The Tax Adviser

Details of tax reform legislation revealed

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The House Ways and Means Committee released draft tax reform legislation on Thursday. The Tax Cuts and Jobs Act, H.R. 1, incorporates many of the provisions listed in the Republicans' September tax reform framework while providing new details. Budget legislation passed in October would allow for the tax reform bill to cut federal government revenue by up to $1.5 trillion over the next 10 years and still be enacted under the Senate's budget reconciliation rules, which would require only 51 votes in the Senate for passage. The Joint Committee on Taxation issued an estimate of the revenue effects of the bill on Thursday showing a net total revenue loss of $1.487 trillion over 10 years.

The bill features new tax rates, a lower limit on the deductibility of home mortgage interest, the repeal of most deductions for individuals, and full expensing of depreciable assets by businesses, among its many provisions.

Lawmakers had reportedly been discussing lowering the contribution limits for Sec. 401(k) plans, but the bill does not include any changes to those limits.

The Senate Finance Committee is reportedly working on its own version of tax reform legislation, which is expected to be unveiled next week. It is unclear how much that bill will differ from the House bill released on Thursday.

Individuals

Tax rates: The bill would impose four tax rates on individuals: 12%, 25%, 35%, and 39.6%, effective for tax years after 2017. The current rates are 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. The 25% bracket would start at $45,000 of taxable income for single taxpayers and at $90,000 for married taxpayers filing jointly.

The 35% bracket would start at $200,000 of taxable income for single taxpayers and at $260,000 for married taxpayers filing jointly. And the 39.6% bracket would apply to taxable income over $500,000 for single taxpayers and $1 million for joint filers.

Standard deduction and personal exemption: The standard deduction would increase from $6,350 to $12,200 for single taxpayers and from $12,700 to $24,400 for married couples filing jointly, effective for tax years after 2017. Single filers with at least one qualifying child would get an $18,300 standard deduction. These amounts will be adjusted for inflation after 2019. However, the personal exemption would be eliminated.

Deductions: Most deductions would be repealed, including the medical expense deduction, the alimony deduction, and the casualty loss deduction (except for personal casualty losses associated with special disaster relief legislation). The deduction for tax preparation fees would also be eliminated.

However, the deductions for charitable contributions and for mortgage interest would be retained. The mortgage interest deduction on existing mortgages would remain the same; for newly purchased residences (that is, for debt incurred after Nov. 2, 2017), the limit on deductibility would be reduced to $500,000 of acquisition indebtedness from the current $1.1 million. The overall limitation of itemized deductions would also be repealed.

Some rules for charitable contributions would change for tax years beginning after 2017. Among those changes, the current 50% limitation would be increased to 60%.

The deduction for state and local income or sales taxes would be eliminated, except that income or sales taxes paid in carrying out a trade or business or producing income would still be deductible. State and local real property taxes would continue to be deductible, but only up to $10,000. These provisions would be effective for tax years beginning after Dec. 31, 2017.

Credits: Various credits would also be repealed by the bill, including the adoption tax credit, the credit for individuals over age 65 who have retired on disability, the credit associated with mortgage credit certificates, and the credit for plug-in electric vehicles.

The child tax credit would be increased from $1,000 to $1,600, and a $300 credit would be allowed for nonchild dependents. A new "family flexibility" credit of $300 would be allowed for other dependents. The $300 credit for nonchild dependents and the family flexibility credit would expire after 2022.

The American opportunity tax credit, the Hope scholarship credit, and the lifetime learning credit would be combined into one credit, providing a 100% tax credit on the first $2,000 of eligible higher education expenses and a 25% credit on the next $2,000, effective for tax years after 2017. Contributions to Coverdell education savings accounts (except rollover contributions) would be prohibited after 2017, but taxpayers would be allowed to roll over money in their Coverdell ESAs into a Sec. 529 plan.

The bill would also repeal the deduction for interest on education loans and the deduction for qualified tuition and related expenses, as well as the exclusion for interest on U.S. savings bonds used to pay qualified higher education expenses, the exclusion for qualified tuition reduction programs, and the exclusion for employer-provided education assistance programs.

Other taxes: The bill would repeal the alternative minimum tax (AMT).

The estate tax would be repealed after 2023 (with the step-up in basis for inherited property retained). In the meantime, the estate tax exclusion amount would double (currently it is $5,490,000, indexed for inflation). The top gift tax rate would be lowered to 35%.

Passthrough income: A portion of net income distributions from passthrough entities would be taxed at a maximum rate of 25%, instead of at ordinary individual income tax rates, effective for tax years after 2017. The bill includes provisions to prevent individuals from converting wage income into passthrough distributions. Passive activity income would always be eligible for the 25% rate.

