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Senate Finance Releases Tax Reform Proposal

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Yesterday, the Senate released information on its tax reform proposal, which contains several differences from the bill reported out of the House yesterday. The Republican conference was briefed on the proposal yesterday morning and a description by the Joint Committee on Taxation of the Senate Finance Chairman's mark of the Tax Cuts and Jobs Act was released late last night. Significant differences include:

- Delaying the start of the corporate tax rate cut by one year, despite the Administration's "strong preference" for the cut to begin in 2018
- Keeping the number of tax brackets at seven instead of dropping it to four, and lowering the top tax bracket from 39.6% to 38.5%
- Eliminating the state and local tax deduction entirely (whereas the House would retain a deduction for property taxes up to $10,000)
- Maintaining the estate tax, while doubling the exclusion and
- Significant differences in the treatment of pass-throughs, taxation of foreign income and foreign persons, and the treatment of tax-exempt organizations.

As it stands now, the Senate proposal is intended to stay inside a $1.5 trillion cap on the spending, though it may require some additional changes to ensure it will not increase deficits outside the 10-year budget window to comply with the "Byrd Rule". The Senate is scheduled to begin a markup on Monday, November 13 at 3pm.

Major provisions of the Senate's proposal include:

BUSINESSES - GENERAL

- **Corporate Rate**
  - The Senate proposal reduces the corporate rate from 35% to 20%, effective for tax years beginning after 2018, with no sunset. This rate reduction is similar to the rate reduction proposed in the House bill, but would take effect one year later. The Senate proposal, like the House bill, also repeals the corporate alternative minimum tax.
  - The Senate proposal amends the dividends received deduction that applies to distributions from one corporation to another. Under current law, a corporation receives a 100% deduction for dividends received from another corporation in the same affiliated group, an 80% deduction for dividends received from a corporation in which it owns at least 20%, and a 70% deduction for dividends received from a corporation in which it owns less than 20%. Under the proposal, the 80% deduction would be reduced to 65% and the 70% deduction would be reduced to 50%. The House bill, as reported out of the Ways and Means Committee, contained the same reductions. The reductions are intended to align the dividends received deduction with the reduction in the corporate rate.
- **Pass-through Provisions**
  - The Senate's tax reform proposal contains several key differences from the House bill with respect to the treatment of pass-through businesses.

- Like the House bill, the Senate proposal:
  - Would limit like-kind exchange treatment under section 1031 to real property that is not held primarily for sale;
  - Would not make any technical changes to the new partnership audit and litigation regime scheduled to take full effect in 2018 (although such changes may be included as the proposal works its way through the legislative process); and
  - Would not make any changes to the self-employment tax regime for shareholders of S corporations and limited partners of limited partnerships (or equivalents).
    - Although a House proposal initially would have eliminated the preferential self-employment tax treatment for shareholders of S corporations and limited partners of limited partnerships, an amendment to the House bill removed this proposed change.
- The Senate proposal would generally allow an individual taxpayer to deduct 17.4% of "domestic" "qualified business income" from a partnership, S corporation, or sole proprietorship. This differs from the House bill, which would generally impose a 25% tax rate (with a 9% rate applying in certain cases) on qualified business income of individuals engaged in business activities through partnerships, S corporations, or sole proprietorships.
  - "Qualified business income" generally means the net amount of domestic qualified items of income, gain, deduction, and loss with respect to the taxpayer's qualified businesses (i.e., any trade or business other than specified service trades or businesses, except for a limited exception described below). There is no definition of "domestic."
  - Qualified business income of a taxpayer does not include:
    - Any amount paid by an S corporation that is treated as "reasonable compensation" of such taxpayer (no additional definition of reasonable compensation is provided);
    - Any amount allocated or distributed by a partnership to the taxpayer-partner who is acting other than in his or her capacity as a partner for services (section 707(a) service payments);
    - Any amount that is a guaranteed payment to the taxpayer-partner for services actually rendered to or on behalf of a partnership to the extent that the payment is in the nature of remuneration for those services (section 707(c) service payments); or
    - "Certain" investment-related income, gain, deductions, or loss (no additional definition of such investment items is provided).
  - The Joint Committee's description states "in the case of a taxpayer who has qualified business income from a partnership or S corporation, the amount of the deduction is limited to 50% of the W-2 wages of the taxpayer." It is unclear from this description how this limitation is intended to operate. For example, it might mean that, if a partner has any distributive share of qualified business income but no W-2 wages from such partnership (a rather typical situation), then such

partner would be ineligible for any such deduction (an outcome that would not exist under the House provisions). This also might mean that passive investors would be ineligible for any such deduction (as opposed to the House provisions that provide reduced tax rates for passive investors that have qualified business income). Instead, perhaps what is intended is that "the W-2 wages of the taxpayer" be determined with respect to the qualified business activities of the partnership and S corporation (rather than literally the W-2 wages received by the taxpayer partner/shareholder). In that case, each partner/shareholder would be allocated a proportionate share of such entities' W-2 wages that are paid to all employees of such entities, and then the 50% limitation would be applied at the partner/shareholder level based on allocated qualified business income and allocated W-2 wages from such entities.

