Overview of Ways and Means Chairman Brady's tax reform bill

November 5, 2017

In brief

House Ways and Means Committee Chairman Kevin Brady (R-TX) on November 2, 2017 introduced a 429-page "Tax Cuts and Jobs Act" (HR 1) that would make dramatic changes to the taxation of businesses and individuals.

Chairman Brady released a substitute amendment to the bill on November 3, and announced that he intends to offer additional amendments for Ways and Means Committee 'markup' sessions scheduled to begin on November 6. Chairman Brady's November 3 changes include accelerating the use of a 'chained' consumer price index (CPI) to adjust for inflation certain tax provisions (such as individual tax brackets) and striking a proposal in the bill that would have limited tax treaty benefits for certain deductible payments.

Below is a general summary of select business and individual tax proposals in Chairman Brady's bill as modified (the 'bill'), along with links to explanations and updated revenue estimates released by the Ways and Means Committee and Joint Committee on Taxation staffs.

Observation: The legislation is proposed to be generally effective for tax years beginning after 2017. Certain provisions have separate effective dates, most commonly after date of introduction (November 2, 2017), but others are effective after the date of enactment and some are effective for tax years beginning after 2016. The bill also proposes some temporary measures and provides transition rules for certain proposals.

For a brief outline of Ways and Means Committee Chairman Brady's bill as originally introduced and coming steps in the tax reform process, see our November 2 PwC Insight. We will be providing additional analysis of House and Senate tax reform legislation in coming PwC Insights.

In detail

Business tax reform proposals

Corporate tax rate

Under the bill, the current graduated corporate tax rate structure with a top rate of 35 percent would be eliminated, and corporate income generally would be taxed at 20 percent, effective for tax years beginning after 2017. A 25-percent corporate rate would apply for certain 'personal service corporations' in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, or consulting in which services are substantially performed by employee-owners.

Observation: A 20-percent federal corporate income tax rate combined with current

average state income tax rates would total 24.8 percent, just above the 23.75-percent average rate for all other OECD countries in 2017. With the reduction in the US federal corporate tax rate, taxpayers' state income tax burden will likely be of greater significance to the computation of taxpayers' overall effective tax rates.

Observation: Companies impacted by the many proposals of the bill, such as a reduced corporate income tax rate, will want to consider the tax accounting effects of tax reform legislation on financial statements (see discussion below).

Alternative minimum tax

The alternative minimum tax (AMT) would be repealed under the bill, effective for tax years beginning after 2017. Taxpayers with AMT credit carryforwards could claim a refund of 50 percent of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning in 2019, 2020, and 2021. For any remaining AMT credit carryforwards after 2021, taxpayers could claim a refund for all the credits in the tax year beginning in 2022.

Full expensing of certain property

The Brady bill would amend Section 168(k)(1)(A) by striking '50 percent' and inserting '100 percent,' thus allowing taxpayers to expense immediately the entire cost of certain depreciable assets acquired and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain aircraft and qualified property with a longer production period).

Observation: For taxpayers that do not wish to avail themselves of the immediate expensing provision, the ability to elect out of Section 168(k) would continue to exist.

Observation: Since many states already decouple from or modify Section 168(k), we expect continued nonconformity in this area. Given the potential magnitude of the benefit, other states may enact legislation to decouple. Nonconformity raises many state issues, including federal and state basis discrepancies, modifications required in computing state taxable income, and the financial statement implications associated with the potential book-to-tax differences from a state income tax perspective.

The bill would make two notable modifications to the definition of 'qualified property' under Section 168(k)(2). First, it would expand the definition of qualified property by repealing the requirement that the original use of the property begin with the taxpayer. As a result, as long as such used property had not been used by the taxpayer at any time prior to the acquisition and meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of Section 179(d), it generally should be considered qualified property under Section 168(k) and eligible for immediate expensing. Second, the term qualified property would not include any property used in the trade or business of certain regulated public utilities or property used in real property trades and businesses as defined in Section 469(c)(7)(C).

Interest expense limitation

The bill would repeal current Section 163(j), and replace it with a new Section 163(j) interest limitation, which would broadly apply to the business interest of most large taxpayers (including both corporate and passthrough entities, and including entirely domestic entities and entities part of a US-parented or foreign-parented group), effective for tax years beginning after 2017. The bill would limit an entity's deduction for net business interest to 30 percent of the business's 'adjusted taxable income' (similar concept to the current Section 163(j)). The current safe harbor, where the debt to equity ratio is no greater than 1.5 to 1, would be eliminated. Certain regulated public utilities and real property trades or businesses would be specifically excluded from the limitations under new Section 163(j), as well as certain small businesses (businesses with average annual gross receipts for the prior three tax years of $25 million or less).

Observation: While the bill provides an exception for regulated public utilities, further clarification on the operation of the interest expense allocation rules and adjusted taxable income rules for consolidated groups with both regulated utilities and non-regulated operations may be necessary.

The bill also would add new Section 163(n), which would further limit the US interest deductions of US corporations (and foreign corporations with US businesses) that are part of large multinational groups (i.e., groups with consolidated/audited financial statements and average annual gross receipts greater than $100 million). Specifically, this provision would apply to both US and foreign multinational corporations. A US business's net interest expense deduction would be disallowed to the extent it exceeds a portion of the group's worldwide net interest expense, determined by reference to the US business's share of the group's worldwide consolidated EBITDA. In effect, the interest expense deduction would be limited to the extent the US corporation's share of the group's global net interest expense exceeds 110 percent of the US corporation's share of the group's global EBITDA. The bill also specifies that disallowed interest expense under new Section

163(n) would be subject to carryover under Section 381 and limitation under Section 382.

New Section 163(n) and revised Section 163(j) would apply concurrently, with the 'harsher' provision denying the greater amount of interest expense deduction applying. Existing loans are not grandfathered under these proposals.

In the case of a partnership, the interest expense disallowance is determined at the partnership level (instead of at the partner level). Any deduction for interest is taken into account in determining the partnership's nonseparately stated income or loss. In order to prevent double counting of income, partners, for purposes of calculating their limitation, determine their adjusted taxable income without regard to their share of the partnership's nonseparately stated income or loss. A partnership's unused interest limitation for the taxable year may be used by the partners.

Observation: While new Section 163(j) may apply to limit the deductibility of interest by an S corporation, Section 1363(b) might be asserted to exclude S corporations from the proposed Section 163(n) limitation on interest deductions for domestic corporations that are members of an international financial reporting group.

***Observation*:** States may decide to conform with the new interest limitations. It is unclear how they would be applied in combined and consolidated reporting states, since the limitation is applied to 'the taxpayer' which could mean an individual entity or an entire combined or consolidated group. Further, states may conform to or decouple from the federal interest deduction five-year carryforward period.

