TAX ALERT

SENATE FINANCE COMMITTEE UNVEILS ITS VERSION OF GOP TAX OVERHAUL

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On November 9, 2017, Senate GOP leaders unveiled their own version of the tax reform bill, following closely on the heels of the House GOP plan (the Tax Cuts and Jobs Act bill) that was released on November 2 and approved in amended form by the House Ways and Means Committee on November 9. Click here to see our Tax Alert providing a detailed discussion of the House Bill, as well as our Tax Alert discussing the amended version passed by the House Ways and Means Committee.

The staff of the Joint Committee on Taxation prepared a Description of the Chairman's Mark of the Tax and Jobs Act (TCJA) that outlines the various proposals recommended by the Senate GOP. The Chairman's Mark is scheduled for markup by the Senate Finance Committee beginning November 13.

Below is a discussion of the key provisions of both the TCJA approved by the House Ways and Means Committee and the Senate's tax reform proposals as detailed in the Description of the Chairman's Mark. [1]

Individuals

Individual Tax Rates.

House Plan. Consolidation of the current seven brackets to four. Maintains top 39.6% marginal rate. The benefit of the 12% bracket will be phased out for taxpayers with adjusted gross income in excess of $1 million (single) or $1.2 million (joint filers).

	Married Filing Jointly	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 tax brackets and rates applicable to estates and trusts under the House plan are as follows:

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

Senate Plan. Retains seven tax brackets, although the tax rates and the bracket amounts are different than in the current tax code. Lowers top marginal rate from 39.6% to 38.5%.

	Married Filing Joint	Married Filing Separate	Head of Household	Single
10%	Up to $19,050	Up to $9,525	Up to $13,600	Up to $9,525
12%	$19,051 to $77,400	$9,526 to $38,700	$13,601 to $51,800	$9,526 to $38,700
22.5%	$77,401 to $120,000	$38,701 to $60,000	$51,801 to $60,000	$38,701 to $60,000
25%	$120,001 to $290,000	$60,001 to $145,000	$60,001 to $170,000	$60,001 to $170,000
32.5%	290,001 to $390,000	$145,001 to $195,000	$170,001 to $200,000	$170,001 to $200,000
35%	$390,001 to $1million	$195,001 to $500,000	$200,001 to $500,000	$200,001 to $500,000
38.5%	Over $1million	Over $500,000	Over $500,000	Over $500,000

The tax brackets and rates applicable to estates and trusts under the Senate plan are as follows:

10%	Up to $2,550
25%	$2,551 to $9,150
35%	$9,151 to $12,500
38.5 %	Over $12,500

Both the House and Senate plans index the new brackets for inflation, with the changes effective for tax years beginning after December 31, 2017.

Standard Deduction.

Both plans nearly double the standard deduction and index it for inflation.

Personal Exemptions.

The personal exemption would be repealed beginning in 2018 under both plans. Taxpayers will no longer be able to claim personal exemptions for themselves, a spouse, or any dependents.

[1] We will highlight substantial differences between the Senate and House versions. At this juncture, the bills also contain certain definitional and other differences which are not necessarily reflected in this discussion.

Alternative Minimum Tax (AMT).

Both the House and Senate plans repeal the AMT 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.

Both the House and Senate plans make substantial changes to itemized deductions. However, there remain significant differences between the two plans:

- State & Local Income Taxes:
  - The House plan eliminates the deduction for state and local income taxes other than those paid or accrued in carrying on a trade or business, or for the production of income.
  - The Senate plan eliminates the deduction for state and local income taxes.
- Real Estate Taxes:
  - The House plan continues to allow a real estate tax deduction, but caps it at $10,000.
  - The Senate plan eliminates all state and local property taxes for individual taxpayers other than those paid or accrued in carrying on a trade or business, or for the production of income.
- Mortgage Interest Deduction:
  - The House plan allows a mortgage interest deduction related to new loans up to $500,000 (instead of the current $1 million). The mortgage would have to be on the taxpayer's principal residence, thus it repeals any deduction for mortgage interest related to a second home (generally a vacation home). In addition, it repeals the deduction for new home equity indebtedness that is not acquisition indebtedness (i.e. a second mortgage or a home equity line of credit).
  - The Senate Plan retains from current law both the $1 million deduction limit and the allowance of the deduction for mortgage interest on debt used to acquire a second home. However, it repeals the allowance of a deduction for home equity indebtedness.
- Medical Expenses:
  - Under the House plan, medical expenses would no longer be deductible.
  - The Senate plan retains the medical expense deduction allowable under current law.
- Tax Preparation Expenses: Both plans repeal the deduction for tax preparation expenses.
- Expenses Attributable to the Trade or Business of Being an Employee: Both plans repeal the deduction for expenses attributable to the trade or business of being an employee.
- Personal Casualty Losses: Both plans eliminate personal casualty losses subject to certain exceptions related to losses incurred in a federally-declared disaster area.
- Miscellaneous Itemized Deductions Subject to the Two-Percent Floor:
  - The House plan does not modify the current law with respect to the two-percent floor deductions, aside from the change to tax preparation expenses and un-reimbursed employee business expenses discussed above.
  - The Senate plan eliminates all two-percent floor deductions. This would include expenses such as investment advisory fees, certain legal fees, indirect miscellaneous deductions from pass-through entities, etc.
- Overall Limitation on Itemized Deductions: Both plans repeal the overall limitation on itemized deductions.

