TAX ALERT

HOUSE GOP UNVEILS TAX OVERHAUL DETAILS

BY RICHARD BLOOM, JAMES WIENCLAW, TIFPHANI WHITE-KING, NATHAN PLISKIN, AND TIMOTHY EVANS

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MAZARS USA TAX PRACTICE BOARD

Jeffrey Katz
212.375.6816
jeffrey.katz@mazarsusa.com

James Toto
732.205.2014
james.toto@mazarsusa.com

James Wienclaw
516-620-8551
james.wienclaw@mazarsusa.com

Howard Landsberg
212.375.6604 | 516.282.7209
howard.landsberg@mazarsusa.com

Faye Tannenbaum
212.375.6713
faye.tannenbaum@mazarsusa.com

EDITOR

Richard Bloom
732.475.2146
richard.bloom@mazarsusa.com

On November 2, 2017, House GOP leaders unveiled their much anticipated tax reform bill, disclosing for the first time specific details that build off of the nine-page framework previously released in September. The legislation, titled the Tax Cuts and Jobs Act (TCJA), reduces the number of individual income tax brackets, eliminates many itemized deductions, eliminates and simplifies education incentives, eliminates the estate tax after a certain number of years, eliminates the alternative minimum tax, reduces the corporate tax rate, enhances cost recovery deductions, modifies and eliminates many corporate deductions, eliminates many business tax credits, changes the taxation of pass through entities, establishes a participation exemption system for taxation of foreign income, provides for repatriation of foreign earnings, and attempts to prevent base erosion.

As written, the plan stands to add approximately $1.5 trillion to the federal deficit over the next 10 years. The two main drivers of the increase to the federal deficit are the steep reduction in corporate rates and the change in the individual income tax rates according to JCT estimates provided in the Section-by-Section Summary of the TCJA released by the House Committee on Ways and Means. The TCJA attempts to simplify the code, particularly as it relates to individuals, by eliminating most itemized deductions and repealing the alternative minimum tax. It also seeks to make the United States more competitive in the business arena by reducing the corporate tax rate and moving towards a territorial tax system. The 429 page bill covers the full range of tax matters, from individuals to entities, domestic to international. We discuss some of the key provisions below.

Individuals

Individual Tax Rates. Consolidation of the current seven brackets to four: 12%; 25%; 35%; and 39.6%. Additionally, the benefit of the 12% bracket will be phased out for taxpayers with AGI in excess of $1million (single) or $1.2million (joint filers) The new tax brackets would be:

	Married Filing Joint	Married Filing Separate	Head of Household	Single
12%	Up to $90,000	Up to $45,000	Up to $67,500	Up to $45,000
25%	$90,001 to $260,000	$45,001 to $130,000	$67,501 to $200,000	$45,001 to $200,000
35%	$260,001 to $1million	$130,001 to $500,000	$200,001 to $500,000	$200,001 to $500,000
39.6%	Over $1million	Over $500,000	Over $500,000	Over $500,000

The income tax rates applicable to estates and trusts were also modified as follows:

12%	*Up to $2,550*
25%	*$2,551 to $9,150*
35%	*$9,151 to $12,500*
39.6%	*Over $12,500*

The rate changes and new brackets would be effective for tax years beginning after December 31, 2017. In addition, the brackets would be indexed for inflation.

Standard Deduction. The standard deduction will be almost doubled, resulting in indexed deductions for tax year 2018 in the amounts of $24,400 for joint filers, $18,300 for single filers with a qualifying child and $12,200 for individual filers.

Personal Exemptions. Beginning in 2018, the personal exemption would be repealed, with taxpayers no longer able to claim personal exemptions for themselves, a spouse, or any dependents.

Alternative Minimum Tax (AMT) AMT is repealed beginning in 2018. Taxpayers carrying forward AMT credits will be able to utilize a portion of those credits over the next several years.

Itemized Deductions. The bill provides for substantial changes to itemized deductions:

- Elimination of the deduction for state and local income taxes.
- The deduction for real estate taxes is retained, but capped at $10,000.
- Mortgage interest related to new loans up to $500,000 (instead of the current $1 million) would be deductible. The mortgage would have to be on the taxpayer's principal residence. Under current law, mortgage interest related to one's principal residence and a second home (generally a vacation home), is deductible.
- Medical expenses would no longer be deductible.
- Tax preparation expenses would no longer be deductible.
- Alimony payments would no longer be deductible.
- Moving expenses would no longer be deductible.
- Most personal casualty losses would no longer be deductible.
- Expenses attributable to the trade or business of being an employee would no longer be deductible.
- The overall limitation on itemized deductions is repealed.