Domestic production activities deduction

Under current law, a taxpayer may claim a deduction under Section 199 for certain qualified production activities performed in whole or in significant part within the United States, subject to a W-2 wage limitation. The bill would repeal Section 199 for tax years beginning after 2017. The bill also would retroactively extend section 199 for domestic gross receipts from Puerto Rico for tax years beginning after December 31, 2016 and before January 1, 2018.

Net operating losses

Current law generally permits a taxpayer to carry back a net operating loss (NOL) two years and carry forward an NOL 20 years to offset taxable income in such years. Effective for tax years beginning after 2017, the bill would limit a taxpayer's ability to utilize its NOL deduction to 90 percent of taxable income (determined without regard to the deduction), similar to the rule applicable to AMT NOLs under current law. The bill generally would eliminate the carryback of all NOLs arising in a tax year beginning after 2017 and instead would permit all such NOLs to be carried forward indefinitely. Moreover, the bill would increase the carryforwards for NOLs arising in tax years beginning after 2017 by an interest factor (the short-term AFR plus four percentage points) in an attempt to preserve the real value thereof. Under the bill, an NOL arising in 2017 could be carried back under current-law rules, except to the extent such NOL was attributable to the increased expensing proposal discussed above.

Observation: Taxpayers initially may be disappointed that NOL carrybacks generally would be eliminated under the bill. However, the new proposed rules, which also would allow NOLs to be carried forward indefinitely, appear to ensure that the real value of an NOL carryforward does not decrease as a result of inflation, thus providing an offsetting benefit.

Observation: Most state net operating loss rules differ from federal NOL rules, with a few exceptions (e.g., Delaware and Missouri).

Like-kind exchanges

Under current law, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a 'like kind' that is held for productive use in a trade or business or for investment. In a qualifying like-kind exchange, the basis in the new property equals the taxpayer's adjusted basis in the exchanged property, thus deferring any gain inherent in the exchanged property. The bill would limit the applicability of the gain deferral rules to only like-kind exchanges of real property, effective for transfer exchanges completed after December 31, 2017. A transition rule would allow for like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired replacement property on or before December 31, 2017.

Contributions to capital

Under present-law Section 118, the gross income of a corporation generally does not include contributions to its capital. Moreover, under Section 108(e)(6), a debtor corporation that acquires its own debt from a shareholder as a contribution to capital generally will not recognize cancellation of debt income except to the extent the shareholder's basis in such debt is less than the adjusted issue price thereof.

The bill would repeal both provisions, and add a new Section 76, which would provide that the gross income of any entity includes any contribution to capital. However, in the case of a corporation, the gross income of such corporation would include contributions to its capital only to the extent that the amount of money and the fair market value of property contributed to the corporation exceeds the fair market value of any stock that is issued in exchange for such money or property. In the case of a contribution to an entity other than a corporation (such as a partnership), similar rules would apply. The proposal would apply to contributions made, and transactions entered into, after the date of enactment.

Observation: The Ways and Means Committee's summary states that this provision is intended to remove a federal tax subsidy for state and local governments to offer incentives and concessions to businesses to locate operations within their state, through transfers of money or property without taxation to the recipient entity. However, the text of new Section 76 is not limited to such contributions, and the provision appears to apply to any contribution to capital not involving the issuance of stock of equivalent value. Thus, the pro rata contribution of capital to a corporation by all shareholders of the corporation in exchange for no issuance of additional stock, which has long been regarded as a nontaxable event to the transferee corporation, potentially would result in gain recognition to the transferee corporation under new Section 76. Additionally, the elimination of Section 108(e)(6) would limit the flexibility of a corporation to restructure its debt on a tax-efficient basis.

Section 179

The bill would increase the Section 179 dollar limitation to $5 million from $500,000, while increasing the cost of property subject to the phase-out to $20 million from $2 million. The new dollar limitations would be indexed for inflation and would be effective for tax years beginning after December 31, 2017 through tax years beginning before January 1, 2023. The property subject to Section 179 would be expanded to include qualified energy efficient heating and air-conditioned property, as defined in the bill. The application of Section 179 to qualified energy efficient heating and air-conditioned property would be effective for property acquired and placed in service after November 2, 2017.

Business credits

The research credit and low income housing tax credit would be retained.

The bill would repeal the New Markets Tax Credit, the Work Opportunity Tax Credit, the rehabilitation tax credit, the employer-provided child care credit, the credit for eligible-access expenditures, and the so-called 'orphan drug' credit. Section 196, which allows a deduction for certain unused business credits, also would be repealed.

Observation: Repeal of the orphan drug credit could have a significant effect on investment decisions by certain pharmaceutical companies.

The bill would provide several modifications, extensions, and repeal for certain energy tax credits prevalent in the power and utility industry, most notably the Section 45 Production Tax Credits (PTC) and the Section 48 Investment Tax Credits (ITC).

- The bill would modify Section 45 to reduce the amount of PTCs by eliminating the inflation adjustment that exists in the current credit, thereby limiting the credit to a maximum of 1.5c per kWh of electricity generated, effective for facilities for which construction begins after date of enactment. In addition, the bill would amend Section 45(e) to retroactively require a 'program of continuous construction' to meet the PTC 'begin construction' test.
- The bill would modify Section 48 to eliminate the 10-percent investment tax credit (ITC) for qualified solar property for which construction would begin after 2027.

Observation: Certain wind investors and developers currently relying on existing safe harbor provisions may be impacted by the retroactive 'continuous construction' requirement for PTCs.

Oil and gas

The bill would repeal the Section 43 Enhanced Oil Recovery Credit, and Section 45I credit for producing oil and gas from marginal wells, effective for tax years after 2017.

As noted below, income from commodities, including oil and gas, would be specifically excluded from current taxation of certain 'high return' foreign income and an excise tax on certain payments to foreign affiliates as discussed in the new proposed Section 951A and Section 4491, respectively. The bill also would amend Sections 952 and 954 by removing the treatment of foreign base company oil-related income as Subpart F income.

Power and utilities

The bill would provide for the normalization of a regulated utility's excess deferred income taxes (the difference between the utility's deferred taxes at the present-law 35-percent US corporate rate and the proposed 20-percent rate), similar to what was provided by section 203(e) of the Tax Reform Act of 1986, effective for tax years after 2017.

Observation: Normalization of excess deferred income taxes generally provides regulated utilities the opportunity to reduce rates charged to customers over the book life of the property, thus avoiding sharp fluctuations in rates charged to customers as a result of the tax rate change.