For income from nonpassive business activities (including wages), owners and shareholders generally could elect to treat 30% of the income as eligible for the 25% rate; the other 70% would be taxed at ordinary income rates. Alternatively, owners and shareholders could apply a facts-and-circumstances formula.

However, for specified service activities, the applicable percentage that would be eligible for the 25% rate would be zero. These activities are those defined in Sec. 1202(e)(3)(A) (any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees), including investing, trading, or dealing in securities, partnership interests, or commodities.

Business provisions

A flat corporate rate: The bill would replace the current four-tier schedule of corporate rates (15%, 25%, 34%, and 35%, with a $75,001 threshold for the 34% rate) with a flat 20% rate (25% for personal services corporations). The corporate AMT is repealed along with the individual AMT.

Higher expensing levels: The bill would provide 100% expensing of qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023 (with an additional year for longer-production-period property). It would also increase tenfold the Sec. 179 expensing limitation ceiling and phaseout threshold to $5 million and $20 million, respectively, both indexed for inflation.

Cash accounting method more widely available: The bill would increase to $25 million the current $5 million average gross receipts ceiling for corporations generally permitted to use the cash method of accounting and extend it to businesses with inventories. Such businesses also would be exempted from the uniform capitalization (UNICAP) rules. The exemption from the percentage-of-completion method for long-term contracts of $10 million in average gross receipts would also be increased to $25 million.

NOLs, other deductions eliminated or limited: Deductions of net operating losses (NOLs) would be limited to 90% of taxable income. NOLs would have an indefinite carryforward period, but carrybacks would no longer be available for most businesses. Carryforwards for losses arising after 2017 would be increased by an interest factor. Other deductions also would be curtailed or eliminated:

- Instead of the current provisions under Sec. 163(j) limiting a deduction for business interest paid to a related party or basing a limitation on the taxpayer’s debt-equity ratio or a percentage of adjusted taxable income, the bill would impose a limit of 30% of adjusted taxable income for all businesses with more than $25 million in average gross receipts.
- The Sec. 199 domestic production activities deduction would be repealed.
- Deductions for entertainment, amusement, or recreation activities as a business expense would be generally eliminated, as would employee fringe benefits for transportation and certain other perks deemed personal in nature rather than directly related to a trade or business, except to the extent that such benefits are treated as taxable compensation to an employee (or includible in gross income of a recipient who is not an employee).

Like-kind exchanges limited to real estate: The bill would limit like-kind exchange treatment to real estate, but a transition rule would allow completion of currently pending Sec. 1031 exchanges of personal property.

Business and energy credits curtailed: Offsetting some of the revenue loss resulting from the lower top corporate tax rate, the bill would repeal a number of business credits, including:

- The work opportunity tax credit (Sec. 51).
- The credit for employer-provided child care (Sec. 45F).
- The credit for rehabilitation of qualified buildings or certified historic structures (Sec. 47).
- The Sec. 45D new markets tax credit. Credits allocated before 2018 could still be used in up to seven subsequent years.
- The credit for providing access to disabled individuals (Sec. 44).
- The credit for enhanced oil recovery (Sec. 43).
- The credit for producing oil and gas from marginal wells (Sec. 45I)

Other credits would be modified, including those for a portion of employer Social Security taxes paid with respect to employee tips (Sec. 45B), for electricity produced from certain renewable resources (Sec. 45), for production from advanced nuclear power facilities (Sec. 45J), and the investment tax credit (Sec. 46) for eligible energy property. The Sec. 25D residential energy-efficient property credit, which expired for property placed in service after 2016, would be extended retroactively through 2022 but reduced beginning in 2020.

Bond provisions: Several types of tax-exempt bonds would become taxable:

- Private activity bonds would no longer be tax-exempt. The bill would include in taxpayer income interest on such bonds issued after 2017.
- Interest on bonds issued to finance construction of, or capital expenditures for, a professional sports stadium would be taxable.
- Interest on advance refunding bonds would be taxable.

- Current provisions relating to tax credit bonds would generally be repealed. Holders and issuers would continue receiving tax credits and payments for tax credit bonds already issued, but no new bonds could be issued.

Insurance provisions: The bill would introduce several revenue-raising provisions modifying special rules applicable to the insurance industry. These include bringing life insurers' NOL carryover rules into conformity with those of other businesses.

Compensation provisions: The bill would impose new limits on the deductibility of certain highly paid employees' pay, including, for the first time, those of tax-exempt organizations.

- Nonqualified deferred compensation would be subject to tax in the tax year in which it is no longer subject to a substantial risk of forfeiture. Current law would apply to existing nonqualified deferred compensation arrangements until the last tax year beginning before 2026.

- The exceptions for commissions and performance-based compensation from the Sec. 162(m) $1 million limitation on deductibility of compensation of certain top employees of publicly traded corporations would be repealed. The bill would also include more employees in the definition of "covered employee" subject to the limit.