Charitable Contributions The adjusted gross income limitation on cash contributions to public charities and certain private foundations is increased from 50% to 60%.

Child Tax Credit/Family Tax Credit The child tax credit would be increased from $1000 under current law to $1600 per child. Additionally, non-child dependents would be eligible for a $300 credit.
The bill also introduces a family flexibility credit of $300 for those who are neither a child, nor a non-child dependent, for example, a spouse. Both $300 credits will expire in 2023.

The phase-out relating to such credits will also be increased to $230,000 for joint filers, and $115,000 for single filers.

Education related provisions Various changes are proposed to education related credits and deductions, including:

- Consolidation of the three higher education tax credits into a single American Opportunity Tax Credit which will offer a 100% credit on the first $2,000 of certain higher education expenses, and a 25% credit for the next $2,000 of qualifying expenses.
- Income from discharge of student debt on account of death or disability would be excluded from taxable income for years after 2017.
- Deductions for qualified tuition and related expenses, as well as student loan interest would be repealed for tax years after 2017.

Gain from the Sale of a Principal Residence Exclusion The taxpayer would need to own and use the home for five out of the previous eight years instead of the current two of out of the previous five years. Additionally, the $500,000 exclusion for joint filers ($250,000 for single filers) will phase out dollar for dollar for gross income in excess of $500,000 for joint filers ($250,000 for single filers). Finally, the exclusion would be able to be used only once every five years.

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The major income tax changes impacting individuals are the change in the income tax rates and brackets and the repeal of the majority of itemized deductions, a move anticipated to reduce the number of taxpayers opting to itemize from approximately 33% to less than 10%.

It is difficult to predict the net impact of these changes since each taxpayer's situation is unique, and many of the changes are interrelated. The elimination of many itemized deductions, especially the state and local income tax deduction as well as the limitation on the deduction for real estate taxes will have a disparate geographical impact, as those taxpayers resident in high tax jurisdictions are far more likely to itemize, and thus be hit hardest by the inability to deduct state and local income taxes, as well as the limitation on property tax deductions.

The TCJA could have a disruptive impact on many industries such as real estate. The further limitation of the mortgage interest deduction, the inability to deduct mortgage interest on debt used to finance the purchase of a vacation home, and the limitation on the deductibility of real estate taxes, could cause some taxpayers to rethink the size of the home they are purchasing as well as the after tax cost of a vacation home.

Estate & Gift Tax The bill would increase the federal estate, generation skipping transfer and gift tax unified credit to $10 million (indexed for inflation) from the currently applicable $5 million (as of 2011) for all decedents dying and generation skipping transfers and gifts made after December 31, 2017.

The federal estate and generation skipping transfer tax will be repealed with respect to decedents dying and generation skipping transfers made after 2023. The gift tax is retained and the applicable federal gift tax rate will be reduced to 35% from 40% for gifts made after 2023.

The bill retains the rule that allows a beneficiary to step up the basis of assets received from a decedent to its fair market value as of the date of the decedent's death, even after the estate tax is repealed.

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Estate tax planning will become even more difficult if this bill becomes law as one would now need to consider the potential repeal of the estate tax in 2024 and the possibility that the repeal will be reversed by a future Congress or administration.
Retention of the gift tax is a backstop to potential manipulation of the income tax. For instance, without the gift tax, an ownership interest in a business could be transferred to someone in a lower tax bracket or to someone resident in a state that does not have an income tax. The business could be sold, resulting in lower income taxes, and the proceeds could, sometime thereafter, be gifted back to the original transferor.

Domestic Entities

Corporate Tax Rate For tax years beginning after 2017, corporations would be subject to a flat tax rate of 20%, replacing the current graduated rates that cap at 35%. Additionally, personal service corporations (the principal activity of which is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting) would be subject to a flat tax rate of 25%, down from the 35% flat tax rate currently in effect. The TCJA eliminates the 20% corporate alternative minimum tax.