- The deduction generally does not apply to specified service businesses (i.e., any trade or business activity 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).
    - However, a broad exception exists in the case of any taxpayer to the extent his or her taxable income does not exceed $150,000. The benefit of a deduction for such taxpayers is phased out over a $50,000 range for taxable income exceeding $150,000. All such figures are for married individuals filing jointly; analogous figures are provided for other individuals. It is unclear how the taxable income phase-out is to operate vis-à-vis the deduction itself. Perhaps the phase-out will be determined without regard to the potential deduction.
- The Senate has described this new deduction as "simple." It seems that neither the House's special tax rates on similar income nor this deduction approach from the Senate will be simple for taxpayers to apply or for the IRS to administer.

- Under the Senate proposal, "excess business losses" of a taxpayer other than a C corporation (generally, net losses in excess of $500,000) are not allowed for the taxable year, but rather are carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent taxable years. This proposal essentially disallows excess active net business losses, effectively extending the current treatment of net passive activity losses to active losses. There is no counterpart in the House bill.
    - An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer, over the sum of "aggregate gross income or gain" of the taxpayer plus a threshold amount. For married taxpayers filing jointly, such threshold amount is $500,000. The term "aggregate gross income or gain" is not qualified by "attributable to trades or businesses of the taxpayer," which suggests that such business deductions would need to exceed all types of income or gain (including passive and portfolio) before such net amount became subject to the loss limitation.
    - In the case of a partnership or S corporation, the proposal applies at the partner or shareholder level.

- The Senate proposal would overrule *Grecian Magnesite Mining v. Commissioner* and codify Revenue Ruling 91-32. There is no counterpart in the House bill.
  - In Revenue Ruling 91-32, the IRS adopted an "aggregate theory" approach, holding that the gain realized by a foreign partner on the sale or disposition of its interest in a partnership engaged in a trade or business through a fixed place of business in the United States should be analyzed at the partnership level and on an asset by asset basis, and that, to the extent there would be effectively connected income (ECI) with respect to such asset sales, the selling partner's pro rata share of such gain should be treated as ECI.
  - In *Grecian Magnesite*, the Tax Court disagreed with this approach and concluded that the relevant Code and regulatory provisions did not support the use of the aggregate theory of partnerships in these types of cases. Instead, the court concluded that an entity theory of partnerships was more appropriate, and, therefore, there should be no "look-through" applied. Consequently, gain or loss on a sale or exchange by a foreign person of an interest in a tax partnership that is engaged in a US trade or business would generally be treated as foreign-source.
  - Under the Senate proposal, gain or loss from the sale or exchange of a partnership interest is effectively connected with a US trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. Any gain or loss from the hypothetical asset sale by the partnership would be allocated to interests in the partnership in the same manner as non-separately stated income and loss.
  - Additionally, under the proposal, the transferee of a partnership interest must withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. Such proposal appears to share some similarities to the current FIRPTA withholding/reporting regime.
- The Senate proposal would expand the definition of a substantial built-in loss for purposes of section 743(d). There is no counterpart in the House bill.
  - Under current law, a partnership generally does not adjust the basis of partnership property following a transfer of a partnership interest. However, if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest. A substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.
  - The Senate proposal would provide that a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all of the partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

- The Senate proposal modifies the section 704(d) outside basis limitation on partner losses to provide that generally a partner's distributive share of charitable contributions and foreign tax expenditures are allowed only to the extent of the partner's outside basis at the end of the partnership taxable year in which the expenditure occurs. There is no counterpart in the House bill.
  - Under current law, in applying the section 704(d) outside basis limitation on partner losses, Treasury regulations do not take into account the partner's share of partnership charitable contributions and foreign taxes paid or accrued, which effectively permits such items to be taken into account by partners regardless of whether they have tax basis in their partnership interests.
- The Senate proposal does not contain any specific changes to the treatment of carried interest, although the issue may be addressed in markup. An amendment to the House bill would impose with respect to partnership interests received in connection with performing certain management services a three-year holding period requirement for allocable gain from partnership assets to be eligible for long-term capital gain tax rates (essentially increasing the relevant holding period for the assets generating such gain from 1 year to 3 years).
- The Senate proposal does not make any specific changes to the S corporation rules. An amendment to the House bill includes provisions that would provide relief of S corporations that convert to C corporations within two years of the enactment of the tax reform legislation.
- Unlike the House bill, the Senate proposal does not repeal the partnership technical termination rule.