Charitable Contributions.

Under both plans, 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.

House Plan. Increases the child tax credit to $1,600 per child and includes a $300 family tax credit and a $300 credit for non-child dependents. These credits will be phased out for taxpayers earning over $230,000 ($115,000 for unmarried individuals). The non-child dependent and the family tax credit expire after 2022.

Senate Plan. Increases the child tax credit to $1,650 per child. It also provides a $500 nonrefundable credit for non-child dependents. The credits are phased out for taxpayers earning over $1,000,000 ($500,000 for unmarried individuals).

Education Related Provisions.

House Plan. The House plan consolidates the education tax credits, excludes discharge of student debt on account of death or disability from taxable income, and eliminates the deduction for qualified tuition and related expenses as well as the deduction for student loan interest.

Senate Plan. The Senate plan retains the current law's treatment of these items.

Moving Expenses.

Both plans repeal the adjustment for moving expenses, except for members of the Armed Forces.

Gain from the Sale of a Principal Residence Exclusion.

Both plans retain the $500,000 exclusion for joint filers ($250,000 for single filers). However, a taxpayer would need to own and use the home for five out of the previous eight years instead of the current two out of the previous five years, and the exclusion would be able to be used only once every five years.

Under the House Plan, the exclusion will phase out dollar for dollar for gross income in excess of $500,000 for joint filers ($250,000 for single filers). The Senate Plan does not provide for a phase-out.

Alimony Expenses.

House Plan. Alimony payments would no longer be deductible, effective for divorce agreements executed in 2018 or later.

Senate Plan. Retains the deduction for alimony payments under current law.

Estate & Gift Tax.

Both the Senate and House Plans 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 House Plan fully repeals the federal estate and generation skipping transfer tax with respect to decedents dying and generation skipping transfers made after 2023. The Senate plan does not provide for a repeal of the estate tax or generation skipping transfer tax. The House plan also reduces the gift tax rate to 35% for gifts made after 2023. The Senate plan does not reduce the gift tax rate.

<u>Domestic Entities</u>

Corporate Tax Rate.

House Plan. Cuts the corporate tax rate to 20% for tax years beginning after 2017. 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%.

Senate Plan. Cuts the corporate tax rate to 20% effective for tax years beginning after 2018. According to the JCT, "the proposal eliminates the special tax rate for personal service corporations" therefore they will presumably also be subject to the 20% rate after 2018.

Both plans eliminate the corporate alternative minimum tax and allow for utilization of existing AMT tax credits going forward.

Dividends Received Deduction.

Both the House and Senate plans reduce the deduction permissible by a corporation with respect to dividends it receives from corporations. The 70% rate available to corporations owning less than 20% of a corporation's stock would be reduced to 50%, and the 80% rate available to corporations owning more than 20% and less than 80% would be reduced to 65%. There would be no change to the 100% exclusion for dividends received by a corporation owning greater than 80% of another corporation.

Research Expenditures.

House Plan. For certain research expenditures incurred for research within the United States in taxable years beginning after 2023, a business will be required to amortize the amount over a 5-year period. For research performed outside of the United States, the relevant amortization period will be 15 years.

Senate Plan. The Senate plan does not contain this provision.

S Corporation Conversions into C Corporations.

House Plan. Distributions from an eligible terminated S corporation would be treated as paid from its Accumulated Adjustments Account (previously taxed S corporation earnings) and C corporation earnings & profits on a pro rata basis. Under this proposal, distributions will be partially non-taxable until the terminated S corporation's accumulated adjustments account is fully distributed.

Senate Plan. The Senate plan does not contain this provision.

Increased Expensing.

Both plans allow taxpayers to immediately expense 100% of the cost of qualified property placed in service after September 27, 2017 and before January 1, 2023.

Section 179 Expensing.

Both plans expand both the definition of Section 179 property and the expensing limitations, but contain significant differences.

House Plan. For tax years after 2017 and before 2023, the small business expensing limitation under Section 179 would be increased from the current limit of $510,000 to $5 million, with the phase-out threshold also being increased from the current $2.03 million threshold to $20 million. After 2022, the limit and phase-out would return to the inflation-indexed amounts provided under current law.