Other business provisions

- Section 1235 addressing a special rule for the sale or exchange of patents would be repealed.
- Certain self-created property -- i.e., self-created patents, inventions, models, or designs (whether or not patented), or secret formulas or processes -- no longer would be considered capital assets. Further, the election to treat musical compositions and copyrights in musical works as capital assets would be repealed. The provision would be effective for dispositions of such property after 2017.
- Section 162(e) would be modified to disallow deductions for lobbying activities with respect to legislation before local government bodies, including Indian tribal governments. The provision would be effective for amounts paid or incurred after 2017.
- Section 274 would be modified to provide that no deduction is allowed for the cost of membership dues, entertainment, amusement, or recreation that is directly related to the active conduct of a taxpayer's trade or business. As a result, the 50-percent limitation under current law for meals and entertainment would apply only to expenses for food or beverage (or other qualifying business meals), with no deduction for other entertainment-related provisions. Other changes to the Section 274 deduction rules would be made. The proposal would be effective for amounts paid or incurred after 2017.
- For tax years beginning after 2017, a partnership would be treated as continuing to exist (i.e., there would be no deemed technical termination) even if more than 50 percent of the total capital and profits interests of such partnership are sold or exchanged.

Insurance

The bill generally would not change the current-law tax treatment of purchasers of life insurance or annuity contracts. The bill would, however, change a number of provisions that apply to insurance companies.

Insurance proposals contained in the bill include changes to the computation of tax-deductible reserves of both life and nonlife insurance companies. For life insurance companies, tax reserves would be a fixed percentage of statutory reserves, and changes in basis of computing reserves would be treated under the same rules that apply to changes in accounting methods of other taxpayers. For nonlife companies, changes would be made to both the discount rate and loss payment patterns used to compute discounted unpaid losses. Additionally, the rates used to capitalize policy acquisition expenses (DAC) with regard to life insurance and annuity contracts would significantly increase.

The bill also would modify the proration rules for both life and nonlife companies. For life insurance companies, prescribed percentages of 40 percent (company's share) and 60 percent (policyholders' share) would result in a significantly lower dividends-received deduction than under current law. For nonlife companies, the current-law reduction in the reserve deduction would be increased from 15 percent to 26.25 percent of tax preferred income.

Other insurance provisions include the following:

- Change in NOL rules for life insurance companies to mirror the rules that would be used by other industries.
- Repeal of small life insurance company deduction.
- Repeal of special rule for distributions to shareholders from pre-1984 policyholders surplus account.
- Repeal of special estimated tax payments.

Observation: Together, the insurance provisions would benefit some insurers but would dramatically increase the burden on others, particularly companies with significant life insurance reserves, deferred acquisition costs (DAC), and dividends-received deductions.

Banking

The bill would phase out deductions for any Federal Deposit Insurance Corporation (FDIC) premiums paid or incurred by financial institution

groups with assets between $10 billion and $50 billion, effective for tax years beginning after 2017.

Observation: The Brady bill does not include an excise tax on systemically important financial institutions that was proposed in 2014 by then-Ways and Means Committee Chairman Dave Camp (R-MI) as part of his tax reform bill.

Tax-exempt bonds

The bill includes proposals affecting tax-exempt bonds.

- Termination of new tax-exempt private activity bonds and repeal of advance refunding bonds, for bonds issued after 2017.
- Denial of tax-exempt financing eligibility for construction of professional sports stadiums, effective for bonds issued after November 2, 2017.

Deductions for executive compensation

Corporations generally can deduct ordinary and necessary compensation expenses, but Section 162(m) imposes a $1 million limit on deductions for remuneration paid by a publicly held corporation to its CEO and the three named executive officers reported in the corporation's annual proxy report. The bill would include qualified performance-based compensation and commission as compensation in determining the $1 million threshold, and would expand the definition of covered employee to include the chief financial officer. The bill also broadens the definition of a publicly traded corporations to those with any security required to be registered under section 12 of the Securities Exchange Act of 1934 and corporations required to file reports under section 15(b) of such Act. This provision would be effective for tax years beginning after 2017. The bill also proposes changes to nonqualified deferred compensation arrangements (discussed below)

Observation: As a result of the broadening of the definition of publicly traded corporation, an S corporation with specified registered securities may have excess compensation disallowed. If applicable to an S corporation, the disallowed wages would be taxed twice; once as wage income to the shareholder and again as passthrough income. In addition, a percentage of the disallowed wage deduction could be subject to self-employment taxes twice. One might be able to assert that section 1363(b) precludes section 162(m) from applying to S corporations.

Accounting methods

The bill includes several accounting method changes aimed at simplifying tax compliance for small businesses.

Cash method of accounting

Under current law, businesses structured as C corporations or partnerships with a C corporation partner may only use the cash method of accounting if their average annual gross receipts for the prior three tax years do not exceed $5 million for all prior tax years (including the prior tax years of any predecessor of the entity). The bill would increase the $5 million threshold for corporations and partnerships with a C corporation partner to $25 million. Additionally, the requirement that such businesses satisfy the gross receipts requirement for all prior tax years would be repealed.

Accounting for inventories

Under current law, businesses must use an inventory method if the production, purchase, or sale of merchandise is a material income-producing factor. Furthermore, businesses required to use an inventory method generally must use the accrual method of accounting for tax purposes unless certain narrow exceptions apply. The bill would allow businesses, including those with inventories, to use the cash method of accounting if the average annual gross receipts for the prior three tax years does not exceed $25 million. If a taxpayer meets the gross receipts test, the provision would allow the taxpayer to account for inventories as either: (1) non-incidental materials and supplies; or (2) consistent with the method of accounting used in its financial statements or books and records.

Uniform capitalization

In general, taxpayers that produce real or tangible personal property, or acquire real or personal property to resell in the ordinary course of business, are subject to the uniform capitalization (UNICAP) rules requiring the capitalization of certain direct and indirect costs to the property. Under current law, a taxpayer is not subject to the UNICAP rules with respect to personal property acquired for resale if its average annual gross receipts for the prior three tax years does not exceed $10 million. No such exemption exists for taxpayers that produce real or tangible personal property or acquire real property. The bill would provide an exemption from the UNICAP rules for all businesses with average annual gross receipts for the prior three tax years of $25 million or less.

Accounting for long-term contracts

Under current law, the taxable income attributable to a long-term contract generally must be determined under the percentage-of-completion method (PCM). An exception from this requirement is available for certain construction contracts expected to be completed within a two-year period

from the contract commencement date if a taxpayer has average annual gross receipts for the prior three tax years of $10 million or less.

The bill would increase the $10 million average annual gross receipts test to $25 million. A business that meets the increased average annual gross receipts test could use its overall method of accounting or any other permissible exempt contract method (e.g., completed contract method) for construction contracts expected to be completed within a two-year period from the contract commencement date.

All of the above small business provisions would be effective for tax years beginning after 2017. Further, the average annual gross receipts referenced in the small business provisions would be indexed for inflation for any tax year beginning after 2018.

