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The Path to Tax Reform 2017: Pass-through Entities

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*On Nov. 16, 2017, the House passed its tax reform bill, the Tax Cuts and Jobs Act (***"House Bill"***). The bill materially changes taxation of pass-through income from partnerships, LLCs taxed as partnerships and S corporations. On the same day, the Senate Finance Committee completed a conceptual markup of its own tax reform plan (***"Senate Plan"***) introduced two weeks ago.*

Pass-through Provisions

Reduced taxation of pass-through income

Although both the House Bill and the Senate Plan include measures which reduce the taxation of pass-through business income, they employ fundamentally different approaches. While the House Bill implements a reduced rate structure, the Senate Plan permits a partial deduction.

House Bill: The House Bill would limit the tax rate on the portion of an individual's pass-through profits attributable to capital or qualified business income (**QBI**) to a maximum rate of 25 percent (instead of the top rate of 39.6 percent otherwise applied). QBI includes (i) net income derived from passive business activities, plus (ii) the portion ("**capital percentage**") of net income derived from business activities in which the taxpayer materially participates. The remaining portion of active business income (the "**labor percentage**") would be subject to tax at applicable ordinary rates.

The House Bill provides for a safe harbor capital percentage of 30 percent. However, a taxpayer may elect to apply a higher capital percentage based upon a presumed rate of return on the adjusted basis of the assets used to conduct the trade or business.

Taxpayers earning less than $150,000 (for joint filers) of taxable income from a pass-through business would be eligible for a reduced rate of 9 percent (instead of the 12 percent rate otherwise applied) on QBI up to $75,000. The 9 percent rate would phase out as taxable income exceeds $150,000, and is fully phased out at $225,000.

Income from personal service activities, including those in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services and brokerage services, generally is not eligible for the reduced 25 percent, as the House Bill presumes their capital percentage to be zero. Personal service businesses shown to have a capital percentage of 10 percent or more, however, may elect to apply such percentage to calculate QBI.

Senate Plan: Instead of proposing reduced tax rates, the Senate Plan provides for a deduction of 17.5 percent of the pass-through entity's domestic QBI. QBI generally excludes income from specified service trades or businesses and amounts treated as reasonable compensation by an S corporation or guaranteed payments by partnerships. The deduction generally is limited to 50 percent of the taxpayer's share of the W-2 wages paid by the pass-through entity. Both the W-2 wage limitation and the exclusion for service businesses would not apply to taxpayers with taxable income that does not exceed $500,000 (married filing jointly) or $250,000 (other filers) and are phased in for taxable incomes in excess of those thresholds up to $600,000 (married filing joint) or $300,000 (other filers). The deduction would expire after Dec. 31, 2025.

Reduced corporate rate

House Bill: The House Bill would reduce the corporate tax rate to 20 percent. Distributions from S corporations that convert to C corporations within two years of enactment of the Tax Cuts and Jobs Act generally would be treated as paid from the corporation's accumulated adjustments account (amounts already passed through and taxed but not yet distributed) and from its earnings and profits (taxable as dividends) on a pro rata basis.

Senate Plan: The Senate Plan also would reduce the corporate tax rate to a flat 20 percent rate, but it does not address S corporation conversion issues.

Carried interest holding period

House Bill: The House Bill would increase to three years the holding period required for long-term capital gain treatment with respect to partnership interests held in connection with the performance of services. This would include carried interest, or the portion of an investment fund's profit paid to investment managers. This increased holding period appears to apply to both gain recognized upon a sale of the partnership interest by the taxpayer and gain allocated to the taxpayer from a sale of assets by the entity. Therefore, an affected partner would be required to hold its partnership interest for at least three years to obtain long-term capital gain treatment on the sale of such interest. In addition, affected partners who received allocations of capital gain in connection with a sale of assets by the partnership would be entitled to long-term treatment only if the partnership held the assets for at least three years prior to sale.

The new holding period rules would apply to partnership interests received (or held) by non-corporate taxpayers in connection with the performance of substantial services in connection with certain industries. The applicable industries include any trade or business related to (i) raising or returning capital or (ii) investing in (or disposing of) or developing specified assets, including securities, commodities, certain real estate, and cash or cash equivalents.

Senate Plan: The Senate Plan contains the same provision.

Repeal of technical termination

House Bill: Under current law, a sale or exchange of 50 percent or more of the total interest in partnership capital or profits within any 12-month period causes a partnership to terminate. The House Bill would repeal this rule, eliminating the need to file short-period returns due to such technical terminations. Therefore, notwithstanding a substantial change in ownership, a partnership would continue, retaining all tax attributes, accounting methods and elections, including any remaining cost recovery periods.

Senate Plan: Issue not addressed.

Transfer of partnership interests

House Bill: The House Bill is silent regarding any change to the taxation of the sale or exchange of a partnership interest.

Senate Plan: The Senate Plan would introduce new rules to treat the gain or loss from the sale or exchange of a partnership interest as effectively connected with a U.S. trade or business to the extent 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. Such provisions would prospectively overrule the Tax Court's decision in a recent case, *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017) (holding a foreign company's gain on the redemption of a U.S. partnership interest would not be effectively connected to a U.S. trade or business). Moreover, the Senate Plan would expand the definition of a substantial built-in loss as it affects transfers of partnership interests.

Provisions Affecting All Business Entities

Interest deductibility limitations

House Bill: The House Bill would limit the deduction for net interest expense of large business entities (including both corporate and pass-through entities) to 30 percent of the entity's adjusted taxable income (roughly, EBITDA). The limitation would not apply to floor plan financing interest (i.e., the interest paid or accrued on certain indebtedness used to finance the acquisition of motor vehicles held for sale to retail customers). The interest expense disallowance would be determined at the entity level, not at the ownership level. Special rules would apply to prevent double counting of entity income for purposes of calculating an owner's allowed interest expense deduction. Disallowed net interest expense would be carried forward to the succeeding five taxable years as an attribute of the entity, not its owners.