Senate Plan. Increases the small business expensing limitation to $1 million, with the phase-out threshold also being increased to $2.5 million. The Senate plan indexes these amounts to inflation and does not expire after five years.

Depreciation of Real Property.

House Plan. Retains the current law's 27.5 year class life for residential real property and 39 year class life for nonresidential real property.

Senate Plan. The Senate plan shortens the recovery period for both residential rental real property and nonresidential real property to 25 years.

Cash Method of Accounting.

Both plans expand the threshold for eligibility to use the cash method of accounting to include corporations and partnerships with a corporate partner. The plans also expand the gross receipts test threshold from $5 million under current law to $25 million under the House plan or $15 million under the Senate plan. Both amounts are indexed for inflation.

UNICAP Rules.

Businesses eligible to use the cash method under the increased $25 million (House) or $15 million (Senate) threshold will also be exempt from UNICAP for all real and personal property acquired or manufactured by the business.

Interest Expense Deduction.

Both the House and Senate plans contain similar interest expense limitations for tax years beginning after 2017.

House Plan. No deduction is allowed for interest expense in excess of 30% of adjusted taxable income. The House plan defines adjusted taxable income as 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 taxable years. Businesses with average gross receipts of $25 million or less would be exempt from this limitation.

Senate Plan. No deduction is allowed for interest expense in excess of 30% of adjusted taxable income. The Senate plan defines adjusted taxable income as a business's taxable income computed without regard to business interest expense, business interest income, net operating losses, and the new 17.4% deduction for certain pass-through income (discussed below). Interest disallowed would be carried forward indefinitely. Businesses with average gross receipts of $15 million or less would be exempt from this limitation.

Under both plans, the limitation would be determined at the entity level (i.e., partnership level rather than partner level).

Net Operating Loss Deduction.

The House and Senate plans differ slightly but contain the same general framework for modifying net operating losses: For losses arising in years after 2017, carrybacks will be disallowed, subject to minor exceptions. Additionally, taxpayers will only be able to deduct an NOL carryover to the extent of 90% of taxable income. Both plans allow for indefinite carryforward of NOLs and the House Plan provides for an annual inflation adjustment to preserve the value in future years.

Like-Kind Exchanges.

Under both plans, like-kind exchanges, except for those relating to the like-kind exchange of real property, would be repealed.

Contributions to Capital.

House Plan. 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.

Senate Plan. Retains the present law's exclusion of contributions to capital from the gross income of a corporation.

Domestic Production Deduction.

Both plans repeal the 9% domestic production deduction relating to qualified production activities income. However, the House and Senate plans would be effective for years beginning after December 31, 2017 and December 31, 2018, respectively.

Entertainment Expense.

Under both plans, 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 is retained.

Various Business Credits.

House Plan. Changes 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. In most cases, the plan repeals the deduction for unused business credits (currently available for carryback one year and carry forward 20 years).

Senate Plan. Makes much more modest changes to business credits and retains all of the credits mentioned above. The Senate plan also repeals the deduction for unused business credits in certain cases.

Technical Termination of Partnerships.

House Plan. Repeals the partnership technical termination rule.

Senate Plan. Retains the present law's technical termination rule.

Limitations on Partner's Share of Charitable Contributions and Foreign Taxes.

House Plan. Retains the current law's treatment of a partner's distributive share of charitable contributions and foreign taxes paid.

Senate Plan. Limits a partner's distributive share of charitable contributions and foreign taxes paid to the extent of the partner's adjusted basis in the partnership.

Carried Interest.

House Plan. Includes a three-year holding period requirement in order to obtain long-term capital gain rates with respect to partnership interests received in connection with the performance of services in the amended bill.

Senate Plan. Does not address the taxation of carried interest, retaining the rules under current law.

Pass-Through Tax Rate.

Both the House and Senate plans contain special provisions to lower the tax burden of business owners. However, the two plans create separate frameworks for achieving this goal.

House Plan. 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.; fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, 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.

In addition, the House plan introduces a 9% small pass-through tax rate applicable to the first $75,000 ($37,500 for unmarried individuals) of net business income earned by an active stakeholder in a pass-through business where the owner earns less than $150,000 ($75,000 for unmarried individuals) from the pass-through entity. This benefit is fully phased out once the owner earns $225,000, and would be implemented over a 5 year period, with 2018-2019 eligible for an 11% rate, 2020-2021 eligible for a 10% rate, and the full reduction in effect for years on or after 2022.

Senate Plan. Provides an individual deduction of 17.4% of "domestic qualified business income" earned from a pass-through entity. Qualified business income is the net amount of items of income, gain, loss and deduction.