Observation: As a result of the proposed increase to the average annual gross receipts threshold in these provisions, additional taxpayers may become eligible to use one or more of the small business provisions. Any change to one of these methods would constitute a voluntary change in method of accounting that generally would require the filing of a Form 3115, *Application for Change in Accounting Method*. A taxpayer's change in method of accounting for long-term contracts would be implemented on a cut-off basis and would only apply to eligible contracts entered into on or after the year of change. The accounting method change for all other small business provisions would be implemented with a Section 481(a) adjustment.

International tax reform proposals

The bill would provide a 100-percent dividends received deduction (DRD) for future foreign-source dividends, impose a 'toll charge' on the undistributed earnings and profits (E&P) of US-owned foreign corporations, amend current sourcing rules related to inventory, and introduce new 'anti-base erosion' rules that include current taxation of certain 'high return' foreign income that is taxed below a minimum rate and a 20-percent excise tax on certain payments from domestic corporations to related foreign corporations unless an election is made to treat such payments as effectively connected income (ECI). As discussed above, interest expense limitations under Section 163(j) have been replaced with two new general business interest limitation rules that apply generally to both US businesses and foreign-parent businesses with US operations.

Territorial tax

The bill would enact new Section 245A, which would provide a 100-percent DRD for the foreign-source portion of dividends received by a US corporation from foreign corporations with respect to which it is a US corporate shareholder. The foreign-source portion of dividends from such 'specified 10-percent owned foreign corporations' would include only the portion of undistributed E&P that is not attributable to ECI or dividends from an 80-percent owned domestic corporation, determined on a pooling basis.

In addition, the bill would require that, in order to qualify for the DRD, a US corporate shareholder must own the stock of the distributing specified 10-percent owned foreign corporation for a six-month period.

The proposal applies to distributions made (and, for purposes of determining a taxpayer's foreign tax credit limitation under Section 904, deductions with respect to taxable years ending) after 2017.

Observation: While domestic C corporations will be able to exclude income distributions from certain foreign subsidiaries, S corporations and REITs will continue to include these distributions in income. Section 1363(b) requires an S corporation to compute its income in the same manner as an individual. Section 857(b)(2)(A) provides that REITs are not eligible for the DRD. Accordingly, S corporations and REITs can not avail themselves of the new DRD.

'Deemed repatriation' toll charge

As part of a move to a territorial system, the bill would impose a toll charge on a US shareholder's pro rata share of its foreign subsidiaries' post-1986 undistributed E&P (as of November 2, 2017 or December 31, 2017, whichever is higher). A US shareholder (or affiliated group) could reduce the amount of undistributed E&P subject to the toll charge by E&P deficits of other foreign subsidiaries.

The toll charge would be imposed at a bifurcated effective rate: 12 percent on E&P to the extent of foreign cash and other liquid assets, and five percent on all residual E&P. Foreign tax credits (FTCs) would be partially available to offset the toll charge tax, but only for the portion of earnings subject to the tax, with a 20-year carryforward period.

The bill would permit a US shareholder to elect to pay the tax liability imposed under the toll charge tax over up to eight years.

The proposal is effective for the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to US shareholders, for the taxable years in which or with which such taxable years of the foreign corporation ends.

Observation: S corporations also are subject to the toll charge tax with the net amount flowing up to the shareholders. S corporation shareholders can elect to defer payment of the tax until the year in which a triggering event occurs (generally, a termination of S status, liquidation or sale of substantially all of the assets, or any transfer of any share of stock in such S corporation). If a shareholder elects to defer the tax, the S corporation becomes jointly and severally liable for such tax if not paid. Upon the occurrence of some triggering events, an S corporation shareholder also may be able to elect to defer such payment under the installment method.

Observation: While many states provide some level of deduction for domestic and foreign dividends (including Subpart F income) in computing taxable income, not all states do. The impact of repatriation under the bill for each state will depend in part on whether the state automatically conforms or subsequently adopts the revisions to Section 956 and if so, then how the state DRD and/or elimination provisions would be applied. In addition, many states may not allow any state income tax related to repatriation to be paid over the eight years allowed for payment of the federal toll charge tax.

Sourcing

The bill would modify current Section 863(b) with respect to income, profits, and gain from the sale of inventory by sourcing such amounts entirely to the place of production rather than by reference to the location of production and sales. The proposal is effective for tax years beginning after 2017.

Anti-base erosion 'minimum tax'

The bill would enact new Section 951A, which would require a US shareholder to include in income 50 percent of the 'foreign high return amount' of its controlled foreign corporations (CFCs). The 'minimum tax' rate for such income would be 10 percent, relative to the proposed 20-percent US corporate income tax rate. The foreign high return amount would be determined by first calculating the aggregate net income of the US shareholder's CFCs without regard to ECI, Subpart F income, certain commodities income, and income that qualifies for specified exceptions to Subpart F (e.g., Section 954(c)(6)). This amount then would be reduced by a percentage (seven percent plus the Federal short-term rate) of the CFCs' aggregate basis in associated tangible depreciable business property to the extent, if any, that it exceeds the CFCs' aggregate interest expense.

FTCs would be available for 80 percent of the foreign taxes imposed on the income of the US shareholder's CFCs that is included in the foreign high return amount. However, the foreign high return amount would be treated as a separate basket, and excess taxes may not be carried over to another taxable year of the US shareholder.

Observation: The effect of this rule would be to subject a US shareholder to tax at a reduced rate on its CFCs' combined net income above a routine return on tangible depreciable business asset investment that is not otherwise subject to US tax or to foreign tax at a minimum rate or is not otherwise specifically excluded. Section 951A would be effective for tax years of foreign corporations after 2017.

Observation: The state tax impact of the proposed Section 951A tax will depend on how a state adopts the federal tax code (rolling, fixed date, etc.) and whether a state chooses to decouple from this provision. To the extent states conform to this new section, states would need to consider how such income is apportioned and what, if any, apportionment factors would be attributed to this income.

Excise tax or ECI election

The bill would enact a new excise tax that would be imposed on certain 'specified amounts' paid or incurred after December 31, 2018 by a US corporation (and a foreign corporation's US branch) to a related foreign corporation that is a member of the same 'international financial reporting group' -- i.e., a group of entities that prepare consolidated financial statements with respect to the year and that had an average annual aggregate amount of specified payments exceeding $100 million over a 3-year period -- unless such amounts constitute ECI to the recipient. The excise tax would be imposed at the highest rate in effect for US corporate income, which would be 20 percent under the proposed legislation. The specified amount subject to the excise tax generally would include amounts that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset with respect to the US corporation.

The excise tax would apply to both inbound and outbound corporations.

The bill would permit a foreign corporation to elect to treat the specified amount as ECI in lieu of the excise tax imposed on the payor. To the extent this election is made, the foreign corporation's net taxable income attributable to this specified amount would be subject to full US tax at the new 20 percent tax rate plus the branch profits tax which is imposed at 30 percent of the after-tax earnings, bringing the total tax burden to 44 percent (subject to treaty reduction of the branch profits

tax). However, rather than looking to the actual expenses incurred by the foreign corporation to determine this net taxable income amount, the foreign corporation would reduce the specified amount by a deemed deduction determined by reference to the profit margin of the relevant product of the international financial reporting group. No FTCs would be allowed for foreign taxes paid or incurred with respect to amounts treated as ECI under this election.