- **International Provisions**
  - The international provisions in the Senate's initial tax reform plan (as described in the Joint Committee on Taxation's summary) contain similarities and differences from those included in the House's final tax reform bill. Both the Senate's and House's versions propose moving toward a territorial tax system (specifically, through the adoption of a dividend-exemption system), but the base erosion mechanisms are different.
  - **Dividend-Exemption System.**
    - The Senate proposal provides for a 100% deduction for the foreign-source portion of dividends received from specified 10% owned foreign corporations by domestic corporations that are United States shareholders of those foreign corporations within the meaning of section 951(b) (referred to in the proposal as DRD). No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the DRD. There are also provisions addressing hybrid dividends, holding periods, and sales or transfers.
    - The proposal is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of US shareholders in which or with which such taxable years of foreign corporations end.
  - **Tax on Deferred Foreign Income Upon Transition to Dividend-Exemption System.**
    - The proposal generally requires that, for the last taxable year beginning before January 1, 2018, any US shareholder of a specified foreign corporation must include in income its pro rata share of the undistributed, non-previously-taxed

post-1986 foreign earnings of the corporation, generally determined as of November 9, 2017 ("mandatory inclusion"). Generally, the tax on the aggregate earnings and profits attributable to cash assets is 10%, while the tax on aggregate earnings and profits attributable to other assets is 5%. These rates are lower than the rates in the House bill (14% and 7%). A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income. The increased tax liability generally may be paid over an eight-year period (without interest).

- For purposes of this proposal, a specified foreign corporation is any foreign corporation that has at least one US shareholder. It does not include PFICs that are not also CFCs.

- **Current Year Inclusion of Global Intangible Low-Taxed Income by United States Shareholders.**
  - Under the proposal, a US shareholder of any CFC must include in gross income for a taxable year its global intangible low-taxed income (GILTI) in a manner generally similar to inclusions of subpart F income. GILTI means, with respect to any US shareholder for the shareholder's taxable year, the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The shareholder's net deemed tangible income return is an amount equal to 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("QBAI") of each CFC with respect to which it is a US shareholder. This is the Senate version of the House "foreign high returns" proposal.
  - The proposal is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of US shareholders in which or with which such taxable years of foreign corporations end.
- **Deduction for Foreign-Derived Intangible Income.**
  - In the case of a domestic corporation, the proposal allows (for the corporation's taxable year) a deduction equal to 37.5% of the lesser of (1) the sum of its foreign-derived intangible income plus the amount of GILTI that is included in its gross income, or (2) its taxable income, determined without regard to this proposal. The foreign-derived intangible income of any domestic corporation is the amount which bears the same ratio to the corporation's deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income. The Secretary is authorized to prescribe regulations or other guidance as may be necessary or appropriate to carry out this proposal.
  - The proposal is effective for taxable years beginning after December 31, 2017.
- **Special Rules for Transfers of Intangible Property from Controlled Foreign Corporations to United States Shareholders.**
  - The Senate proposal includes a provision to allow intangible property to be transferred back to the United States without incurring US tax. For certain distributions of intangible property held by a CFC on the date of enactment of this proposal, the fair market value of the property on the date of the distribution is treated as not exceeding the adjusted basis of the property immediately before the distribution. If the distribution is not a dividend, a US shareholder's adjusted

basis in the stock of the CFC with respect to which the distribution is made is increased by the amount (if any) of the distribution that would, but for this proposal, be includible in gross income. The adjusted basis of the property in the hands of the US shareholder immediately after the distribution is the adjusted basis immediately before the distribution, reduced by the amount of the increase (if any) described previously.

- For purposes of the proposal, intangible property means intangible property as described in section 936(h)(3)(B) and computer software as described in section 197(e)(3)(B).
- The proposal applies to distributions that are (1) received by a domestic corporation from a CFC with respect to which it is a US shareholder and (2) made by the CFC before the last day of the third taxable year of the CFC beginning after December 31, 2017.
- The proposal is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of US shareholders in which or with which such taxable years of foreign corporations end.

