STRADLEY RONON

Tax Insights

A Publication of the Stradley Ronon
Tax Practice Group

WWW.STRADLEY.COM

NOVEMBER 15, 2017

U.S. Senate Releases Tax Reform Proposal

On Nov. 9, the U.S. Senate Committee on Finance revealed its version of the Tax Cuts and Jobs Act (the Act) (and released a modification of the Act late last night). A summary of the policy highlights of the Act can be found here (https://www.finance.senate.gov/imo/media/doc/11.9.17%20Policy%20Highlights.pdf), and a description of the Act prepared by the Staff of the Joint Committee on Taxation can be found here (https://www.finance.senate.gov/imo/media/doc/11.9.17%20Chairman's%20Mark.pdf) (and a description of the Chairman's modification here (https://www.jct.gov/publications.html?func=startdown&id=5037)). Last week we summarized portions of the U.S. House of Representatives' version of the Act (see our prior coverage here (http://www.stradley.com/insights/publications/2017/11/tax-insights-november-8-2017)).

Major sections of the Senate version of the Act are described below:

Individual taxes

- The House version of the Act proposes four tax rates, while the Senate version maintains the current seven tax rates, but it changes the brackets at which certain rates apply and reduces the top marginal rate of tax to 38.5 percent – down from 39.6 percent under current law.
- The standard deduction would be increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers and $12,000 for all other taxpayers.
- Like the House version of the Act, the Senate version proposes to repeal the deduction for personal exemptions.
- The Senate version reduces the individual shared responsibility payment under the Affordable Care Act to zero (effective with respect to health coverage status for months beginning after Dec. 31, 2018).
- Unlike the House version of the Act – which proposes to tax a portion of net income distributed by a pass-through entity, e.g., a partnership, to an owner or shareholder as business income subject to a maximum rate of 25 percent – the Senate version proposes to allow an individual taxpayer to deduct 17.4 percent of qualified business income from a pass-through entity generally limited to 50 percent of the taxpayer's allocable or pro rata share of W-2 wages of the partnership or S corporation or 50 percent of the W-2 wages of the sole proprietorship. Like the House version of the Act, the Senate version proposes that individuals engaged in the practice of law, accounting, health care, etc., through a pass-through entity would not be eligible for the deduction.
- In the case of an individual, the Senate version allows state, local and foreign property taxes and state and local sales taxes as deductions only when paid or accrued in carrying on a trade or business or an activity described in Section 212 (relating to expenses for the production of income). This differs from the House version, which would allow the state and local tax deduction limited to real property taxes paid up to $10,000. (Section references are to the Internal Revenue Code of 1986, as amended (the Code)).
- The Act proposes the complete repeal of the deduction for interest on home equity indebtedness. Unlike the House version, the Senate proposal maintains the deduction for interest paid on newly purchased homes for mortgages up to $1 million, the same as under current law.
- The Act proposes the complete repeal of all miscellaneous itemized deductions that are subject to the 2 percent floor under present law.
- The income-based percentage limit described in Section 170(b)(1)(A) for certain charitable contributions by an individual taxpayer of cash to public charities and certain other

Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware

Christopher C. Scarpa

Kristin M. McKenna

www.meritas.org

Our firm is a member of Meritas – a worldwide business alliance of more than 180 law offices in 86 countries, offering high-quality legal services through a closely integrated group of independent, full-service law firms.

Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. The enclosed materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of clients and others who may be interested in the subject matter.

Copyright © 2017
Stradley Ronon Stevens & Young, LLP
All rights reserved.

organizations is increased from 50 percent to 60 percent.
- The overall limitation on itemized deductions (i.e., the phaseout of itemized deductions for taxpayers over a certain level of income) is repealed.
- The length of time a taxpayer must own and use a residence to qualify for the exclusion of gain from sale of a principal residence is extended. Specifically, under the proposal, the exclusion is available only if the taxpayer has owned and used the residence as a principal residence for at least five of the eight years ending on the date of the sale or exchange.