Observation: The Brady bill does not feature a proposal included in former Ways and Means Committee Chairman Camp's 2014 tax reform bill that sought to encourage the development and economic exploitation of intellectual property (IP) within the United States, including a provision that would encourage companies to repatriate IP that is currently owned overseas. The Brady bill's impact on US companies with significant IP will depend heavily on their current operating structure and supply chain. Companies with supply chains that have any costs of sales or research performed overseas may be exposed to the excise tax on outbound payments, dramatically increasing their post-tax operating costs.

Other international proposals

In addition, the bill would:

- Repeal Section 902. FTCs would only be available under Section 960 to the extent foreign taxes are imposed on Subpart F income that is included in a US shareholder's gross income.
- Exclude domestic corporations from the application of Section 956.
- Modify the current anti-deferral rules to include an inflation adjustment for the de minimis exception under Section 954(b)(3), permanently extend Section 954(c)(6), broaden the stock attribution rules for determining CFC status, and eliminate the requirement that a foreign corporation must be a CFC for 30 days in order for its US shareholders to have Subpart F inclusions.
- Modify the passive foreign investment company rules as applied to certain income derived by a qualifying insurance corporation.

Observation: While the bill does not propose significant changes to the Foreign Investment in Real Property Tax Act (FIRPTA), which subjects dispositions of US real estate by non-US persons to special tax rules, the fact that tax rates were lowered for US corporations will also indirectly lower the tax rates for many non-US investors that invest in US real estate. The bill does propose some changes to FIRPTA information reporting rules (see below).

Passthrough business income

Maximum rate on business income of individuals

The bill would provide a new 25-percent rate for qualified business income earned by an individual as a sole proprietor or through a passthrough entity, such as a partnership or S corporation. Qualified business income would equal 100 percent of any net business income derived from a passive business activity and the portion of any net business income from an active business activity that is treated as a return on capital.

Net business income generally would be determined by netting together items of income, gain, loss, and deduction with respect to a business activity. Wages, guaranteed payments received by a partner in a partnership, or directors' fees received by a taxpayer with respect to a business activity would be included as items of income. Investment-related items, including capital gain or loss, dividends, interest (other than interest properly allocable to a trade or business), income from commodities transactions, and currency gain, are excluded from net business income. Whether a business activity is active or passive would be determined by applying the passive activity loss limitation rules of the Code (Section 469).

Observation: Passive investors in partnerships and S corporation should be entitled to the reduced rate on all of their net business income from such investments. Partners still would be entitled to preferential rates on their distributive shares of investment-related items such as long-term capital gain and qualified dividend income and still would be taxed at ordinary income rates on their distributive shares of investment-related items such as short-term capital gain and interest that is not allocable to a trade or business.

By default, 30 percent of an individual's net business income from an active business activity would be deemed to be a return on capital (the capital percentage) and 70 percent would be attributable to labor (the labor percentage). These default percentages would not apply, however, to any active 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, investing, trading, or dealing in securities, partnership interests, or commodities (specified service activities). In the case of such specified business

activities, all of the taxpayer's net business income would be treated as being attributable to labor, i.e., the capital percentage defaults to zero.

Instead of using the default capital percentages, a taxpayer engaged in an active business activity, including a specified service activity, may elect to determine its capital percentage using a formula that divides the taxpayer's 'specified return on capital' by the taxpayer's net business income from such activity. The taxpayer's specified return on capital is the product of its adjusted basis in property used in connection with the business activity as of the end of the taxable year (determined without regard to Sections 168(k) and 179) multiplied by the 'deemed rate of return' on capital, which is equal to the short-term applicable federal rate (AFR) plus seven percentage points.

The technical explanation of the bill provided by the Joint Committee on Taxation staff indicates that property used in connection with an activity would be limited to property described in Section 1221(a)(2), which includes property of a character that is subject to the allowance for depreciation provided in Section 167 and real property used in the trade or business. In the case of a taxpayer carrying on a business through a partnership or an S corporation, the taxpayer takes into account its share of the partnership's or S corporation's adjusted basis in assets used in connection with the business.

***Observation*:** To illustrate the way the rule would operate, suppose a taxpayer has $1 million of net business income from an active business activity and used assets with adjusted basis at the end of the tax year of $9 million in the activity. If the short-term AFR were three percent, the deemed rate of return on capital would be 10 percent. The taxpayer's capital percentage would be 90 percent -- i.e., 10 percent of $9 million (i.e., $900,000) divided by $1 million.

Observation: While 70 percent of the income of some active members of real estate partnerships will not be eligible for the lower rate, this amount can be reduced to the extent the partner contributes significant capital, which is often the case with real estate partnerships.

***Observation*:** In the case of a taxpayer carrying on a business through a partnership, it is unclear whether the taxpayer's share of the partnership's adjusted basis in its assets would include any adjustment to basis determined under Section 743(b).

If the active business activity is one of the specified service activities, then the taxpayer may make the election to use the redetermined capital percentage only if such redetermined percentage is at least 10 percent. The election to use the redetermined percentage applies to the taxable year for which the election is made and the four subsequent taxable years.

In any case in which a taxpayer with an active business activity receives wages or a guaranteed payment with respect to such activity, the capital percentage would be capped. The cap is an amount equal to one minus a fraction the numerator of which is the salary or guaranteed payment and the denominator of which is the net business income. (Net business income, the denominator of the fraction, includes the salary or guaranteed payment from the active business activity).

***Observation*:** In the case of a partner receiving only a guaranteed payment from a partnership in which the partner is active, the capital percentage would be capped at zero.

***Observation*:** While some S corporation shareholders might be able to avail themselves of the reduced tax on business income, the benefit in many cases would be reduced as a result of the imposition of self-employment tax on a portion of the S corporation income. For purposes of determining the self-employment tax associated with income from an S corporation, active shareholders are able to reduce their earnings subject to self employment after application of the applicable labor percentage by the wages actually received from the S corporation. The imposition of self-employment taxes on some S corporation income, the limited benefit of the reduced tax on pass through income, and the immediate tax on dividends from foreign corporations would reduce the tax benefits of operating as an S corporation.

The provision generally applies for taxable years beginning after 2017. The bill includes a transition rule that would provide fiscal year taxpayers, whose taxable year includes December 31, 2017, a proportional benefit of the reduced rate under the provision for the period beginning January 1, 2018, and ending on the day before the beginning of the taxable year beginning after December 31, 2017.

