section 163(j) limitation with respect to business interest expense would be applied at the partner and S corporation shareholder level. Currently, the business interest expense limitation is applied at the entity level (also see *Maximize interest expense deductions*, above).
- Various states have enacted PTE tax elections that seek a workaround to the federal personal income tax limitation on the deduction of state taxes for individual owners of pass-through entities. See *State pass-through entity tax elections*, below.