- **Other Modifications to Subpart F Provisions.**
  - The proposal eliminates foreign base company oil related income as a category of foreign base company income. A similar provision was in the House bill reported out of committee.
  - In the case of any taxable year beginning after 2017, the proposal indexes for inflation the $1,000,000 *de minimis* amount for foreign base company income, with all increases rounded to the nearest multiple of $50,000. A similar provision was in the House bill reported out of committee.
  - The proposal repeals section 955. As a result, a US shareholder in a CFC that invested its previously excluded subpart F income in qualified foreign base company shipping operations is no longer required to include in income a pro rata share of the previously excluded subpart F income when the CFC decreases such investments. A similar provision was in the House bill reported out of committee.
  - The proposal amends the ownership attribution rules of section 958(b) so that certain stock of a foreign corporation owned by a foreign person is attributed to a related US person for purposes of determining whether the related US person is a US shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. In other words, the proposal provides "downward attribution" from a foreign person to a related US person in circumstances in which present law does not so provide. The pro rata share of a CFC's subpart F income that a United States shareholder is required to include in gross income, however, continues to be determined based on direct or indirect ownership of the CFC, without application of the new downward attribution rule. A similar provision was in the House bill reported out of committee.
  - The proposal expands the definition of US shareholder under subpart F to include any US person who owns 10% or more of the total value of shares of all classes of stock of a foreign corporation. (Current law requires 10% or more of the total combined voting power.)

- The proposal eliminates the requirement that a corporation must be controlled for an uninterrupted period of 30 days before subpart F inclusions apply. A similar provision was in the House bill reported out of committee.
- The proposal makes permanent the exclusion from foreign personal holding company income for certain dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties received or accrued by one CFC from a related CFC. A similar provision was in the House bill reported out of committee.
- The requirement in subpart F that US shareholders recognize income when earnings are repatriated in the form of increases in investment by a CFC in US property is amended to provide an exception for domestic corporations that are US shareholders in the CFC either directly or through a domestic partnership. The House bill reported out of committee would repeal section 956 entirely.

○ **Anti-Base Erosion Measures.**

- Denial of deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic indebtedness.
  - The proposal limits the deductibility of interest paid or accrued by US corporations that are members of a worldwide affiliated group. For any domestic corporation that is a member of a worldwide affiliated group, the proposal reduces the deduction for interest paid or accrued by the corporation by the product of the net interest expense of the domestic corporation multiplied by the debt-to-equity differential percentage of the worldwide affiliated group. A global thin capitalization rule was also included in the House bill reported out of committee.
  - The proposal is effective for taxable years beginning after December 31, 2017.
- Limitations on income shifting through intangible property transfers.
  - The proposal addresses recurring definitional and methodological issues that have arisen in controversies involving transfers of intangible property for purposes of sections 367(d) and 482, both of which use the statutory definition of intangible property in section 936(h)(3)(B). The proposal revises that definition to include workforce in place, goodwill, and going concern value. The proposal also confirms the authority to require certain valuation methods. It does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property.
  - The proposal applies to transfers in taxable years beginning after December 31, 2017. No inference is intended with respect to application of section 936(h)(3)(B) or the authority of the Secretary to provide by regulation for such application on or before the date of enactment.
- Denial of deduction for any certain related party amounts paid or accrued in hybrid transactions or with hybrid entities.
  - The proposal denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty

paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a US shareholder under section 951(a). A related party for these purposes is generally determined under the rules of section 954(d)(3).

- The proposal is effective for taxable years beginning after December 31, 2017.

- Termination of special rules for domestic international sales corporations.
  - The proposal repeals the special rules for DISCS and IC-DISCS and includes a transition rule for shareholders of corporations the DISC elections of which are terminated. The proposal is effective for taxable years beginning after December 31, 2018.
- Surrogate foreign corporations not eligible for reduced rate on dividends.
  - Any individual shareholder who receives a dividend from a corporation which is a surrogate foreign corporation as defined in section 7874(a)(2)(B), other than a foreign corporation which is treated as a domestic corporation under section 7874(b), is not entitled to the lower rates on qualified dividends provided for in section 1(h). The proposal is effective for dividends paid in taxable years beginning after December 31, 2017.

