HOUSE WAYS AND MEANS COMMITTEE RELEASES PROPOSED "TAX CUTS & JOBS ACT"

Tax Alert
November 6, 2017

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On November 2, Rep. Kevin Brady (R-TX), Chairman of the House Ways and Means Committee, released a proposed bill, titled the "Tax Cuts and Jobs Act", which is designed to create "more jobs, fairer taxes, and bigger paychecks" by making major changes to federal income taxation of individuals and businesses. The proposed changes would represent the most comprehensive tax reform in more than 30 years (since 1986). The proposed bill began its markup period on November 6. Before going to the President, however, the proposed bill would need to be passed by both the House and the Senate, which is expected to introduce its own tax reform proposal during the week of November 6.

Changes affecting businesses. The proposed legislation contains numerous provisions that, generally effective January 1, 2018, would change current business tax rates, deductions, exclusions, and credits, including, among others, the following:

- Corporate Tax Rate. The proposal would eliminate the current corporate tax rate structure that has a maximum rate of 35% and replace it with a flat 20% corporate tax rate (or a 25% rate for personal service corporations).
- New Tax Rate on Pass-through "Business Income". Owners of certain pass-through entities would be subject to a maximum rate of 25% on the portion of their net income treated as "business income", with the remaining portion of the net income taxed at each owner's applicable individual income tax rate. The amount of "business income" that would qualify for the 25% rate would be limited and owners of certain personal service businesses (*e.g.*, law, accounting, consulting, engineering, financial services, or performing arts) generally would be excluded from qualifying for the 25% rate.
- Increased expensing. The proposal would allow immediate expensing of 100% of the cost of qualifying property acquired and placed in service after September 27, 2017 and before January 1, 2023.
- Expansion of section 179 expensing. The section 179 small business expensing limit would increase to $5 million (indexed for inflation) and the phase-out amount would be increased to $20 million (indexed for inflation) for tax years beginning after 2017 and before 2023.
- Interest deductions. The deduction of net interest expense would be limited to 30% of the business's adjusted taxable income (businesses with average gross

receipts of $25 million or less would be exempt from this rule).

- Net operating loss deduction. The deduction of a net operating loss (NOL) would be limited to 90% of a business's taxable income, and NOL carrybacks generally would be eliminated, effective for losses arising in tax years beginning after 2017.
- Holding period extension for certain partnership interests. The proposed bill would require a three-year holding period before certain partnership interests received in connection with the performance of services would qualify for long-term capital gains.
- Like-kind exchanges. Like-kind exchanges would be allowed only for real property, effective for transfers after 2017.
- Tax-exempt private activity and advance refunding bonds. The proposed bill would terminate new tax-exempt private activity bonds and repeal advance refunding bonds, for bonds issued after 2017.

Changes affecting international tax. The proposed bill includes several significant changes to our international tax system, some of which are discussed below.

- Territorial system for U.S. corporate shareholders owning 10% of a foreign subsidiary. Currently, U.S. corporations generally are taxed on their worldwide income, with a credit allowed for taxes paid to a foreign country (a "FTC"). When FTCs are insufficient to offset the U.S. tax on the distribution of earnings of a U.S. corporation's foreign subsidiary, the additional U.S. tax that the U.S. corporate parent must pay upon receipt of those earnings from the subsidiary is referred to as the "U.S. residual tax". The new rules would eliminate the U.S. residual tax on all distributions from a foreign subsidiary to a 10% or greater U.S. corporate shareholder by allowing a 100% deduction for foreign-sourced dividends.

- One-time transition tax. As a transition from our current system to the new system, U.S. shareholders owning at least 10% of a foreign subsidiary generally will have to include in income the foreign subsidiary's undistributed earnings and profits (E&P). Such E&P will be taxed at a reduced rate of either 12% or 5%. At the election of the U.S. shareholder, the tax liability can be paid over a period of up to 8 years, in equal annual installments of 12.5% of the total tax due.

- New anti-deferral provision: "foreign high-return amount". 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, defined as the excess of the U.S. parent's foreign subsidiaries' aggregate net income, subject to certain adjustments, 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. Foreign high returns generally would be treated similar to currently-taxed subpart F income and, therefore, a FTC would be allowed, but would be limited to 80% of the foreign taxes paid.

Changes affecting individuals. The proposed bill would modify individual income tax rates and eliminate many itemized deductions, but provide a higher standard deduction amount. Some of the proposed changes are as follows:

- Individual income tax rates. The proposed legislation would consolidate the seven current income tax brackets into four: 12%, 25%, 35%, and 39.6%. For taxpayers filing jointly, those bracket thresholds would be $0, $90,000, $260,000, and $1 million, respectively (indexed for inflation). For unmarried and married individuals filing separately, the bracket thresholds would be cut in half, except for the unmarried 35% bracket threshold, which would be set at $200,000.

Notably, the proposed bill does not repeal the 3.8% net investment income tax.

- Standard deduction. The standard deduction would increase to $24,000 for joint filers and $12,000 for individual filers (indexed for inflation). Overall limitations on itemized deductions would be repealed.
- State and local tax deduction. The proposed bill would allow taxpayers to deduct state and local taxes only to the extent the taxes paid are (1) related to income-producing activities or (2) real property taxes up to $10,000.
- Mortgage interest deduction. The home mortgage interest deduction would be limited to $500,000 of principal for new home purchases.
- Other deductions. Individuals would no longer be permitted to deduct, among other things, tax preparation expenses, medical expenses, and alimony payments.
- Personal exemptions. The proposed legislation would replace personal exemptions with child and family tax credits, which would phase out for high income taxpayers.
- Alternative minimum tax. The proposal would repeal the alternative minimum tax.

Changes affecting the estate tax. The proposed bill also would immediately double the estate tax exemption amount to $10 million (indexed for inflation) and would repeal the estate tax in 2024, while retaining the step-up in basis of assets received from a decedent. Please see following link for an alert from Hodgson Russ' Estates and Trusts Practice Group for more information on the proposed bill's changes to the U.S. taxation of wealth transfers: http://www.hodgsonruss.com/newsroom-publications-9951.html

Please contact one of the members of Hodgson Russ' Federal/International Tax Practice Group for more information on the proposed Tax Cuts and Jobs Act or to discuss its specific effect on you.