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House Releases the Tax Cuts and Jobs Act

On Nov. 1, Rep. Kevin Brady, R-Texas, introduced H.R. 1, the Tax Cuts and Jobs Act (the Act) (https://www.congress.gov/115/bills/hr1/BILLS-115hr1ih.pdf). The Act is a substantial tax reform plan that proposes sweeping changes to individual and corporate tax rates and to itemized and business deductions. It also proposes the repeal of the alternative minimum tax and the estate tax, and moves the U.S. to a territorial tax system for taxing foreign income. The Senate is also expected to release its own tax reform package shortly.

The Section-by-Section Summary prepared by the House Ways and Means Committee is available here (https://s3.amazonaws.com/pdfs.taxnotes.com/2017/2017-93904_TNTDocs-TaxRefSecbySec.pdf). The Estimated Revenue Effects of the Act is available here (https://www.jct.gov/publications.html?func=startdown&id=5026). Section references are to the Internal Revenue Code of 1986, as amended (Code).

Major sections of the Act are described below:

Individual taxes

- The current seven tax brackets are simplified into four brackets: 12 percent, 25 percent, 35 percent and 39.6 percent.
- The standard deduction would be increased from $12,700 (for married individuals filing jointly) to $24,000 ($6,350 for single individuals increased to $12,000).
- The deduction for personal exemptions and personal casualty losses would be repealed.
- A portion of net income distributed by a pass-through entity, e.g., a partnership, to an owner or shareholder may be treated as business income subject to a maximum rate of 25 percent instead of ordinary individual income tax rates. Pass-through entities such as law firms, accounting firms, and other professional services firms would not qualify under the provision.
- For debt incurred after Nov. 2, the mortgage interest deduction will be permitted only on debt up to $500,000 and only interest on a taxpayer's principal residence will be deductible.
- The state and local tax deduction will be limited to real property taxes paid up to $10,000. State and local government income taxes and state and local government sales taxes will no longer be deductible.

Estate and generation-skipping transfer taxes

- The basic exclusion amount for estate taxes is increased from $5 million to $10 million and, beginning in 2023, the estate and generation-skipping transfer taxes are repealed.

Alternative minimum tax

- The alternative minimum tax (AMT) would be repealed. A taxpayer that has AMT credit carryforwards may claim a refund of 50 percent of the remaining credits in tax years beginning in 2019, 2020 and 2021. All remaining credits could be claimed in 2022.

Business taxes

- The four-tier corporate tax rate would become a flat 20 percent rate. Personal service corporations would be subject to a flat 25 percent rate.
- Taxpayers may fully and immediately expense 100 percent of the cost of qualified property acquired and placed in service after Sept. 27 and before Jan. 1, 2023.
- Small businesses will see the expensing limitation under Section 179 increased to $5 million

and the phaseout amount increased to $20 million; greater access to the cash method of accounting, other simplified accounting method rules and the exemption from computing uniform capitalization rules; and an exemption from the interest limitation rules.

- Taxpayers would be able to deduct a net operating loss (NOL) carryover or carryback only to the extent of 90 percent of the taxpayer's taxable income (determined without regard to the NOL deduction). All carrybacks are generally repealed but for a special one-year carryback for small businesses and farms.
- The rehabilitation credit, work opportunity tax credit and unused business credits are repealed, and the new market tax credit will be terminated.