The interest limitation rules would not apply to an entity with average gross receipts of $25 million or less, certain regulated public utilities and certain real property trades or businesses.

Senate Plan: The Senate Plan would similarly limit the deduction for net interest expense to 30 percent of the business's adjusted taxable income (roughly EBIT plus any 17.4 percent deduction for pass-through income), without an exception for floor plan financing interest. Disallowed interest expense would be carried forward indefinitely. The Senate Plan would exclude certain regulated public utilities and real property trades or businesses from the interest limitation rules. The limitation would not apply to an entity with average gross receipts of $15 million or less. Certain farming businesses may elect out of the limitation.

Tax on foreign earnings

House Bill: As part of a transition to a territorial system, the House Bill imposes a deemed repatriation tax on foreign earnings either accumulated abroad or reinvested. The House Bill proposes to tax the foreign accumulated earnings held in cash or cash equivalents at 14 percent and the foreign reinvested earnings held in illiquid assets at 7 percent. Taxpayers would be able to elect to pay the resulting liability over an eight-year period.

A specific carve-out for S corporations would allow S corporation shareholders to elect to defer such deemed repatriation liabilities until either (i) the shareholder transferred stock in the S corporation or (ii) the S corporation ceased to exist, ceased doing business, liquidated, sold substantially all its assets or terminated its S corporation status.

Senate Plan: The Senate Plan includes the specific carve-out for S corporations but would tax cash or cash equivalents at 10 percent and illiquid assets at 5 percent. The resulting liability would be payable over eight years at the taxpayer's election. The statute of limitations for assessment would be extended to six years for such mandatory inclusions. Taxpayers may elect to preserve net operating losses (NOLs) and coordinate the interaction of NOLs, overall domestic losses and foreign tax credit carryforward rules upon transition to the new system.

Contributions to capital

House Bill: The House Bill would repeal the tax-free treatment of contributions to capital by nonshareholders to corporations and confirms that such treatment is not available to partnerships and limited liability companies. This provision is specifically directed at incentives and concessions offered by state and local governments to induce businesses to locate operations within their jurisdictions. The House Bill would generally require an entity to include such contributions in gross income. For contributions in exchange for ownership interests, however, the entity would not realize gross income to the extent the fair market value of money or other property contributed does not exceed the fair market value of the ownership interest (e.g., the stock or membership interest).

Separately, the House Bill would also repeal current rules regarding corporate debt contributed to capital, which avoid cancellation of indebtedness income to the extent of the shareholder's basis in the contributed debt. This change would require corporations to recognize cancellation of indebtedness income equal to the excess of the amount of the contributed debt over the fair market value of stock issued in exchange therefor.

Senate Plan: Issue not addressed.

Cash method of accounting

House Bill: The House Bill would expand the availability of the cash method of accounting. Corporations (including S corporations) and partnerships with a corporate partner with annual average gross receipts of $25 million (presently $5 million) or less may use the cash method. Additionally, such businesses would have to satisfy the threshold requirement for only a three-prior-taxable-year period rather than for all prior years as required under current law.

Furthermore, a business which does not exceed the $25 million threshold would be permitted to use the cash method of accounting even if it has inventories. Again, this is an expansion of current law, which generally requires small businesses with average gross receipts of more than $1 million (or $10 million in certain industries) to use an inventory method to account for inventories and the accrual method of accounting for tax purposes. In contrast, the proposed rules would allow a business with average gross receipts of up to $25 million that qualifies for and uses the cash method of accounting to account for its inventory using its method of accounting reflected on its financial statements or its books and records.

Senate Plan: The Senate Plan would increase the threshold to use the cash method of accounting, even if it has inventories, from $5 million to only $15 million.

Executive compensation

House Bill: The House Bill provides that the executive compensation rules under current Section 162(m) would apply to large private C or S corporations in addition to publicly traded entities. The proposal would retain the limitation for a $1 million per year corporate deduction for compensation paid or accrued regarding a "covered employee" but would eliminate certain exceptions.

Specifically, such corporations would no longer be permitted to deduct amounts in excess of $1 million for commissions or other performance-based compensation. Moreover, the proposed rules would revise the definition of "covered employee" to include the CEO, the CFO and the three other highest-paid employees, rather than the CEO and the four most highly

compensated officers. Further, an individual would be a covered employee if the individual is the CEO or CFO at any time during the year, and covered employees would remain covered employees for all future years.

Senate Plan: The Senate Plan generally proposes similar rules with a transition rule excluding from the proposed changes any remuneration paid pursuant to a written contract in effect on Nov. 2, 2017, that is not subsequently modified in any material respect.

Timing and Process

The Republicans are highly motivated to move quickly on tax reform, and the window for achieving tax reform will not be open for very long. The House passed its tax reform bill, and the markup process in the Senate Finance Committee is complete. The Senate is expected to pass its bill shortly after Thanksgiving. Depending on how long it takes to get a unified bill through conference committee, Congress could be in a position to pass tax reform before year-end. Tax reform requires only 51 votes in the Senate because this legislation is proceeding under the budget reconciliation process.

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Sen. Roy Blunt (R-MO) at BakerHostetler's 28th Annual Legislative Seminar on April 26, 2017.

Rep. Peter Roskam (R-Ill.), chairman of the House Ways and Means Subcommittee on Tax Policy, talks tax reform at BakerHostetler's 28th Annual Legislative Seminar on April 26, 2017.

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