Net earnings from self-employment and repeal of the limited partner exception

The bill would amend section 1402 to strike the present-law definition of 'net earnings from self-employment' and instead apply self-employment tax to the 'labor percentage' of an individual's income from a business carried on by the individual directly, through a partnership, or through an S corporation. The labor percentage of the individual's income would be determined using the rules that apply for purposes of determining the labor

and capital percentages of an individual's net income with respect to an active business activity (i.e. the rules with respect to the 25-percent rate for business income of individuals).

In addition, the bill would repeal present-law Section 1402(a)(13), which excludes from the definition of 'net earnings from self-employment' the distributive share of any item of income or loss of a limited partner in a limited partnership.

These proposals generally would apply to tax years beginning after 2017.

Observation: Some commentators have suggested that it is not clear that an amount subject to self-employment tax under the bill would not also be subject to the net investment income tax under Section 1411 of the Code.

Reduced rate for REIT and cooperative dividends

The bill would provide a maximum rate of 25 percent for certain dividends of real estate investment trusts (REITs) and cooperatives, generally effective for tax years beginning after December 31, 2017.

Income tax accounting considerations

ASC 740, Accounting for Income Taxes, requires the effects of changes in tax laws or rates to be recognized in the period in which the law is enacted regardless of the effective date. For US federal tax purposes, the enactment date is most often the date the President signs the bill into law. While the release of the bill does not constitute enactment, companies should stay abreast of current legislative developments and evaluate the potential implications on financial reporting to ensure they are prepared to account for any changes in the period of enactment.

Observation: The bill proposes significant changes that, if enacted, will have pervasive financial reporting implications. For example, lowering the corporate tax rate and mandatory taxation of deferred foreign income will impact measurement of deferred taxes and taxes payable in the period of enactment. Other changes, such as elimination or limitation of certain deductions and changes to international taxation, will impact both current and deferred taxes on a prospective basis. Changes in enacted tax law may also require the reassessment of realizability of deferred tax assets. In the period of enactment, critical analysis of the resulting changes in US tax law will be needed to determine the appropriate financial statement effects. For many companies, this assessment will be complex and will require significant effort.

In periods prior to enactment, consideration should be given to disclosure within Management's discussion and analysis (MD&A) where the potential impacts on the financial statements may be significant. The emphasis should be on the potential effect of the proposed legislation on the variability of earnings, financial condition, and liquidity. As future tax law or rate changes cannot be anticipated and should not be recognized until enacted, it generally is expected that disclosures in the period prior to enactment should be limited to the MD&A. Nevertheless, if enactment occurs after the balance sheet date but before issuance of financial statements it may be necessary to include more transparent disclosures regarding the change in tax law and an estimate of its impact on the financial statements, or include a statement that such an estimate cannot be made.

Individual tax reform proposals

Tax rates/standard deduction/exemptions

The bill would reduce the current seven tax brackets to four brackets: 12 percent, 25 percent, 35 percent and 39.6 percent. The 39.6-percent bracket would start at $1,000,000 for married filing jointly (or $500,000 for unmarried individuals). Trusts reach the top tax bracket at $12,500 of income. These figures would be adjusted for inflation based on chained CPI for taxable years beginning after 2018.

The benefit of the 12-percent rate would be phased out for individuals with AGI over $1,000,000 ($1,200,000 for married individuals filing jointly). This provision essentially would create a marginal income tax rate six percentage points above the 39.6-percent top rate for those with incomes in the phase out range.

The bill generally retains present-law maximum rates on net capital gains and qualified dividends. The bill also leaves in effect the Affordable Care Act's 3.8-percent net investment income tax and the 0.9-percent additional Medicare tax that apply to higher-income individuals.

Current Law (2018)			Tax Cuts and Jobs Act (HR 1)		
Rate	Taxable income		Rate	Taxable income	
	Single	Married		Single	Married
10%	$0 to $9,525	$0 to $19,050	12%	$0 to $45,000	$0 to $90,000
15%	$9,526 to $38,700	$19,051 to $77,400			
25%	$38,701 to $93,700	$77,401 to $156,150	25%	$45,001 to $200,000	$90,001 to $260,000
28%	$93,701 to $195,450	$156,151 to $237,950			
33%	$195,451 to $424,950	$237,951 to $424,950	35%	$200,001 to $500,000	$260,001 to $1 million
35%	$424,951 to 426,700	$424,951—$480,050			
39.6%	$426,701 or more	$480,051 or more	39.6%	Over $500,000	Over $1 million

The standard deduction for 2018 would be increased to $24,400 for joint filers, $12,200 for individual filers and $18,300 for single filers with at least one qualifying child. Amounts would be adjusted for inflation based on chained CPI. Personal exemptions would be repealed.

The bill retains the concept of a ‘Kiddie Tax’ for the unearned income of children under the age of 19 by the close of the tax year, or for full time students under the age of 24. However, the bill would modify the tax calculation for these taxpayers by referencing the income tax brackets of non-grantor trusts instead of the taxable income of the parent.

These provisions would apply to tax years beginning after 2017.

Alternative minimum tax for individuals

The bill would repeal the individual alternative minimum tax (AMT) after 2017. To the extent a taxpayer has AMT credit carryforwards, the taxpayer would be able to claim a refund of 50 percent of the remaining credits in tax years 2019, 2020, and 2021 and all remaining credits in 2022.

Observation: The individual AMT has been particularly burdensome for individual taxpayers living in states with high income taxes because the deduction for state and local income taxes was not allowed in the AMT computation. With the proposed repeal of both the AMT and the state and local income tax deduction, taxpayers will have to evaluate how they are impacted by the interrelationship of these two provisions.

Family and individual tax credits

The bill consolidates the current $1,000 per child tax credit into a new family tax credit. The family credit would consist of a partially refundable $1,600 tax credit for each qualifying child, and a nonrefundable $300 credit for a taxpayer (both spouses in the case of married taxpayers filing a joint return) and each dependent who is not a qualifying child. These credits would start to be phased out at $230,000 of AGI for joint filers (so for a family of four with two children, the credit would be entirely phased out at $306,000 of income). The new $300 credits would be terminated after 2022.

A number of nonrefundable credits are repealed by the bill. Under current law, certain individuals who are over the age of 65 or who have retired on disability are eligible for a tax credit based on their filing status. Current law also provides an adoption tax credit. Some state and local governments provided mortgage credit certificates that enabled homebuyers to take a federal tax credit. Finally, credits are available for the purchase of qualified plug-in electric-drive motor vehicles. The bill would repeal these nonrefundable credits, generally effective for tax years beginning after 2017. In addition, a Social Security number would be required to claim refundable tax credits (such as the child tax credit, American Opportunity Tax credit, and Earned Income Tax credit).

Education incentives

The three education tax credits -- the American Opportunity Tax Credit, the Hope Scholarship Credit and the Lifetime Learning Credit -- would be consolidated into an enhanced American Opportunity Tax Credit (AOTC). The deduction for interest payments on qualified education loans and the exclusion for qualified tuition reductions would be repealed starting in 2018.