- The bill would impose similar rules on executives of organizations exempt from tax under Sec. 501(a), with a 20% excise tax on compensation exceeding $1 million paid to any of a tax-exempt organization's five highest-paid employees, including "excess parachute payments."

Foreign income and persons

Deduction for foreign-source dividends received by 10% U.S. corporate owners: The bill would add a new section to the Code, Sec. 245A, which replaces the foreign tax credit for dividends received by a U.S. corporation with a dividend-exemption system. This provision would be effective for distributions made after 2017. This provision is designed to eliminate the "lock-out" effect that encourages U.S. companies not to bring earnings back to the United States.

The bill would also repeal Sec. 902, the indirect foreign tax credit provision, and amend Sec. 960 to coordinate with the bill's dividends-received provision. Thus, 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 of the bill would apply.

Elimination of U.S. tax on reinvestments in U.S. property: Under current law, a foreign subsidiary's undistributed earnings that are reinvested in U.S. property are subject to current U.S. tax. The bill would amend Sec. 956(a) to eliminate this tax on reinvestments in the United States for tax years of foreign corporations beginning after Dec. 31, 2017. This provision would remove the disincentive from reinvesting foreign earnings in the United States.

Limitation on loss deductions for 10%-owned foreign corporations: In a companion provision to the deduction for foreign-source dividends, the bill would amend Sec. 961 and add new Sec. 91 to require a U.S. parent to reduce the basis of its stock in a foreign subsidiary by the amount of any exempt dividends received by the U.S. parent from its foreign subsidiary, but only for determining loss, not gain. The provision also requires a U.S. corporation that transfers substantially all of the assets of a foreign branch to a foreign subsidiary to include in the U.S. corporation's income the amount of any post-2017 losses that were incurred by the branch. The provisions would be effective for distributions or transfers made after 2017.

Repatriation provision: The bill would amend Sec. 956 to provide that U.S. shareholders owning at least 10% of a foreign subsidiary will 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 that E&P have not been previously subject to U.S. tax, determined as of Nov. 2, 2017, or Dec. 31, 2017 (whichever is higher). The portion of E&P attributable to cash or cash equivalents would be taxed at a 12% rate; the remainder would be taxed at a 5% rate. U.S. shareholders can elect to pay the tax liability over eight years in equal annual installments of 12.5% of the total tax due.

Income from production activities sourced: The bill would amend Sec. 863(b) to provide that income from the sale of inventory property produced within and sold outside the United States (or vice versa) is allocated solely on the basis of the production activities for the inventory.

Changes to Subpart F rules: The bill would repeal the foreign shipping income and foreign base company oil-related income rules. It would also add an inflation adjustment to the *de minimis* exception to the foreign base company income rules and make permanent the lookthrough rule, under which passive income one foreign subsidiary receives from a related foreign subsidiary generally is not includible in the taxable income of the U.S. parent, provided that income was not subject to current U.S. tax or effectively connected with a U.S. trade or business.

Under the bill, a U.S. corporation would be treated as constructively owning stock held by its foreign shareholder for purposes of determining CFC status. The bill would also eliminate the requirements that a U.S. parent corporation must control a foreign subsidiary for 30 days before Subpart F inclusions apply.

Base erosion provisions: Under the bill, a U.S. parent of one or more foreign subsidiaries would be subject to current U.S. tax on 50% of the U.S. parent's foreign high returns—the excess of the U.S. parent's foreign subsidiaries' aggregate net income over a routine return (7% plus the federal short-term rate) on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense.

The deductible net interest expense of a U.S. corporation that is a member of an international financial reporting group would be limited to the extent the U.S. corporation's share of the group's global net interest expense exceeds 110% of the U.S. corporation's share of the group's global earnings before interest, taxes, depreciation, and amortization (EBITDA).

Payments (other than interest) made by a U.S. corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset would be subject to a 20% excise tax, unless the related foreign corporation elected to treat the payments as income effectively connected with the conduct of a U.S. trade or business. Consequently, the foreign corporation's net profits (or gross receipts if no election is made) with respect to those payments would be subject to full U.S. tax, eliminating the potential U.S. tax benefit otherwise achieved.

Exempt organizations

Clarification that state and local entities are subject to unrelated business income tax (UBIT): The bill would amend Sec. 511 to clarify that all state and local entities including pension plans are subject to the Sec. 511 tax on unrelated business income (UBI).

Exclusion from UBIT for research income: The act would amend the Code to provide that income from research is exempt from UBI only if the results are freely made available to the public.

Reduction in excise tax paid by private foundations: The bill would repeal the current rules that apply either a 1% or 2% tax on private foundations' net investment income with a 1.4% rate for tax years beginning after 2017.

Modification of the Johnson Amendment: Effective on the date of enactment, the bill would amend Sec. 501 to permit statements about political campaigns to be made by religious organizations.

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