Estate and generation-skipping transfer taxes

- Unlike the House version of the Act – which would, beginning in 2023, repeal the estate and generation-skipping transfer taxes – the Senate proposal doubles the estate and gift tax exemption amount by increasing the basic exclusion amount from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011.

Alternative minimum tax

- Like the House, the Senate proposes to repeal the alternative minimum tax.

Business taxes

- Like the House, the Senate proposes that the four-tier corporate tax rate would become a flat 20 percent rate, but the Senate version of the Act proposes to implement the rate beginning in tax years after Dec. 31, 2018 (the House proposal makes the rate effective next year).
- Small businesses will see the expensing limitation under Section 179 increased to $1 million and the phaseout amount increased to $2.5 million – lower thresholds than those proposed by the House.
- The Senate, unlike the House, does not propose to eliminate the rehabilitation tax credit or the new markets tax credit. With respect to the rehabilitation tax credit, the 10 percent credit for pre-1936 buildings is repealed and a 10 percent credit (not 20 percent as under current law) is permitted for qualified rehabilitation expenditures with respect to a certified historic structure.
- Under current law, the deduction for business interest generally is not limited. Under the Senate plan, like the House plan, net interest is limited to 30 percent of modified taxable income.
- Real property (nonresidential and residential rental property) has its depreciable life reduced to 30 years, down from 39 years under current law.
- The Act permits taxpayers to fully and immediately expense 100 percent of the cost of qualified property acquired and placed in service through 2022.
- Like the House proposal, the Senate version of the Act permits taxpayers to deduct a net operating loss carryover or carryback only to the extent of 90 percent of the taxpayer's taxable income.
- The Act limits the like-kind exchange rules, making them applicable only to real property that is not held primarily for sale.
- The cost of any specified security sold, exchanged, or otherwise disposed of on or after Jan. 1, 2018, will be determined on a first-in, first-out basis except to the extent the average basis method is otherwise allowed (as in the case of shares of a regulated investment company (RIC)). The provision would apply to sales of portfolio securities by a fund taxed as a RIC.

Partnerships

- Gain or loss from the sale or exchange of a partnership interest is 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. Any gain or loss from the hypothetical asset sale by the partnership would be allocated to interests in the partnership in the same manner as non-separately stated income and loss. Also, the transferee of a partnership interest would be required to withhold 10 percent 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.
- The definition of a "substantial built-in loss" for purposes of Section 743(d), affecting transfers of partnership interests, is modified. In addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.
- The basis limitation on partner losses is modified to provide that a partner's distributive share of items that are not deductible in computing the partnership's taxable income, and not properly chargeable to capital account, are allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership taxable year in which the expenditure occurs. Thus, the basis limitation on partner losses applies to a partner's distributive share of charitable contributions and foreign taxes.

Taxation of foreign income and foreign persons

- Similar to the House proposal, the Senate proposal includes an exemption for certain foreign income by means of a 100 percent deduction for the foreign-source portion of dividends received from "specified 10 percent owned foreign corporations" by domestic corporations that are U.S. shareholders of those foreign corporations within the meaning of Section 951(b) (DRD). The DRD would not be available for any amount received from a controlled foreign corporation for which a deduction would be allowed under this proposal and for which the specified 10 percent owned foreign corporation received a deduction (or other tax

© 2017 Stradley Ronon Stevens & Young, LLP

benefit) from taxes imposed by a foreign country. Further, the DRD would not be available with respect to any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the DRD.