- **Modifications to Foreign Tax Credit System.**
  - Repeal of section 902 indirect foreign tax credits and the determination of section 960 credit on current-year basis.
    - The proposal repeals the deemed-paid credit with respect to dividends received by a domestic corporation which owns 10% or more of the voting stock of a foreign corporation. A deemed-paid credit is provided with respect to any income inclusion under subpart F. The deemed-paid credit is limited to the amount of foreign income taxes properly attributable to the subpart F inclusion. The proposal eliminates the need for computing and tracking cumulative tax pools. A similar provision was in the House bill reported out of committee.
  - Separate foreign tax credit limitation basket for foreign branch income.
    - The proposal requires foreign branch income to be allocated to a specific foreign tax credit basket. Foreign branch income is the business profits of a US person which are attributable to one or more QBUs in one or more foreign countries. Under this proposal, business profits of a QBU shall be determined under rules established by the Secretary. Business profits of a QBU shall not, however, include any income which is passive category income.
    - The proposal is effective for taxable years beginning after December 31,

2017.

- Acceleration of election to allocate interest on a worldwide basis.
  - This proposal accelerates the effective date of the worldwide interest allocation rules to apply to taxable years beginning after December 31, 2017, rather than to taxable years beginning after December 31, 2020.
- Source of income from sales of inventory determined solely on basis of production activities.
  - Under this proposal, gains, profits, and income from the sale or exchange of inventory property produced partly in, and partly outside, the United States is allocated and apportioned on the basis of the location of production with respect to the property. Likewise, income derived from inventory property sold in the United States, but produced entirely in another country, is sourced in that country even if title passage occurs in the United States. If the inventory property is produced partly in, and partly outside, the United States, however, the income derived from its sale is sourced partly in the United States. A similar provision was in the House bill reported out of committee.
  - The proposal is effective for taxable years beginning after December 31, 2017.

- **Base Erosion Minimum Tax.**
  - Under the proposal, an applicable taxpayer is required to pay a tax equal to the base erosion minimum tax amount for the taxable year. In general, the base erosion minimum tax amount means, with respect to an applicable taxpayer for any taxable year, the excess of 10% of the modified taxable income of the taxpayer (generally, taxable income adding back deductible payments to foreign affiliates, to the extent not subject to full withholding) for the taxable year over an amount equal to the regular tax liability of the taxpayer for the taxable year reduced (but not below zero) with certain adjustments for credits. In sum, the base erosion tax would equal 10% of the excess of deductible payments to foreign affiliates over the taxable income of the US payor computed with regard to the deductible payments.
  - An applicable taxpayer means, with respect to any taxable year, a taxpayer: (A) which is a corporation other than a regulated investment company, a real estate investment trust, or an S corporation; (B) which has average annual gross receipts of at least $500 million for the three-taxable-year period ending with the preceding taxable year; and (C) which has a base erosion percentage (generally, deductible payments to foreign affiliates divided by total allowable deductions) of 4% or higher for the taxable year.
  - The proposal introduces additional reporting requirements under section 6038A. The penalties provided for under sections 6038A(D)(1) and (2) are both increased to $25,000.
  - The proposal applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.
- **Other Provisions.**

- The proposal creates a category of income defined as passenger cruise gross income, provides rules for determining the extent to which such income is effectively connected to a US trade or business, and removes such income from eligibility for the reciprocal exemption of section 883. The proposal is effective for taxable years beginning after December 31, 2017.
- The proposal modifies the PFIC rules for determining active income of a foreign corporation engaged in insurance activities by replacing the test based on whether a corporation is predominantly engaged in an insurance business with a test based on the corporation's insurance liabilities. The requirement that the foreign corporation would be subject to tax under subchapter L if it were a domestic corporation is retained. The proposal applies to taxable years beginning after December 31, 2017. The House bill reported out of committee contains a similar provision addressing the PFIC insurance rules.
- The proposal prohibits members of a US affiliated group from allocating interest expense on the basis of the fair market value of assets for purposes of section 864(e). Instead, the members must allocate interest expense based on the adjusted tax basis of assets. The proposal is effective for taxable years beginning after December 31, 2017.

- **Business Deductions**
  - **Interest**. Under the Senate proposal, the amount of net interest that can be deducted by any business with gross receipts of $15 million or more is generally limited to 30% of the adjusted taxable income for the year. Adjusted taxable income means the taxable income of the taxpayer computed without regard to: (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the 17.4% deduction for certain pass-through income; and (4) the amount of any net operating loss deduction. The limitation does not apply to certain regulated public utilities. In addition, the trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation. Also, at the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses. The amount of any business interest not allowed as a deduction may be carried forward and used as a deduction in a subsequent year. If the limitation on deduction of interest by a domestic corporation that is a member of a worldwide affiliated group with excess domestic indebtedness would also apply, then whichever rule imposes the lower limitation controls. This proposal is similar in certain respects to the interest deduction limitation proposed in the House bill, but with important differences. The gross receipts threshold is lower in the Senate proposal. In addition, the definition of "adjusted taxable income" in the Senate proposal is different than in the House bill. The Senate proposal does not include amortization, depreciation, or depletion (i.e., it uses EBIT instead of EBITDA for the computation).
  - **Net Operating Losses**. The Senate proposal limits the net operating loss deduction to 90% of taxable income, consistent with the rule that applies under the current law alternative minimum tax. The proposal repeals the two-year carryback and special carryback provisions, but provides an exception for certain farming losses. This provision

is similar to the net operating loss provision in the House bill.