Qualified business income does not include certain investment related income or income earned from pass-throughs engaged in professional services, i.e.; fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, etc. However, the deduction is still available from such professional services firms to the extent a taxpayer's income does not exceed $150,000 ($75,000 for unmarried individuals), with a phase out for income up to $200,000 ($100,000 for unmarried individuals).

The plan contains a second limitation for taxpayers with qualified business income from a pass-through entity. The deduction is limited to the lesser of 17.4% of domestic business income or 50% of W-2 wages allocable to qualified business income.

International Issues

Deduction for Foreign Source Portion of Dividends Received by Domestic Corporations from Specified 10% Owned Foreign Corporations.

Both the House and Senate propose a 100% deduction for the foreign-source portion of dividends paid by a 10% owned foreign subsidiary to a US corporate shareholder. Additionally, both the House and Senate plans disallow foreign tax credits for any taxes paid or accrued with respect to any dividend that qualifies for the aforementioned deduction.

House Plan. Holding period requirement for underlying stock equal to 180 days out of 361 day period beginning 180 days prior to dividend.

Senate Plan. Stricter holding period requirement amounting to 365 days out of 731 days.

Foreign Tax Credit Modifications.

Both the House and Senate plans repeal the Section 902 indirect foreign tax credit.

Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation.

Both the House and the Senate propose to tax a US shareholder's pro-rata share of untaxed, accumulated E&P of a 10% foreign subsidiary.

House Plan. Mandatory repatriation subject to the following rates: cash and cash equivalents at a rate of 14% and the remainder at 7%.

Senate Plan. Lower applicable tax rates on repatriation of 10% on cash and cash equivalents and 5% on the remainder.

The Senate Plan additionally proposes to deny deductions and impose a 35% rate on the entire repatriation to the extent that a US shareholder becomes an expatriated entity during the ten year period following enactment of this legislation.

Investment in US Property.

House Plan. Amends Section 956(a) by eliminating the tax on a foreign subsidiary's investment in US property.

Senate Plan. Proposes an exception to US shareholders recognizing income when earnings are repatriated in the form of increased investment in US property by a CFC and where the US shareholders are domestic corporations (either owning the CFC directly or through a domestic partnership).

Limitations on Losses with Respect to Specified 10% Owned Foreign Corporations.

Both plans provide that for purposes of determining loss on the sale of the stock of a foreign subsidiary, a domestic corporation must reduce its basis in the specified 10% owned foreign corporation's stock by the amount of any exempt dividends received. Additionally, both plans provide that where a US corporation transfers substantially all of the assets of a foreign branch to a foreign subsidiary, then the US corporation must include in gross income an amount equal to the transferred loss amount.

House Plan. No additional provisions relating to Sections 1248 or 964(e).

Senate Plan. Provides additional clarification that if the sale of stock in a foreign corporation gives rise to an amount treated as a dividend for purposes of Sections 1248 (Gains from certain sales or exchanges of stock in certain foreign corporations) or Section 964(e) (Gain on certain stock sales by CFCs treated as dividends) would be treated as dividends for purposes of the 100% exclusion.

Subpart F Issues.

- Foreign Base Company Oil and Shipping Rules
  - Repealed by both the House and Senate proposals.
- De Minimis Exception for Foreign Base Company Income
  - Adjusted for inflation by both the House and Senate proposals.
- Modification of Stock Attribution Rules
  - The House and Senate proposals both propose to treat a US corporation as constructively owning stock held by its foreign shareholders for purposes of determining an entity's status as a CFC.
- 30 Day Holding Period
  - Both the House and Senate propose to eliminate the requirement that a corporation must be controlled for a period of 30 days before subpart F inclusions apply.
- Definition of United States Shareholder

- *House Plan.* No relevant provision.
- *Senate Plan.* The Senate proposes an adjustment to the definition of US shareholder for purposes of subpart F to include US persons who own 10% or more of total vote AND value, rather than just 10% of vote.

- Look-Through Rule
  - The House and Senate proposals would both make permanent the look-through rule that excludes from the taxable income of a US parent any 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.

Tax on Gain on the Sale of a Partnership.

House Plan. Retains the current law's taxation of a foreign partner's gain on the sale of a US partnership interest.

Senate Plan. Overrules the recent Grecian Magnesite Tax Court case to explicitly adopt a look through approach to taxation of a foreign partner's gain on the sale of a US partnership interest. The Senate plan would require gain from the sale of a US partnership to be treated as effectively connected income to the extent partnership assets have built in gain.

Mazars USA LLP will continue to monitor both bills' progress and report accordingly. A detailed analysis of the impact of the final bill will be issued once it is enacted into legislation, an event that could potentially occur as early as mid-December.

Please contact your Mazars USA LLP professional for additional information.

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