Increased Expensing Replacing the current rules relating to bonus depreciation, taxpayers would be able to immediately expense 100% of the cost of qualified property placed in service after September 27, 2017 and before January 1, 2023. Notably, the definition of qualified property will be expanded, making this expensing available for both original and acquired property if it is the taxpayer's first use. Property used in a real property trade or business will be excluded.

Section 179 Expensing. For tax years after 2017 and before 2023, the small business expensing limitation under Section 179 would be increased from the current limit of $500,000 to $5 million, with the phase-out also being increased from the current $2 million threshold to $20 million.

Cash Method of Accounting. Eligibility to use the cash method of accounting would be expanded to include corporations and partnerships with a corporate partner with gross receipts of $25 million or less instead of the current threshold of $5 million. The requirement that the business satisfy that test for all prior year years would be repealed. Cash basis reporting may be simpler in some circumstances, but may not be the most advantageous tax reporting method. Careful consideration must be given to the most beneficial method of reporting income and expenses.

Accounting for Inventories The aforementioned cash method limitation would also be applicable to businesses with inventories, and such businesses may account for inventory as non-incidental materials and supplies if opting to use the cash method. Many businesses will maintain their inventory accounting method for both internal and external financial reporting purposes and consideration should be given to the most beneficial tax reporting method.

Overall cash basis tax reporting can result in significant swings in taxable income reporting. Cash management, while always critical to operating the business, will require even closer attention in managing tax payment requirements in future periods.

There are not many details available as to what specific anti-avoidance mechanisms would apply.

UNICAP Rules Businesses eligible to use the cash method under the increased $25 million threshold will also be exempt from UNICAP for all real and personal property acquired or manufactured by the business. This should be a welcome change for small businesses, as compliance with these regulations is complicated and onerous to both taxpayers and practitioners.

Accounting for Long-term Contracts The $10 million average gross receipts exception to the percentage-of-completion method for accounting for long-term contracts would be increased to $25 million. This will allow taxpayers greater flexibility in using the completed contracted method.

Interest Expense Deduction For tax years beginning after 2017, businesses will generally not be allowed to deduct net interest expense in excess of 30% of adjusted taxable income. Adjusted taxable income is a business's taxable income computed without regard to business interest expense, business interest income, net operating losses, and depreciation, amortization, and depletion. Interest disallowed would be carried forward for five table years. Such determinations would be made at the entity level (i.e., partnership level rather than partner level). Businesses with average gross receipts of $25 million or less would be exempt from this limitation. The TCJA contains provisions for other limitations and thresholds which are beyond this discussion. This provision poses significant issues in choosing debt vs. equity capitalization, debt financing for business expansion, and the overall use of debt to manage a business. We should expect more will develop on this issue.

Net Operating Loss Deduction For losses arising in years after 2017, carrybacks will be disallowed, with the exception of a special one-year carryback rule for certain small businesses and farms that incur casualty or disaster losses. Additionally, taxpayers will only be able to deduct an NOL carryover (or carryback) to the extent of 90% of taxable income. It should be noted that limitations may exist on NOL utilization that result from accelerated expensing under the 'bonus depreciation' provisions noted above. Conversely, the TCJA contains provisions that allow NOLs generated in tax years after 2017 to be increased by an interest factor which is meant to preserve the value of NOL's in future years. Generally, under the TCJA, for corporations carrying forward NOL's in excess of current year taxable income, the base effective tax rate would be 2% of taxable income prior to utilization of NOL's.

Like-kind Exchanges Like-kind exchanges, except for those relating to the like-kind exchange of real property, would be repealed. Taxpayers would have until December 31, 2017 to dispose of or acquire replacement property in order to be grandfathered into the old rule.

Contributions to Capital Effective after the date of enactment, contributions to capital that exceed the fair market value of stock issued in exchange would be considered gross income to the corporation. A similar rule would be implemented with respect to non-corporate entities. This provision essentially eliminates the federal subsidy resulting from financial incentives offered by state and local governments to businesses to locate/remain within their jurisdiction.

Domestic Production Deduction For tax years beginning after 2017, the TCJA repeals the 9% domestic production deduction relating to qualified production activities income. This provision is costly to the Treasury, complicated to administer, and is eliminated in lieu of lower tax rates.

Entertainment Expense Entertainment expenses, even where directly related to the active conduct of a taxpayer's business, will no longer be deductible. The 50% limitation on food/beverages and qualifying business meals would be retained.