- **Depreciation and Expensing**. Under the Senate proposal, the 50% bonus depreciation under current law is increased to 100% through 2022 (through 2023 for longer production period property and certain aircraft). The proposal generally applies to property placed in service after September 27, 2017, and to specified plants planted or grafted after such date. There is a transition rule that allows a taxpayer to elect to apply a 50% allowance for the first taxable year ending after September 27, 2017. This provision is similar to the 100% provision in the House bill, but is broader.
- **Recovery Period for Real Property**. The Senate proposal also includes an additional provision that would shorten the recovery period for determining the depreciation deduction with respect to nonresidential real and residential rental property to 25 years. There is no corresponding provision in the House bill.
- **Like-Kind Exchanges**. The Senate proposal would limit like-kind exchanges under section 1031 to exchanges of real property. The proposal includes a transition rule to allow like-kind exchanges for personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017. This proposal is the same as the proposal on like-kind exchanges in the House bill.

INSURANCE COMPANIES

- **Life Insurance Companies**
  - The provisions concerning life insurance companies in the Senate proposal substantially mirror the unamended original House bill, including changes with respect to net operating losses, repeal of the small life insurance company deduction, adjustments for change in computing reserves, and repeal of the special rule for distributions to shareholders from pre-1984 policyholders surplus accounts.
- **Non-life Insurance Companies**
  - The proposal amends section 832 to provide that, for proration purposes, the reduction in the losses incurred deduction attributable to tax-exempt interest and the dividends received deduction is increased from 15% to an amount equal to 5.25% divided by the top corporate tax rate. A similar provision was included in the House bill but with a different percentage calculation.
  - The proposal amends section 848 to extend the amortization period for specified policy acquisition expenses from a 120-month period to a 600-month period. The proposal does not change the special rule providing for 60-month amortization of the first $5 million of specificied policy acquisition expenses (with phaseout). The proposal provides that for annuity contracts, the percentage is 3.17; for group life insurance contracts, the percentage is 3.72; and for all other specified insurance contracts, the percentage is 13.97.
  - As in the House bill, the proposal repeals section 847 and the special estimated tax payment rules related to the difference between discounted and undiscounted reserves.

COMPENSATION AND RETIREMENT SAVINGS

- **Compensation**

- The Senate proposal repeals section 409A governing deferred compensation for services performed after December 31, 2017, by adding a new section 409B. The effect of the repeal of section 409A is to cause compensation to be immediately taxable upon the lapse of a substantial risk of forfeiture (i.e., upon vesting). Unlike current law, the new Senate proposal causes stock options and stock appreciation rights (SARs) to become immediately taxable upon vesting. Vesting is redefined as time vesting, thereby excluding vesting based on achievement of performance goals. The repeal essentially eliminates the efficacy of stock options and SARs, while retaining the current law rules for incentive stock options and section 423 employee stock purchase plans. Under the new rule, a substantial risk of forfeiture is based only upon the performance of future services, eliminating the concept of vesting after separation of service. Transfers of property under section 83 are unaffected by the Senate proposal (except regarding non-qualified options). The Senate proposal preserves the short-term deferral rule and provides a transition rule for amounts deferred prior to 2018. The House bill originally contained a similar repeal of section 409A, but it was restored in the House bill by amendment. The House bill also allowed an election under a new section 83(i) for broad-based deferred compensation plans for non-public companies, but this provision is not included in the Senate proposal.
- The Senate proposal repeals the special deferred compensation rules for executives of tax-exempt organizations under section 457(f), making such compensation subject to the new section 409B, and repeals the rules applicable to deferred compensation of tax indifferent entities under section 457A. The Senate proposal also would change the contribution limits applicable to eligible deferred compensation plans under section 457(b).
- The Senate proposal contains the House bill's changes to the $1 million deduction cap on public company executive compensation under section 162(m). The change includes commissions and performance-based compensation in the calculation of the $1 million cap, thereby discouraging excess compensation, and changes the executives to whom section 162(m) applies. Under current law, section 162(m) provides for the exclusion of commissions and performance-based compensation from the $1 million cap.
- The Senate proposal, like the House bill, includes a new 20% excise tax on tax-exempt organizations for paying compensation to certain highly compensated employees in excess of $1 million, including, for example, coaches at public colleges and universities. Additionally, a new 20% excise tax similar to the "parachute tax" under section 280G applies to a tax-exempt organization that pays certain executives excess amounts that are contingent upon a separation from employment, rather than upon a change in control.

