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Tax Insights

A Publication of the Stradley Ronon
Tax Practice Group

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DECEMBER 20, 2017

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Final Tax Reform Bill Approved by Congress – Awaits President's Signature

Late Dec. 15, Republicans released the revised Tax Cuts and Job Act (Act) (https://www.congress.gov/115/bills/hr1/BILLS-115hr1eas2.pdf) along with the conference committee report (https://www.gpo.gov/fdsys/pkg/CRPT-115hrpt466/pdf/CRPT-115hrpt466.pdf) (the conference committee report accompanied the original version of the Act released on Dec. 15 before it was revised on Dec. 20). The Act primarily follows the Senate proposal, but many revisions reflect negotiations and deals among the House and Senate members of the conference committee to win the support of fellow Republicans. Today, the Senate and the House voted to approve the revised Act. It is unclear at this time when President Trump will sign the Act, as the "pay as you go" budget rule could impact certain government programs depending on whether it is signed this year or next year.

A brief summary of certain provision in the Act are included below:

Individual taxes

- Seven tax rates for married individuals filing jointly: 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent and 37 percent, reducing the top marginal rate of tax from 39.6 percent under current law; the provision sunsets for taxable years beginning after Dec. 31, 2025.

- 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.

- The deduction for personal exemptions is repealed, subject to a sunset for taxable years beginning after Dec. 31, 2025.

- The individual shared-responsibility payment under the Affordable Care Act would be reduced to zero (effective with respect to health coverage status for months beginning after Dec. 31, 2018).

- For taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026, an individual taxpayer generally may deduct 20 percent of qualified business income from a sole proprietorship and a pass-through entity, e.g., a partnership or an S corporation, as well as 20 percent of aggregate qualified REIT dividends, qualified cooperative dividends and qualified publicly traded partnership income. The deduction is generally limited to the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business or (b) the sum of 25 of percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. Individuals engaged in the practice of law, accounting, health care, etc., through a pass-through entity might be eligible for the deduction depending on the individual's level of qualified business income related to one of the foregoing professions. However, individuals engaged in providing engineering and architecture services may qualify for the deduction in full.

- In the case of an individual, state, local and foreign property taxes and state and local sales taxes are allowed as deductions only when they are 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). However, a taxpayer may claim an itemized deduction of up to $10,000 for state and local property taxes and state and local income, war profits and excess profits taxes (or sales taxes). This provision sunsets for taxable years beginning after Dec. 31, 2025. (Section references are to the Internal Revenue Code of 1986, as amended (the Code)).

- For purposes of the home mortgage deduction, in the case of taxable years beginning after Dec. 31, 2017, and beginning before Jan. 1, 2026, a taxpayer may treat no more than $750,000 as acquisition indebtedness. In the case of acquisition indebtedness incurred before Dec. 15, 2017, this limitation remains $1 million. For taxable years beginning after Dec. 31, 2025, a taxpayer may treat up to $1 million of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred. Additionally, the deduction for interest on home equity indebtedness is suspended, subject to a sunset for taxable years beginning after Dec. 31, 2025.

- The Act would completely repeal 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 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, subject to a sunset for taxable years beginning after Dec. 31, 2025.

- The Act no longer includes an extension of 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.

Estate and generation-skipping transfer taxes

- The estate and gift tax exemption amount would be doubled by increasing the basic exclusion amount from $5 million to $10 million. The $10 million amount is indexed for inflation after 2011.

Alternative minimum tax

- The Act would temporarily increase both the exemption amount (to $109,400 for married taxpayers filing a joint return) and the exemption amount phaseout thresholds (to $1 million for married taxpayers filing a joint return) for the individual AMT. These amounts are indexed for inflation.

- The Act repeals the corporate alternative minimum tax.

Business taxes

- The corporate tax rate would become a flat 21 percent rate, effective for taxable years beginning after Dec. 31, 2017.

- Small businesses will see the expensing limitation under Section 179 increased to $1 million and the phaseout amount increased to $2.5 million.

- With respect to the rehabilitation tax credit, the 10 percent credit for pre-1936 buildings is repealed, and the 20 percent credit as permitted under current law for qualified rehabilitation expenditures with respect to a certified historic structure is maintained; however, the 20 percent credit must be claimed ratably over a five-year period beginning in the taxable year in which a qualified rehabilitated structure is placed in service.

- The new markets tax credit remains unchanged (despite a proposal by the House to terminate the credit).

- The deduction for business interest would be 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, except for general MACRS recovery periods.

- The Act permits taxpayers to fully and immediately expense 100 percent of the cost of qualified property acquired and placed in service through 2022.

- Taxpayers may deduct a net operating loss only to the extent of 80 percent of the taxpayer's taxable income for losses arising in taxable years beginning after Dec. 31, 2017.

- The Act limits the like-kind exchange rules, making them applicable only to real property that is not held primarily for sale.