Additionally, there would be no deduction allowed for certain fringe benefits including: transportation, on-premises gyms/athletic facilities, and any other amenities provided to an employee that are primarily personal in nature (unless taxable as compensation to the employee).

These types of expenses have been a continuous source of controversy with taxing authorities as it can be difficult to determine if such expenses are truly trade or business expenses along with potential for taxpayer abuse in this area. The TCJA aims to remove uncertainty on these issues.

Various Business Credits The bill would bring changes to a number of credits applicable to businesses including, but not limited to, the repeal of the following: the employer provided child care credit; the historic rehabilitation tax credit; the work opportunity tax credit; the new markets tax credit; the FICA tip credit; and various energy related credits. The TCJA, in most cases, repeals the deduction for unused business credits (currently available for carryback one year and carry forward 20).

The bill would preserve the research and development credit as well as the low income housing credit.

Technical Termination of Partnerships The partnership technical termination rule would be repealed, permitting the continuation of a partnership where 50% or more of a capital and profits interest is sold or exchanged during a 12 month period. This would eliminate short year tax returns, the necessity for new tax elections and the resetting of depreciable asset basis would no longer be permitted.

Pass-Through Tax Rate Stakeholders in pass-through entities (sole proprietorships, partnerships, limited liability companies, and S corporations) that conduct an active trade or business would be eligible for a 25% rate on the portion of the income that is deemed "business income". The TCJA provides a 70/30 safe-harbor formula whereby 70% of the income will be subject to the individual's ordinary income tax rates with 30% of the income taxed at the lower of the preferential 25% rate or the taxpayer's marginal tax rate.

Specifically excluded from the safe harbor are pass-throughs that generate income from professional services, i.e.; doctors, legal, accounting, architectural, etc. thus taxing this income at the individual's ordinary income tax rates. Net income derived from passive activities would be eligible for the 25% rate in its entirety.

Stakeholders may elect to apply the safe harbor 25% "business income" rate to 30% of the income derived from the pass-through entity or apply a facts and circumstances formula. The remainder of net business income would be subject to ordinary income tax rates.

The flow-through tax rate provisions will pose many complexities and have generated significant discussion within the tax community. Policy writers have voiced concerns over taxpayers creating or migrating non-business income sources (interest, dividends, capital gain income) in flow-throughs to minimize the tax rate applied to these income items. In addition, certain professional entities could use a non-safe harbor method to their advantage to achieve the 25% preferential tax rate on a portion of their income.

These provisions need more clarity and will undoubtedly get more complex to administer and plan for. Taxpayers and practitioners alike will need to look well beyond the initial year in determining which method may work better.

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The substantial reduction in corporate rates is no doubt one of the hallmarks of the current administration's tax plan. This, coupled with the immediate expensing provisions and repeal or relaxation of certain provisions, may provide a boon for domestic corporations. However, certain provisions may not be accretive to lowering the tax burden of some businesses.

It will be important for stakeholders in pass-through entities to carefully analyze their options with respect to electing which method to apply to pass-through income, as any election made would be binding for a *five-year period. We need to be forward-looking with respect to this issue.*

It is noted that some of the above provisions are not in accordance with financial reporting requirements under generally accepted accounting principles. This creates additional complexities in book vs. tax reporting. While it is too soon to tell, history tells us that state and local taxing authorities do not follow all federal tax provisions. This can pose additional challenges in complying with various tax authorities.

International Issues

Deduction for Foreign Source Portion of Dividends Received by Domestic Corporations from Specified 10% Owned Foreign Corporations In lieu of taxing distributions from 10% owned foreign subsidiaries to their US corporate shareholder, and subsequently permitting a credit for foreign taxes paid, the bill would allow a 100% exemption for dividends paid by such foreign subsidiaries. No credit would be permitted for foreign taxes paid by the foreign subsidiary. This is a repeal of the Section 902 indirect foreign tax credit, and would be effective for distributions made post-2017.

Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation For the last taxable year beginning prior to January 1, 2018, US shareholders owning at least 10% of a foreign subsidiary must include in income their pro-rata share of accumulated E&P (that is, accumulated E&P which was not previously taxed). A US shareholder will be permitted to net positive and negative E&P amounts from multiple subsidiaries. Applicable rates for these mandatory repatriations are 12% for cash and cash equivalents, and 5% for the remainder.