- **Retirement Savings**
  - The proposal includes none of the retirement savings provisions included in the House bill, such as changes to in-service distributions, hardship distributions, loan rollovers and nondiscrimination testing. Nor does the proposal subject governmental pension plans and other entities to the unrelated business income tax (UBIT) rules as the House bill did.
  - The proposal would coordinate the limits for governmental section 457(b) plans with the limits for section 401(k) and 403(b) plans so that the same limits apply to elective deferrals and catch-up contributions under section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans. The proposal would also revise application of the limit on aggregate contributions so that a single aggregate limit applies to contributions

for an employee to any defined contribution plan, section 403(b) plan, and any governmental section 457(b) plan maintained by the same employer.

- The proposal would repeal the special rules allowing additional elective deferrals and catch-up contributions under section 403(b) plans and governmental section 457(b) plans, and would repeal the special rule allowing employer contributions to section 403(b) plans for up to five years after termination of employment.
- Under the proposal, the 10% early withdrawal tax that applies to most employer-sponsored retirement plans would become applicable to a distribution from a governmental section 457(b) plan before age 59½, to the extent the distribution is includible in income.
- The proposal would eliminate catch-up contributions for high wage earners. Under the proposal, an employee could not make catch-up contributions for a year in which the employee received wages of $500,000 or more for the preceding year.
- The retirement provisions would be effective for plan years and taxable years beginning after December 31, 2017.

- **Worker Classification**
  - The Senate proposal addresses the confusing worker classification rules under current law for distinguishing between common law employees and independent contractors for tax purposes. The House bill contained no similar provision. The Senate proposal would establish a safe harbor based on specific requirements, such as whether the worker generally (1) incurs expenses deductible as trade or business expenses and is reimbursed for most such expenses; (2) agrees to work for a particular amount of time, to achieve a specific result, or to complete a specific task; and (3) has a significant investment in the assets or training related to the services, not be required to perform services exclusively for the entity receiving the services, or has not performed substantially the same services as an employee of the service recipient during the prior year; and not be compensated based primarily on hours actually worked. If these requirements are satisfied and the parties enter into a contract that satisfies certain conditions, the safe harbor provides that the worker is not treated as an employee of the entity receiving the services or of the entity charged with paying the worker; neither such entity is treated as the worker's employer, and the compensation received by the worker is not treated as pay for employment. The safe harbor means that the worker could be classified as an independent contractor, rather than an employee, of service recipients and third-party payors.

INDIVIDUALS

- **Individual Rates and Standard Deduction**
  - While the House plan had four individual tax rates, the Senate plan has seven tax brackets: 10, 22, 22.5, 25, 32.5, 35 and 38.5%. The highest individual tax rate of 38.5% would apply to individual taxpayers with incomes over $500,000 and married couples with over $1 million in annual income.
  - As in the House bill, the standard deduction is increased to $12,000 for individuals and $24,000 for married couples.
- **State and Local Tax Deduction**

  - The proposal fully eliminates the deduction for state and local taxes. The Senate plan does not include an exception for state and local property taxes.

- **Mortgage Interest Deduction**
  - The Senate proposal generally would keep the mortgage interest deduction as it stands under current law.
- **Child Tax Credit**
  - The child tax credit is increased to $1,650 from $1,000 per qualifying child. Additionally, the age limit for a qualifying child is increased by one year to include children under 18.
  - The proposal includes an additional $500 credit for non-dependent children, as compared to $300 under the House bill.
  - The threshold at which the credit begins to phase out is increased to $1 million for married taxpayers filing a joint return and $500,000 for all other taxpayers.
  - The Senate proposal does not include the new family flexibility credit proposed by the House.
- **Estate Tax**
  - The Senate proposal doubles the estate, gift and generation-skipping transfer tax exemption from $5 million to $10 million (adjusted for inflation occurring after 2011) for estates of decedents dying, generation-skipping transfers, and gifts made after December 31, 2017.
  - The Senate proposal does not include any provision for ultimate repeal of the estate, gift or generation-skipping transfer taxes.
  - The Senate proposal would maintain the current law basis step up under section 1014 for property received from a decedent at death.