Taxation of foreign income and foreign persons

- The current system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are distributed would be replaced with a dividend-exemption system, which would exempt from U.S. taxation 100 percent of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10 percent or more of the foreign corporation. No foreign tax credit or deduction would be allowed for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend, and no deductions for expenses properly allocable to an exempt dividend (or stock that gives rise to exempt dividends) would be taken into account for purposes of determining the U.S. corporate shareholder's foreign-source income.
- No foreign tax credit or deduction would be allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend to which the dividend exemption described above would apply. A foreign tax credit would be allowed for any Subpart F income that is included in the income of the U.S. shareholder on a current year basis, without regard to pools of foreign earnings kept abroad.
- The imposition of current U.S. tax on U.S. corporate shareholders with respect to untaxed foreign subsidiary earnings reinvested in U.S. property would be repealed.
- U.S. shareholders owning at least 10 percent of a foreign subsidiary, generally, would include in income for the subsidiary's last tax year beginning before 2018 the shareholder's pro rata share of the net post-1986 historical earnings and profits (E&P) of the foreign subsidiary to the extent such E&P has not been previously subject to U.S. tax, determined as of Nov. 2, or Dec. 31 (whichever figure is higher). The E&P would be classified as either E&P that has been retained in the form of cash or cash equivalents or E&P that has been reinvested in the foreign subsidiary's business (e.g., property, plant and equipment). The portion of the E&P comprising cash or cash equivalents would be taxed at a reduced rate of 12 percent, while any remaining E&P would be taxed at a reduced rate of 5 percent. Foreign tax credit carryforwards would be fully available, and foreign tax credits triggered by the deemed repatriation would be partially available, to offset the U.S. tax. At the election of the U.S. shareholder, the tax liability would be payable over a period of up to eight years, in equal annual installments of 12.5 percent of the total tax liability due.
- For purposes of the controlled foreign corporation (CFC) rules, 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.
- A U.S. parent of one or more foreign subsidiaries would be subject to current U.S. tax on 50 percent of the U.S. parent's foreign high returns. Foreign high returns would be measured as the excess of the U.S. parent's foreign subsidiaries' aggregate net income over a routine return (7 percent plus the federal short-term rate) on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense. Foreign high returns would not include income effectively connected with a U.S. trade or business, Subpart F income, insurance and financing income that meets the requirements for the active finance exemption from Subpart F income under current law, income from the disposition of commodities produced or extracted by the taxpayer, or certain related-party payments. As with Subpart F income, the U.S. parent would be taxed on foreign high returns each year, regardless of whether it left those earnings offshore or repatriated the earnings to the U.S.

Exempt organizations

- A 501(c)(3) tax-exempt entity would no longer be prohibited from electioneering (i.e., "participating in, or intervening in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office"). For the provision to apply, the speech must be in the ordinary course of the organization's business and its expenses relating to the activity must be de minimis.
- Interest on newly issued private activity bonds would be included in income and thus subject to tax. Interest on bonds issued by state and local governments would continue to be exempt from federal income tax. Private activity bonds include "qualified 501(c)(3) bonds," such as those that benefit 501(c)(3) organizations such as colleges and universities, hospitals and health care institutions, and other educational organizations.
- Although the Act does not limit the charitable contribution deduction, it doubles the standard deduction and does not make the charitable contribution deduction an "above the line" deduction (i.e., a deduction that a taxpayer can subtract from his or her gross income to arrive at the taxpayer's "adjusted gross income"). The Act proposes other changes to the charitable contribution rules as follows: (a) the 50 percent limitation for cash contributions to public charities and certain private foundations would be increased to 60 percent; (b) the special rule that provides a charitable

deduction of 80 percent of the amount paid for the right to purchase tickets for athletic events would be repealed; (c) the amount deductible per mile driven in service to a charitable organization would be adjustable for inflation; and (d) the exception that relieves a taxpayer from providing a contemporaneous written acknowledgment by the donee organization for contributions of $250 or more when the donee organization files a return with the required information would be repealed.