Foreign Tax Credit carryforwards may be used to offset this tax. Additionally, US shareholders may elect to pay the resulting liability in eight equal annual installments of 12.5% of the total tax due.

Note that for 10% owners that are S Corporations, these provisions would not go into effect until substantially all of the S corporations assets are sold, the S corporation transfers the stock, or otherwise ceases to exist as an S Corporation.

Investment in US Property The proposal amends Section 956(a) by eliminating the tax on a foreign subsidiary's investment in US property.

Foreign High Returns US shareholders of foreign subsidiaries would be taxed on 50% of their foreign high return, which would be equal to the excess of the foreign subsidiaries' net income over a routine return on the foreign subsidiaries' adjusted basis in depreciable tangible property adjusted downward for interest expense. This tax would be imposed irrespective of whether the US parent repatriated the earnings.

Subpart F The bill includes various changes to Subpart F, including:

- The look-through rule for excluding from the taxable income of a US parent amounts received by one foreign subsidiary from a related foreign subsidiary that stem from active income not effectively connected with a US trade or business would be made permanent.
- Foreign based company oil and shipping rules would be repealed.
- The *de minimis* exception for foreign company income would be adjusted for inflation.
- The 30 day holding period by US shareholders of CFCs would be eliminated.

Stock Attribution Rules As provided in the bill, a US corporation would be treated as constructively owning stock held by its foreign shareholders for purposes of determining status as a controlled foreign corporation.

Limitation on Losses with Respect to Specified 10% Owned Foreign Corporations For purposes of determining loss on the sale of the stock of a foreign subsidiary, a domestic corporation would be required to reduce its basis in the specified 10% owned foreign corporation's stock by the amount of any exempt dividends received.

This provision also requires that where a US corporation transfers the assets of a foreign branch to a foreign subsidiary, then such US Corporation must currently include in its gross income the amount of any post-2017 losses that were incurred by the branch. Similar to the foreign dividend exemption system, these provisions would be effective for distributions post-2017.

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There is obvious overwhelming support in the House Bill to encourage the repatriation of offshore funds especially via the participation exemption. While the move to a territorial system is generally a welcome development for US multi-national corporations, the rapid implementation of the proposed rules will leave little time for taxpayers to engage in E&P planning for the transition (unless they have already begun to do so anticipating the enactment of the regime). However, once (and if) the new regime becomes law, complex and costly repatriation planning may become passé. Additionally, the US move to a territorial *system has the potential to adversely impact other countries. What remains to be seen is how such countries may react over time.*

The House Ways and Means Committee began the mark up process on November 6th. House Ways and Means Committee Chairman Kevin Brady (R-Texas) has indicated that he expects the full House will vote on the bill during the week of November 13th. The Senate is expected to release its own version of a tax reform bill during the week of November 6th. The eventual House and Senate bills will need to be reconciled before a final bill is submitted to President Trump for his signature.

The TCJA in its current state provides for a substantial number of legal changes. The above is not all inclusive or meant to cover all provisions of the TCJA. In many instances, more clarity is necessary, as well as details on how transitional issues are to be addressed. While the TCJA remains likely to see significant change as Republicans look to fast-track the bill through the House, Taxpayers and their advisors now have a solid understanding of what to expect. As changes are made and details solidified, Mazars USA LLP will continue to provide updates and commentary on how exactly these changes will affect taxpayers on an industry specific basis, and what planning opportunities may arise for 2018 and beyond.

Please contact your Mazars USA LLP professional for additional information.

FOR MORE INFORMATION CONTACT:

RICHARD BLOOM, CPA, PFS, MST
PARTNER
+1 732.475.2146
richard.bloom@mazarsusa.com

JAMES WIENCLAW, CPA
PARTNER
+1 516.620.8551
james.wienclaw@mazarsusa.com

TIFPHANI WHITE-KING, JD, EA
PARTNER
+1 212.375.6523
tifphani.white-king@mazarsusa.com

NATHAN PLISKIN, JD, LLM
SENIOR
+1 212.375.6717
nathan.pliskin@mazarsusa.com

TIMOTHY EVANS
MANAGER
+1 646.435.1580
timothy.evans@mazarsusa.com

VISIT US AT www.mazarsusa.com

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