EXEMPT ORGANIZATIONS

- As with the House bill, the Senate bill would leave the charitable contribution deduction in place as an itemized deduction, and no “universal” or “above-the-line” deduction is included in the bill. In addition, the increase in the standard deduction, limitations on and repeal of several itemized deductions, and the increase in the estate tax exemption in the Senate bill are expected to reduce the incentive provided by the charitable contribution deduction. The Senate bill also retains the excise taxes on net investment income from private college and university endowments and on certain executive compensation paid by tax-exempt organizations, among other provisions affecting tax-exempt organizations included in the House bill.

- The Senate bill includes a number of significant changes to the intermediate sanctions rules under section 4958 (excise tax on excess benefit transactions):

  - The Senate bill would impose a 10% excise tax on the tax exempt organization (in addition to the existing taxes on disqualified persons and the organization’s managers), unless the organization establishes that the minimum standards of due diligence were met with respect to the transaction or that other reasonable procedures were used to ensure that no excess benefit was provided.

- In addition, the Senate bill would eliminate the rebuttable presumption of reasonableness with respect to compensation arrangements and property transfers.
- Under the proposal, the procedures that presently provide an organization with a presumption of reasonableness generally will establish instead that an organization has performed the minimum standards of due diligence. Consequently, such procedures would only avoid penalties on the organization and not on the disqualified person or organization managers.
- The proposal eliminates the special rule that provides that an organization manager's participation ordinarily is not "knowing" for purposes of the intermediate sanctions excise taxes if the manager relied on professional advice, rather such reliance is one of the factors to be considered.
- The proposal modifies the definition of a disqualified person for purposes of the intermediate sanctions rules to include certain investment advisors and athletic coaches.
- The proposal extends application of the section 4958 intermediate sanctions rules to tax-exempt organizations described in sections 501(c)(5) (labor and certain other organizations) and 501(c)(6) (business leagues and certain other organizations).

- The Senate bill includes a number of other provisions affecting tax-exempt organizations that were not in the House bill, including:
  - A provision that generally subjects any sale or licensing by an organization of any name or logo of the organization (including any trademark or copyright related to a name or logo), and the royalties derived from any such licensing, to the unrelated business income tax (UBIT) provisions.
  - A requirement that UBTI first be computed separately with respect to each separate unrelated trade or business so that deductions from one such trade or business generally will not be able to offset income from another trade or business.
  - A repeal of the tax-exempt status for professional football leagues as section 501(c)(6) organizations, and extends such exclusion to all professional sports leagues.
  - The original House bill included a repeal of the rules for deferred compensation for tax-exempt organization employees under sections 457(f), 457(b), and 457A with respect to services performed after December 31, 2017. This repeal was removed from the original House bill by amendment during the markup process. However, the Senate bill generally has retained this repeal from the original House bill.

- The Senate bill also omits a number of provisions affecting tax-exempt organizations contained in the House bill, including:
  - A provision permitting 501(c)(3) organizations, including churches and certain related organizations, to make statements relating to political candidates in the ordinary course of exempt activities, provided the organization incurred only *de minimis* incremental expenses.

- A simplification of the current two-tier private foundation excise tax on investment income to be replaced by a flat 1.4% excise tax.
- The termination of the tax preference for private activity bonds, including qualified 501(c)(3) bonds, tax credit bonds, and bonds used to finance professional sport stadiums.
- The repeal of the controversial option in section 170(f)(8)(D) under which the IRS currently may allow donee organizations to report charitable contributions to the IRS instead of sending a contemporaneous acknowledgement to the donor.
- A clarification that UBIT rules apply to "dual-status" organizations, which are also exempt under provisions of the code other than section 501.
- Other changes to UBIT, including an inclusion of certain fringe benefits (qualified transportation, qualified parking, and on-premises athletic facilities) provided to employees of tax-exempt organizations in the computation of UBTI and narrowing of the UBIT exclusion for research income, limiting its application to income from research that is freely available to the public.
- A limited exception to the excess business holding rules for private foundations that would be created for certain wholly-owned and independently operated businesses where all net operating income promptly is distributed for use in the foundation's charitable purposes.
- Additional reporting requirements for donor advised fund sponsoring organizations.
- A provision providing that an organization that operates an art museum as a substantial activity will not qualify as a private operating foundation unless the museum is open during normal business hours to the public for at least 1,000 hours per year.
- An adjustment for the amount deductible for use of a passenger automobile for charitable purposes from the current fixed 14 cents per mile, to an amount that reflects the current variable cost of operating an automobile (as is currently used to calculate the medical and moving expense deductions).