- A tax-exempt organization would be subject to a 20 percent excise tax on compensation in excess of $1 million paid to any of its five highest-paid employees for the tax year (a "covered person"). The excise tax would apply to all remuneration paid to a covered person for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, except for payments to a tax-qualified retirement plan, and amounts that are excludable from the executive's gross income.
- All entities exempt from tax under Section 501(a), notwithstanding the entity's exemption under any other provision of the Code, would be subject to the unrelated business income tax (UBIT) rules. The provision was included because it is unclear whether certain state and local entities (such as public pension plans) that are exempt under Section 115(l) as government-sponsored entities as well as Section 501(a) are subject to the UBIT rules.
- The current exclusion of research income from unrelated business taxable income would be permitted only if the results of the research are freely made available to the public.
- The excise tax rate on net investment income of private foundations would be streamlined to a single rate of 1.4 percent (rather than the current 2 percent rate, which can be reduced to 1 percent under certain circumstances). Additionally, the rules providing for a reduction in the excise tax rate from 2 percent to 1 percent would be repealed. The 1.4 percent excise tax rate would be extended to 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 $100,000 per full-time student. State colleges and universities would not be subject to the extension of the tax.
- An art museum claiming private operating foundation status (a form of private foundation that may use tax-free donations to fund its own activities rather than make grants to other charities) would not be recognized as such unless it is open to the public for at least 1,000 hours per year.
- A private foundation would be exempt from the excess business holdings tax where the private foundation owns a for-profit business under the following conditions: (1) the private foundation owns all of the for-profit business's voting stock, (2) the private foundation acquired all of its interests in the for-profit business by means other than by purchasing it, (3) the for-profit business distributes all of its net operating income for any given tax year to the private foundation within 120 days of the close of that tax year, and (4) the for-profit business's directors and executives are not substantial contributors to the private foundation and do not make up a majority of the private foundation's board of directors.
- A donor-advised fund would be required to disclose annually its policies on inactive donor-advised funds as well as the average amount of grants made from its donor-advised funds.
- The exclusion for housing provided for the convenience of the employer and for employees of educational institutions would be limited to $50,000 ($25,000 for a married individual filing a separate return) and would phase out for highly compensated individuals (income of $120,000 for 2017, as adjusted for inflation) at a rate of one dollar for every two dollars of adjusted gross income earned by the individual beyond the statutory threshold of being highly compensated. The exclusion also would be limited to one residence.
- Tax-exempt entities would be taxed on the values of providing their employees with transportation fringe benefits, and on-premises gyms and other athletic facilities, by treating the funds used to pay for such benefits as unrelated business taxable income, thus subjecting the values of those employee benefits to a tax equal to the corporate tax rate.
- A tax-exempt organization would be subject to a 20 percent excise tax on compensation in excess of $1 million paid to any of its five highest paid employees for the tax year. The excise tax would apply to all remuneration paid to a covered person for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, except for payments to a tax-qualified retirement plan, and amounts that are excludable from the executive's gross income. The excise tax also would apply to excess parachute payments paid by the organization to such individuals. Under the provision, an excess parachute payment generally would be a payment contingent on the employee's separation from employment with an aggregate present value of three times the employee's base compensation or more.

Treasury Suggests It Will Not Implement Non-Delta-One Transaction Rules

At a District of Columbia Bar Taxation Community luncheon on Nov. 1, Dana Trier, Treasury deputy assistant secretary for tax policy, commented that Treasury may not implement the rules for non-delta-one transactions in the dividend equivalent regulations. He expects a formal announcement from Treasury in the next few months. In August, Treasury delayed the effective date of the rules in Notice 2017-42 (see our prior coverage here (http://www.stradley.com/insights/publications/2017/08/tax-insights-august-9-2017)). Trier also noted that Treasury intends to issue a notice of proposed rule-making to remove the documentation rules under Regulation Section 1.385-2.

Pennsylvania Governor Signs Fiscal 2018 Budget

Governor Tom Wolf signed legislation to fund Pennsylvania's fiscal 2018 budget. The revenue bill (http://www.legis.state.

pa.us/CFDOCS/Legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2017&sessInd=0&billBody=H&billTyp=B&billNbr=0542&pn=2598) includes provisions mandating a remote seller, a marketplace facilitator, or a referrer with $10,000 or more in aggregate sales into Pennsylvania during the past year to collect and remit sales tax or comply with Pennsylvania's notice and reporting requirements. A gambling expansion bill (http://www.legis.state.pa.us/CFDOCS/Legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2017&sessInd=0&billBody=H&billTyp=B&billNbr=0271&pn=2652) also legalizes fantasy sports contests and imposes a 15 percent tax on the fantasy contest revenue of the operator.

Rhode Island Launches Website for Tax Amnesty Plan

The Rhode Island Division of Taxation officially launched a special website for the state's upcoming tax amnesty: www.TaxAmnesty.ri.gov (http://www.taxamnesty.ri.gov/). The program will run from Dec. 1 through Feb. 15, 2018. The amnesty applies to taxes due for any taxable period ended on or before Dec. 31, 2016.

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