- Also similar to the House proposal, the Senate proposal generally requires that, for the last taxable year beginning before 2018, any U.S. shareholder of a "specified foreign corporation" must include in income its pro rata share of the undistributed, not previously taxed post-1986 foreign earnings of the corporation (mandatory inclusion). For purposes of this proposal, a specified foreign corporation is any foreign corporation that has at least one U.S. shareholder. It does not include passive foreign investment companies that are not also controlled foreign corporations (CFCs). U.S. shareholders with accumulated deferred foreign income may deduct a portion of the mandatory inclusion in an amount that depends upon the proportion of aggregate earnings and profits attributable to cash assets rather than noncash assets. A U.S. shareholder may deduct as much of the aggregate earnings and profits attributable to cash assets as is necessary to result in a tax rate of 10 percent for such inclusion (compared with 12 percent in the House version). For the remainder of the deferred income in the mandatory inclusion, the U.S. shareholder may deduct an amount sufficient to result in a tax rate of 5 percent with respect to such income. At the election of the taxpayer, the increased tax liability generally may be paid over an eight-year period; the payments for each of the first five years equal 8 percent of the net tax liability, 15 percent in the sixth year, 20 percent in the seventh year and 25 percent in the eighth year (compared with an equal 12.5 percent over the eight years in the House proposal). The proposal denies any deduction claimed with respect to the mandatory inclusion and imposes a tax rate of 35 percent on the entire inclusion if a U.S. shareholder becomes an expatriated entity within the meaning of Section 7874(a)(2) at any point within the 10-year period following enactment of the proposal.
- A U.S. shareholder of any CFC must include in gross income for a taxable year its global intangible low-taxed income (GILTI) in a manner generally similar to inclusions of Subpart F income. In general, the GILTI amount included in gross income is treated in the same manner as an amount included under Section 951(a)(1)(A) for purposes of applying certain sections of the Code. The proposal requires that the amount of GILTI included by a U.S. shareholder be allocated across each CFC with respect to which it is a U.S. shareholder. For any amount of GILTI included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign income taxes equal to 80 percent of the product of the corporation's inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued, with respect to "tested income," by each CFC with respect to which the domestic corporation is a U.S. shareholder. In the case of a domestic corporation for its taxable year, the proposal allows a deduction equal to 37.5 percent of the lesser of (1) the sum of its foreign-derived intangible income plus the amount of GILTI that is included in its gross income, or (2) its taxable income, determined without regard to the proposal (the 37.5 percent deduction is reduced to 21.875 percent for taxable years beginning after Dec. 31, 2025).
- Similar to the House proposal, the Senate proposal also modifies the constructive ownership rules for purposes of the CFC rules to provide that a U.S. corporation would be treated as constructively owning stock held by its foreign shareholder. Additionally, a U.S. parent would be subject to current U.S. tax on the CFC's Subpart F income even if the U.S. parent does not own stock in the CFC for an uninterrupted period of 30 days or more during the year.
- The requirement in Subpart F that U.S. shareholders recognize income when earnings are repatriated in the form of increases in investment by a CFC in U.S. property would be amended to provide an exception for domestic corporations that are U.S. shareholders in the CFC either directly or through a domestic partnership.
- The proposal addresses base erosion that results from excessive and disproportionate borrowing in the United States by limiting the deductibility of interest paid or accrued by U.S. corporations that are members of a worldwide affiliated group. For any domestic corporation that is a member of a worldwide affiliated group, the proposal reduces the deduction for interest paid or accrued by the corporation by the product of the net interest expense of the domestic corporation multiplied by the debt-to-equity differential percentage of the worldwide affiliated group. Net interest expense means the excess (if any) of (1) interest paid or accrued by the taxpayer during the taxable year, over (2) the amount of interest includible in the gross income of the taxpayer for the taxable year.
- The proposal addresses recurring definitional and methodological issues that have arisen in controversies in transfers of intangible property for purposes of Sections 367(d) and 482, both of which use the statutory definition of intangible property in Section 936(h)(3)(B). The proposal revises that definition and confirms the authority of the IRS to require certain valuation methods. However, it does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property.
- Under the proposal, a taxpayer (1) which is a corporation other than a regulated investment company, a real estate investment trust or an S corporation; (2) which has average annual gross receipts of at least $500 million for the three-taxable-year period ending with the preceding taxable year; and (3) which has a "base erosion percentage" of 4 percent or higher for the taxable year is required to pay a tax equal to the "base erosion minimum tax amount" for the taxable year. The base erosion minimum tax amount means, with respect to an applicable taxpayer for any taxable year, the excess of

© 2017 Stradley Ronon Stevens & Young, LLP

10 percent of the "modified taxable income" of the taxpayer for the taxable year over an amount equal to the regular tax liability (defined in Section 26(b)) of the taxpayer for the taxable year reduced (but not below zero) by the excess (if any) of credits allowed under Chapter 1 over the credit allowed under Section 38 (general business credits) for the taxable year allocable to the research credit under Section 41(a) (the 10 percent rate is increased to 12.5 percent for taxable years beginning after Dec. 31, 2025).