- The Act modifies Section 118 such 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 repeals the exclusion from gross income for interest on a bond issued to advance refund another bond and the authority to issue tax-credit bonds and direct-pay bonds.

- The Senate proposal to change the cost basis method of certain taxpayers to first in, first out was not included in the Act.

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 immediately after the transfer of the partnership interest, 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.

- 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 are 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

- The Act 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) (dividends-received deduction or DRD). The DRD would not be available for any amount received from a controlled foreign corporation for which a deduction would be allowed under the Act and for which the specified 10 percent-owned foreign corporation received a deduction (or other tax benefit) with respect to any income, war profits and excess profits 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 fewer 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. The DRD is available only to C corporations that are not RICs or REITs. No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the DRD.

- The Act 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). This provision applies to all foreign corporations (other than PFICs), rather than only CFCs and those corporations within the definition of Section 902 corporation, in which a U.S. person owns a 10 percent voting interest. However, in the case of a foreign corporation that is not a CFC, there must be at least one U.S. shareholder that is a domestic corporation in order for the foreign corporation to be a specified foreign corporation. U.S. shareholders with accumulated deferred foreign income may deduct a portion of the mandatory inclusion in an amount based on the rate equivalent percentage method used in the House bill. As a result, the total deduction from the amount of the Section 951 inclusion is the amount necessary to result in a 15.5 percent rate of tax on accumulated post-1986 foreign earnings held in the form of cash or cash equivalents and an 8 percent rate of tax on all other earnings. 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. The Act 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 Act allows a deduction equal to 37.5 percent of the sum of its foreign-derived intangible income plus 50 percent of the amount of its GILTI that is included in its gross income. If the sum exceeds its taxable income determined without regard to this provision, then the amount of FDII and GILTI for which a deduction is allowed is reduced by an amount determined by the excess (the 37.5 percent deduction is reduced to 21.875 percent for taxable years beginning after Dec. 31, 2025). The deduction for FDII and GILTI is available only to C corporations that are not RICs or REITs.

- The Act 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 Act does not include a provision for the modification of Subpart F inclusion for increased investment in U.S. property nor for the limitation on deduction of interest by domestic corporations that are members of an international group (despite such proposals by the House and Senate).

- The Act 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 Act 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 Act, a taxpayer (1) that is a corporation other than a RIC, a REIT or an S corporation; (2) that has average annual gross receipts of at least $500 million for the three-taxable-year period ending with the preceding taxable year; and (3) that 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 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 against such regular tax liability over the sum of (1) the credit allowed under Section 38 for the taxable year that is properly allocable to the research credit determined under Section 41(a), plus (2) the portion of the applicable Section 38 credits not in excess of 80 percent of the lesser of the amount of such credits or the base erosion minimum tax amount (determined without regard to this clause (2)) (for taxable years beginning after Dec. 31, 2025, the 10 percent rate is increased to 12.5 percent and the regular tax liability is reduced by the aggregate amount of the credits allowed under Chapter 1 (and no other adjustment is made)).

Tax-exempt organizations

- A 1.4 percent excise tax on the net investment income of private colleges and universities that have at least 500 students more than 50 percent of which are located in the United States 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 $500,000 per full-time student. State colleges and universities would not be subject to the extension of the tax.

- The Act does not repeal interest on newly issued "qualified 501(c)(3) bonds," such as those that benefit 501(c)(3) organizations (e.g., colleges and universities) but the exclusion for interest on a bond issued to advance refund another bond is repealed.

- The Act does not permit Section 501(c)(3) organizations to engage in electioneering.

- An employer is liable for an excise tax equal to 21 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. For purposes of determining a covered employee, remuneration paid to a licensed medical professional that is directly related to the performance of medical or veterinary services is not taken into account, but remuneration paid to such a professional in any other capacity is taken into account.

- 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.

- 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.

IRS Revises Notice 2017-71 Providing Additional Relief

Notice 2017-71 (https://www.irs.gov/pub/irs-irbs/irb17-51.pdf) amplifies, clarifies and supersedes Notice 2017-47 by providing that additional acts – such as the making of various elections – of partnerships, REMICs and certain other entities made by the date that would have been timely prior to amendment by the Surface Transportation Act will be treated as timely. An earlier release of Notice 2017-71 provided this relief only to taxpayers whose taxable years began and ended in 2016, but the IRS updated the Notice so that the relief also applies to fiscal-year filers whose taxable years began in 2016 but did not end until 2017.

IRS Releases Several Practice Units

The IRS released the following practice units:

- Calculation of the IRC 956 Inclusion (https://www.irs.gov/pub/irs-utl/rpa_p_04_01_03_01.pdf), including a determination of the amount of investment in U.S. property.

- Calculation of initial stock basis (https://www.irs.gov/pub/int_practice_units/sco_c_53_04_01_01_01r.pdf) (partially redacted).

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