New contributions to Coverdell education savings accounts would not be allowed after December 31, 2017, but Coverdell education savings accounts could be rolled over tax-free into a Section 529 plan. Distributions from Section 529 plans to pay for elementary and high school tuition expenses of up to $10,000 per year would be allowed starting in 2018. An ‘unborn’ child may be treated as a

designated beneficiary under Section 529 plans.

If a student loan is discharged after 2017 based on the death or total disability of a student, income resulting from the discharge would be excluded from taxable income.

Mortgage interest

For any mortgage acquired after November 2, 2017, interest would only be deductible if the mortgage is acquired in connection with a primary residence (not for a second home) and only for amounts up to $500,000 (for married filing jointly). No interest would be deductible on a home equity loan incurred after 2017.

Mortgages acquired on a primary residence outstanding on or before November 2, 2017 would be grandfathered; i.e. the present-law limit on acquisition debt of $1,000,000 would apply. In the case of refinancings, the refinanced debt generally would be treated as incurred on the date of the original debt for purposes of determining the limitations. The bill also contains an exception for taxpayers who entered into a written binding contract before November 2, 2017.

State and local income and sales and property tax

The bill would repeal the state and local income and sales tax itemized deductions for noncorporate taxpayers unless related to carrying on a trade or business or in connection with the production of income as defined under Section 212. In addition, the state property tax deduction would be limited to $10,000 (for married filing jointly) and no deduction would be allowed for state and local personal property taxes. These changes would be effective for tax years beginning after December 31, 2017. To the extent property taxes are incurred in connection with a trade or business or production of income, the taxes would remain deductible without a limit.

Observation: This change could significantly affect taxpayers residing in states with relatively high income tax rates such as California and New York or non-resident taxpayers who have taxable income from high income tax states.

Observation: States vary widely in how they treat itemized deductions for individual taxpayers under their income tax laws. To the extent that state law conforms to federal deductions, the repeal of various itemized deductions proposed by the bill could impact a taxpayer's state income tax liability. The repeal of the state income tax and limitation of the property tax deduction will also be of greater significance to the individual taxpayer's overall tax burden.

Charitable contributions

The 50-percent limitation of the donor's AGI for deducting cash contributions to public charities and certain private foundations would be increased to 60 percent. The provision would retain the five-year carryover period to the extent contributions exceed this limitation.

The current charitable deduction of 80 percent of the amount paid for the right to purchase tickets for athletic events would be repealed, and no charitable deduction would be allowed.

Currently, taxpayers are allowed a deduction of 14 cents for each mile driven in service to a charitable organization. The bill would adjust this amount for inflation.

These provisions would be effective for contributions made in tax years starting after 2017.

Observation: The increased AGI limitation would be beneficial for individuals who make significant charitable contributions each year.

Other deductions

The 'Pease' limitation on overall itemized deductions for certain higher-income taxpayers would be repealed after 2017.

Deductions for personal casualty losses would be repealed other than for losses associated with certain special disaster relief legislation. Deductions for medical expenses, alimony (for decrees executed after 2017), moving expenses, tax return preparation fees, and unreimbursed employee business expenses would be repealed.

Exclusion of gain on principal residence

The capital gain exclusion of $500,000 (for married filing jointly) on the sale of a principal residence would be limited to taxpayers who own and use a house for five out of the previous eight years (instead of the current rule of two out of the previous five years). The exclusion could only be used once every five years (instead of once every two years). The exclusion would start to phase out one dollar for every dollar that the taxpayer's AGI exceeds $500,000 (married filing jointly). These changes would be effective for sales and exchanges after December 31, 2017.

Observation: The loss of the capital gain exclusion for higher income taxpayers and the longer use period could affect purchasing and selling behavior and will make it more important for taxpayers to keep track of the basis in their principal residence.

Employer-provided fringe benefits

In general, amounts paid to or for the benefit of employees are presumed to be compensatory in nature and ordinarily included in the employee's gross income as "wages" absent a statutory exclusion. The bill would repeal the tax exclusion for several employer-provided fringe benefits, including:

- Educational assistance programs, currently $5,250 per year.
- Qualified tuition reductions, providing nontaxable tuition reductions for employees, their spouses, and dependents, of certain educational institutions.
- Qualified moving expense reimbursements.
- Dependent care assistance programs.
- Employee achievement awards, which are given in recognition of the employee's length of service or safety achievement.
- Employer-provided adoption assistance programs, currently up to $13,570 for 2017.

While not repealed, nontaxable housing provided for the convenience of the employer under Section 119 is limited to $50,000 for married taxpayers filing a joint return. The housing exclusion would not be available to highly compensated employees or individuals who are five percent owners in the employer at any time during the taxable year.

Retirement plans

The bill generally retains present-law incentives for contributions to retirement savings accounts, including 401(k) plans and Individual Retirement Accounts (IRA), but recharacterization of IRA and Roth IRA contributions and conversions would no longer be allowed after 2017.

The minimum in-service distribution age would be 59 ½ for all defined benefit and defined contribution plans (currently defined benefit plans and State and local government defined contribution plans have a minimum age of 62), for plan years beginning after 2017.

Within one year of the date of enactment, Treasury would be required to change its guidance to allow employees to make contributions to a defined contribution plan after taking a hardship distribution (current regulations do not allow contributions for six months after the distribution). Hardship distributions also would include account earnings and employer contributions instead of only employee contributions.

Additional retirement plan modifications would:

- Allow hardship distributions from employer contributions to defined contribution plans, for plan years on and after December 31, 2017.
- Extend the amount of time an individual has to rollover a loan after a plan or employment termination.
- Ease the nondiscrimination requirements for certain defined benefit plans that are frozen to new entrants, but continue benefit accruals.

Nonqualified deferred compensation

The bill effectively eliminates nonqualified deferred compensation because employees would be taxed on compensation as soon as there is no service-based substantial risk of forfeiture with regard to that compensation. It does this by providing that substantial risk of forfeiture does not include a non-compete agreement or provisions relating to a purpose other than the future performance of service. This provision would be effective for amounts attributable to services performed after 2017. Amounts currently deferred could continue to be deferred until the last tax year beginning before 2026.

Estate, gift and generation-skipping transfer tax

The bill would maintain the estate, gift, and generation-skipping transfer taxes (currently at a 40-percent tax rate) through 2023. Starting in 2018, the bill would double the exemption for all three taxes from $5 million to $10 million per person. These amounts are adjusted for inflation retroactively to 2011, resulting in an exemption amount of $11,200,000 for 2018. The gift and estate tax exemptions would remain unified so any use of the gift tax exemption during lifetime would decrease the estate tax exemption available at death.

