ANDERSEN TAX

SENATE TAX REFORM PROPOSAL – PASS-THROUGH BUSINESSES

The following chart sets forth some of the provisions affecting pass-through businesses in the Senate's version of the Tax Cuts and Jobs Act, as approved by the Senate on December 2, 2017. This chart highlights only some of the key issues and is not intended to address all aspects of the proposed legislation. If you have any questions, please contact your Andersen Tax advisor.

As of December 2, 2017

PASS-THROUGH BUSINESSES		
Provision	**Description of Proposed Change**	**Comments**
23% Deduction to Certain Pass-through Income	An individual taxpayer would be allowed to deduct 23% of qualified business income from a partnership, S corporation, or sole proprietorship that is effectively connected with a U.S. trade or business. Qualified business income does not include reasonable compensation or guaranteed payment paid to the taxpayer for services. The amount of the deduction is generally limited to 50% of the taxpayer's allocable share of W-2 wages. The W-2 wage limit will not apply to a taxpayer with taxable income not exceeding $500,000 for married filing jointly (MFJ) taxpayers or $250,000 for all other individual taxpayers. The W-2 limit is then phased in over the next $100,000 of taxable income for MFJ taxpayers or $50,000 for all other individual taxpayers. The 23% deduction would generally not apply to specified service businesses, unless the taxpayer's taxable income is less than $500,000 for MFJ taxpayers or less than $250,000 for all other taxpayers. The benefit of the deduction for service businesses is then phased out over the next $100,000 of taxable income for MFJ taxpayers or $50,000 for all other taxpayers. The deduction does <u>not</u> apply to trusts and estates. The deduction would be effective for taxable years beginning after December 31, 2017. The deduction would expire after 2025.	In lieu of a change in tax rates, a deduction would be allowed for a portion of qualified business income from pass-through entities, similar to the present law domestic production activities deduction under Sec. 199. With a proposed top individual rate of 38.5%, this provision would approximate a top rate of 29.645% for qualifying income, which is substantially higher than the 25% special rate for qualifying pass-through businesses as proposed in the House bill. The limitation of the deduction to 50% of W-2 wages may be a significant limiter depending on the taxpayer's industry and structure. Also, service businesses would generally not receive any deduction once the $600,000 (MFJ) and $300,000 thresholds are surpassed and the deduction is phased out. The exclusion of trusts would limit many family held businesses from benefiting from the deduction. However, grantor trusts that are taxed as individuals would not be excluded. Dividends from a REIT will be considered qualified items of income. Qualified publicly traded partnership income is also qualified income, a clarification from the original Senate proposal.
Substantial Built-in Loss	For transfers of partnership interests and mandatory basis adjustments, the bill would expand the term "substantial built-in loss" to include the situation where the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical liquidation of the partnership. The proposal is effective for transfers of partnership interests after December 31, 2017.	By including a partner-level test, this will require mandatory downward basis adjustments in more situations than under present law.

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Limitation on Business Losses for Taxpayers Other than Corporations	After the application of the passive loss limitation regime under Sec. 469, excess business losses of a taxpayer (other than a C corporation) are deferred and carried forward as a part of the taxpayer's net operating loss (NOL) carryforward. NOL carryovers are limited to 90% of taxable income before NOLs. An excess business loss is the net business loss from all trades or businesses of the taxpayer, plus $500,000 (MFJ) or $250,000 (single). For trades or businesses that are partnerships or S corporations, the limitation applies at the partner or shareholder level, and excess business loss is determined by looking at the partner's allocable share or shareholder's pro rata share of items from the partnership or S corporation. This limitation would expire for taxable years beginning after December 31, 2025.	This rule is similar to the existing rule that limits passive losses, but it would apply to active business losses. Under this new rule, total net business losses could not offset non-trade or business income including portfolio income or compensation to the extent the loss exceeds the $500,000 or $250,000 threshold. However, because the disallowed loss becomes an NOL carryforward, it can be used in future years other than the year incurred to offset other income.
Basis Limitations on Partner Losses	The basis limitation for the deductibility of partner losses would now take into account the partner's distributive share of charitable contributions and foreign taxes. For purposes of charitable contributions of appreciated property, the limitation does not apply to the partner's distributive share of the excess of the fair market value of the contributed asset over its adjusted basis.	This rule would conform the treatment of charitable contributions and foreign taxes for partner's basis purposes to the treatment that applies to S corporation shareholders. Under the rule, if there is insufficient basis, the deductions are carried forward.
Tax Gain on Sale of Partnership Interest on Look-through Basis	Under the proposal, gain or loss from the sale or exchange of a partnership interest would be considered effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The proposal would require that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss. The proposal would also require the transferee of a partnership interest to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership would be required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold. The proposal provides the Secretary of the Treasury with specific regulatory authority to address coordination with the nonrecognition provisions of the Internal Revenue Code (the Code). The proposal is effective for sales and exchanges after December 31, 2017.	This proposal would overturn a recent Tax Court case (*Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017)) wherein the court declined to follow a controversial 1991 revenue ruling (Rev. Rul. 91-32). The proposal would also introduce a new withholding tax that would need to be considered when acquiring a partnership interest from a foreign partner.

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Carried Interest	With respect to a partnership interest transferred in connection with the performance of services by the taxpayer, the holding period for long-term capital gain treatment for underlying assets would be increased from more than one year to more than three years for gains generated after December 31, 2017.	Currently, taxpayers benefit from carried interest at long-term capital gain rates. This proposal would have a negligible impact to carried-interest holders in private equity firms, which tend to hold onto assets for a longer period of time, but may impact such holders in hedge funds or real estate depending on the turnover of the underlying assets and holding period. A more substantial carried interest proposal could arise through further amendments. This provision would require separate holding period tracking for gains allocated to partners who obtain partnership interests in connection with the performance of services.
S Corporations – Converting to C Corporations	If a corporation is an S corporation on the day before the law is enacted and converts to a C corporation by revocation during the following two years and has the same owners (and in identical proportions) on the date of enactment date and the date the S Corp election is revoked, then (1) any increase in tax due to a change in accounting methods attributable to the revocation is taken into account ratably over six years, and (2) cash distributions after the post-termination transition period are treated as coming proportionately from the accumulated adjustments account and from C corporation earnings and profits rather than first coming from the accumulated adjustment account and then earnings and profits.	
Expansion of Qualifying Beneficiaries of an Electing Small Business Trust (ESBT)	An ESBT would be allowed to have a nonresident alien individual as a potential current beneficiary.	This proposal may expand the use of ESBTs because a nonresident alien individual is not allowed to own the S corporation stock directly. An ESBT is treated as a separate trust and is taxed on the S corporation's income. However, taxpayers will have to use caution because a termination of the ESBT or distribution of the S corporation from the ESBT to the nonresident alien individual would cause a termination of the S corporation status.
Charitable Contribution Deduction for ESBT	The charitable contribution deduction of an ESBT will be determined by the rules applicable to individuals (instead of the rules applicable to trusts).	This proposal will require that the percentage limitations and carry-forward provisions applicable to individuals would apply to contributions made by the portion of an ESBT holding S corporation stock. The S portion of the ESBT will no longer be subject to the requirement that the charitable contribution be paid out of gross income.