

The following chart sets forth some of the provisions affecting pass-through businesses in the Tax Reform Act of 2017 (the Act). This chart highlights only some of the key issues and is not intended to address all aspects of the legislation. If you have any questions, please contact your Andersen Tax advisor.

PASS-THROUGH BUSINESSES		
Provision	Description of Change	Comments
20% Deduction to Certain Pass-through Income	<p>Individuals, trusts, and estates are allowed to deduct 20% 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 or income from a specified service trade or business or the trade or business of performing services as an employee.</p> <p>The amount of the deduction is generally limited to the greater of (i) 50% of the taxpayer's allocable share of W-2 wages or (ii) 25% of the taxpayer's allocable share of W-2 wages plus a capital element (the capital element is 2.5% of the original cost basis of depreciable tangible property used in the business in the current year and placed in service in the past 10 years (or at the end of the recovery period if the recovery period is longer than 10 years)).</p> <p>For example, taxpayer engages in a manufacturing business, operating as a sole proprietorship. The business purchases a machine to be used in its operations for \$100,000, which is placed into service in 2020. The business has no employees in 2020. The limitation is the greater of 50% of W-2 wages, or 0, OR the sum of 25% of W-2 wages (0) plus 2.5% of the unadjusted basis of the machine immediately after acquisition: $\\$100,000 \times 2.5\% = 2,500$. The amount of the limitation is \$2,500.</p> <p>The W-2 wage limit does not apply to small taxpayers with taxable income not exceeding \$315,000 for married filing jointly (MFJ) taxpayers or \$157,500 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.</p> <p>The 20% deduction generally does not apply to specified service businesses, unless the taxpayer's taxable income is below the small taxpayer thresholds (\$315,000/\$157,500). 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. A specified service trade or business includes performance of services in the fields of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, partnership interest, or commodities, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. Engineering and architecture are not included in the definition of specified services.</p> <p>The deduction is taken into account in determining taxable income, instead of being an above-the-line deduction to compute adjusted gross income. The deduction is also allowed for alternative minimum tax (AMT) purposes. Qualified business income is reduced in the current year by qualified business losses in determining the amount of the deduction. If the net amount is a loss, the loss is carried forward and reduces qualified business income in the future for purposes of computing the deduction in a future year.</p>	<p>In lieu of a change in tax rates, a deduction is allowed for a portion of qualified business income from pass-through entities, similar to the prior domestic production activities deduction under Sec. 199. With a top individual rate of 37%, this provision approximates a top rate of 29.6% for qualifying income.</p> <p>The limitation of the deduction to 50% of W-2 wages or 25% of W-2 plus capital element may be a significant limiter depending on the taxpayer's industry and structure. The addition of the capital element opens up the deduction to the real estate sector, which was largely excluded under the original Senate bill.</p> <p>Specified service businesses generally do not receive any deduction once the \$415,000 (MFJ) and \$207,500 thresholds are surpassed and the deduction is phased out. Further, only amounts in excess of reasonable compensation qualify.</p> <p>Unlike the Senate bill, the deduction applies to trusts and estates.</p> <p>Dividends from a REIT and qualified publicly traded partnership income are also qualified income, and are not subject to the wage/capital element.</p>

PASS-THROUGH BUSINESSES		
Provision	Description of Change	Comments
20% Deduction to Certain Pass-through Income (Cont.)	The deduction is effective for taxable years beginning after December 31, 2017. The deduction expires after 2025.	
Substantial Built-in Loss	For transfers of partnership interests and mandatory basis adjustments, the Act expands the term <i>substantial built-in loss</i> 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 provision 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 prior law.
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. Other provisions change the rules for NOL carryovers to limit NOL carryovers to 80% 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 expires for taxable years beginning after December 31, 2025.	This rule is similar to the existing rule that limits passive losses, but it applies 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 now takes 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 conforms 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.
Deemed Termination (i.e., Technical Termination) of a Partnership	The provision eliminates the tax technical termination rule that says if within a 12-month period there are sales or exchanges of interests in a partnership that equal or exceed 50% of the total interest in partnership profits and capital, then the partnership is deemed terminated for tax purposes. The provision applies to partnership taxable years beginning after December 31, 2017.	This hyper-technical rule could have served to reset the clock for depreciating a partnership's assets, which could lower the annual depreciation deduction and increase a partner's tax bill. The Act eliminates this trap for the unwary.
Tax Gain on Sale of Partnership Interest on Look-through Basis	Under the provision, gain or loss from the sale or exchange of a partnership interest is 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 provision requires 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 provision also requires 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 is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.	This provision overturns a recent Tax Court case (<i>Grecian Magnesite Mining v. Commissioner</i> , 149 T.C. No. 3 (July 13, 2017)) wherein the court declined to follow a controversial 1991 revenue ruling (Rev. Rul. 91-32). The provision also introduces a new withholding tax that needs to be considered when acquiring a partnership interest from a foreign partner.

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Tax Gain on Sale of Partnership Interest on Look-through Basis (Cont.)	The provision 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 provision regarding ECI is effective for sales and exchanges on or after November 27, 2017, and the provision regarding withholding is effective for sales and exchanges after December 31, 2017.	
Carried Interest	<p>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 is increased from more than one year to more than three years for gains generated after December 31, 2017.</p> <p>The provision clarifies that the three-year holding requirement applies notwithstanding the rules of Sec. 83 or any election in effect under Sec. 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a Sec. 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest.</p>	<p>Under pre-existing law, taxpayers benefit from carried interest at long-term capital gain rates. This provision has 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.</p> <p>This provision requires separate holding period tracking for gains allocated to partners who obtain partnership interests in connection with the performance of services.</p>
Income from Trade or Business of Partnership or S Corporation – Self Employment Income	No change.	
Contributions to Capital of an S corporation	This provisions retains the general rule that contributions to capital are not included in gross income of a corporation, but it provides that the term “contributions to capital” does not include (1) any contribution in aid of construction or any other contribution as a customer or potential customer, and (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).	The Act intends that Sec. 118, as modified, continues to apply only to corporations and does not apply to partnerships.
S Corporations – Converting to C Corporations	If a corporation was an S corporation on the day before the Act was 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) the adjustment 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.	

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Expansion of Qualifying Beneficiaries of an Electing Small Business Trust (ESBT)	<p>An ESBT is allowed to have a nonresident alien individual as a potential current beneficiary.</p> <p>This provision takes effect on January 1, 2018.</p>	<p>This provision 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.</p>
Charitable Contribution Deduction for ESBT	<p>The charitable contribution deduction of an ESBT will be determined by the rules applicable to individuals (instead of the rules applicable to trusts).</p> <p>This provision applies to taxable years beginning after December 31, 2017.</p>	<p>This provision requires that the percentage limitations and carry-forward provisions applicable to individuals 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.</p>

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