Tax-exempt organizations

- Similar to the House version, the Senate version proposes the imposition of a 1.4 percent excise tax on the net investment income of private colleges and universities that have at least 500 students and assets (other than those used directly in carrying out the institution's educational purposes) valued at the close of the preceding tax year of at least $250,000 per full-time student. State colleges and universities would not be subject to the extension of the tax.
- Unlike the House, the Senate does not propose the repeal of interest on newly issued "qualified 501(c)(3) bonds," such as those that benefit 501(c)(3) organizations like colleges and universities, but the exclusion for interest on a bond issued to advance-refund another bond would be repealed.
- An employer is liable for an excise tax equal to 20 percent of the sum of (1) the remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a taxable year, and (2) any excess parachute payment (under a new definition for this purpose that relates solely to separation pay) paid by certain tax-exempt organizations to a covered employee. Accordingly, the excise tax applies as a result of an excess parachute payment, even if the covered employee's remuneration does not exceed $1 million.
- Royalty income derived from a tax-exempt organization licensing its name or logo generally would be subject to the unrelated business income tax.
- For an organization with more than one unrelated trade or business, unrelated business taxable income is first computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under Section 512(b)(12). The organization's unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under Section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose. The result is that a deduction from one trade or business for a taxable year cannot be used to offset income from a different unrelated trade or business for the same taxable year.
- The tax exemption for professional sports leagues is repealed.
- Under the intermediate sanctions rules, applicable tax-exempt organizations would be subject to an excise tax equal to 10 percent of the excess benefit, unless the participation of the organization in the transaction is not willful and is due to reasonable cause where an initial tax is imposed on a disqualified person. No tax on the organization is imposed if the organization (1) establishes that the minimum standards of due diligence (described below) were met with respect to the transaction, or (2) establishes to the satisfaction of the IRS that other reasonable procedures were used to ensure that no excess benefit was provided.
- The rebuttable presumption of reasonableness under the intermediate sanctions rules is eliminated and due diligence procedures are established. The procedures that presently provide an organization with a presumption of reasonableness (i.e., advance approval by an authorized body, reliance upon data as to comparability, and adequate and concurrent documentation) generally will establish instead that an organization has performed the minimum standards of due diligence with respect to an arrangement or transfer involving a disqualified person. Satisfaction of these minimum standards, however, will not result in a presumption of reasonableness with respect to the transaction.
- The intermediate sanctions rules are extended to Section 501(c)(5) labor organizations and Section 501(c)(6) trade associations.
- No charitable deduction is allowed for any payment to an institution of higher education in exchange for which the payer receives the right to purchase tickets or seating at an athletic event.
- The Act creates an exception to the excess business holdings rules for certain philanthropic business holdings which include business enterprises that distribute all profits to charity and that are independent of the private foundation.

Joint Committee on Taxation Releases Summary of House's Tax Reform Proposal

The Joint Committee on Taxation released a description (JCX-50-17 (https://www.jct.gov/publications.html?func=startdown&id=5031)) Nov. 3 of H.R. 1, the U.S. House of Representative's version of the Tax Cuts and Jobs Act.

House Releases Amendments to Tax Reform Proposal Including Amendment on Carried Interests

A substitute amendment (https://www.congress.gov/115/bills/hr1/BILLS-115hr1rh.pdf) introduced by House Ways and Means Committee Chair Kevin Brady, R-Texas, to H.R. 1 would modify the bill's provisions regarding the employer-provided dependent care exclusion, the earned income credit, international base erosion rules, stock options and carried interest, among others. Under the amendment, the carried-interest tax break would be limited by tripling the length of time assets would have to be held in order to qualify for the capital gains tax rate. Under current law, an investment fund's assets must be held for a year or more to qualify.

© 2017 Stradley Ronon Stevens & Young, LLP