Starting in 2024, the estate and generation-skipping transfer taxes would be repealed. The gift tax would remain in effect, but the top tax rate would be reduced from 40 percent to 35 percent and the gift tax exemption would remain at the new $10 million amount per person (adjusted for inflation). Even though the estate tax is repealed, the current law allowing a "step-up" in basis to fair market value at date of death generally will continue.

The current gift tax exclusion for annual gifts of up to $14,000 per donee ($15,000 in 2018 as adjusted for inflation) would be retained, as well as the provisions for unlimited transfers directly to educational institutions and health care providers.

Observation: The increased exemption amounts, particularly for gifts, are good news for individuals with a taxable estate and may incentivize additional gifting. The repeal of the estate tax in six years introduces some uncertainty for planning purposes, and estate planning documents should be drafted with the flexibility to accommodate this uncertainty. If the generation skipping tax eventually is repealed, gifts and estate transfers to lower generations may be a good planning opportunity. In addition, states may not follow federal law on estate tax, generation-skipping transfer taxes, and gift taxes.

Exempt organizations

The bill contains numerous provisions affecting exempt organization excise taxes, the determination of unrelated business taxable income, the exemption standards for certain organizations, and the charitable deduction (discussed above). The bill would impose a new excise tax on the net investment income of certain large private colleges and universities and a new entity-level excise tax on excess compensation paid by exempt organizations.

Excise taxes on net investment income

The bill would impose a new 1.4-percent excise tax on the net investment income of private colleges and universities with at least 500 full-time students and endowment assets of at least $100,000 per full-time student. The determination of net investment income would be based on rules similar to the determination of net investment income under the Section 4940 excise tax applicable to private foundations. The determination of the '$100,000 per student' amount would be based on the aggregate fair market value of all assets held at the end of the preceding taxable year, excluding assets used directly in carrying out the institution's exempt purposes.

The bill would simplify the present-law two-tier excise tax on net investment income of private foundations by replacing it with a flat 1.4-percent excise tax.

Excise taxes on excess compensation

The bill imposes a 20-percent excise tax on exempt organizations that pay compensation in excess of $1 million or make an excess parachute payment to a covered employee for a taxable year. The organization itself would be subject to the new tax. The excise tax would apply to organizations exempt under Section 501(a), exempt farmers' cooperatives, governmental entities with income excluded under Section 115, and political organizations.

For this purpose, a covered employee means one of the five highest compensated employees (current or former) of the organization for the taxable year or for a prior year beginning after 2016. Compensation means wages as defined for income tax withholding purposes, excluding designated Roth contributions, and includes compensation paid by the organization or by any person or governmental entity that is related to the organization (based on control tests set forth in the bill).

Compensation subject to the excise tax includes the entire amount of an excess parachute payment. The bill provides that 'excess parachute payments' are payments made on account of separation from employment to the extent they exceed three times a base amount average over a five-year period. The proposed tax would apply to tax years beginning after 2017.

Unrelated business taxable income (UBTI)

The bill would clarify that the tax on UBTI applies to all entities exempt from tax under Section 501(a) notwithstanding the entity's exemption under any other section of the Internal Revenue Code (e.g., state and local entities exempt under Section 115 that are also exempt under Section 501(a)). The bill would require tax-exempt organizations to include in UBTI the cost of providing transportation fringe benefits and on-premises gyms and other athletic facilities to the organization's employees. Making such expenditures subject to tax follows the non-deductibility of such expenses for taxable entities provided in the bill. Finally, the bill would limit the research exclusion in Section 512(b)(9) only to fundamental research the results of which are freely made available to the public.

Other exempt organizations provisions:

- The bill would include in taxable income the interest income from newly issued private activity bonds (which include qualified Section 501(c)(3) bonds).
- For private operating foundations that operate an art museum, to maintain such status, the bill would require the museum to be open to the public at least 1,000 hours during the taxable year.
- The bill would provide a limited exception to the excess business holdings excise tax applicable to private foundations for independently operated philanthropic business holdings.
- The bill would provide that churches would not fail to be organized and operated exclusively

for religious purposes by making political campaign statements as long as the speech is part of the regular and customary activities of the organization and the expenses are de minimis.

- Sponsoring organizations of donor advised funds (DAFs) would be required to disclose with their annual Form 990 their policy on the frequency and minimum distributions from DAFs and the average amount of grants made from their DAFs.

Tax administration and compliance

Backup withholding rate

Currently, backup withholding tax at 28 percent applies when a US non-exempt recipient fails to properly provide their taxpayer identification number prior to receiving a reportable payment. This backup withholding rate is based on the fourth-lowest federal income tax rate set in Section 1. As a result, when the individual federal income tax brackets are adjusted, the rate of backup withholding changes correspondingly. The bill would modify Section 3406 to permanently set the backup withholding rate at 25 percent and would remove the relationship to Section 1 so that the backup withholding tax rate is not adjusted when federal income tax rates are modified.

Observation: This provision makes a permanent change in the rate of backup withholding and removes any link with standard individual income tax rates. In the future, changes to the backup withholding rate would require specific action by the Congress; any changes to tax brackets no longer automatically would change the backup withholding rate.

Reporting on student loan interest

Under current law, all lenders that receive $600 or more in interest on qualified education loans in a calendar year must file Forms 1098-E, *Student Loan Interest Statement,* with the IRS and furnish copies to the borrowers. This reporting requirement allows the IRS to receive information on a borrower's student loan interest payments separate from the self-reported information on the borrower's federal income tax return and allows for verification. As discussed above, the bill would eliminate the deduction for student loan interest payments. The bill correspondingly would strike from Section 6050S the provision requiring qualified education loan interest reporting by lenders. The reporting requirement for qualified tuition and related expenses on Forms 1098-T, *Tuition Statement*, remains in place.

Observation: This is a significant change that reflects the elimination of the deductibility of student loan interest. Repeal of the deduction would remove the need to have student loan interest payments specifically reported on an information return that is filed with the IRS and furnished to borrowers. While the loss of the deduction itself negatively impacts individuals in many cases, the elimination of the Form 1098-E filing requirement removes a portion of the information reporting burden on educational lenders.

Withholding taxes on certain amounts subject to FIRPTA

The bill would reduce the rate of withholding tax on allocations or distributions related to gain from the disposition of US real property interests (USRPI) to certain foreign persons. Under the current provisions of FIRPTA, the withholding rate is generally 15 percent of the amount realized. However, certain transactions are subject to a higher withholding rate of 35 percent. This rate applies to foreign corporate distributions that are treated as gain from the disposition of USRPI (the rate applies to the gain recognized and not the amount realized) and on distributions by regulated investment companies (RICs) and real estate investment trusts (REITs) that were treated as gain from the disposition of USRPI. Gain from the disposition of a USRPI by a domestic partnership is not subject to section 1445 withholding and is instead subject to Section 1446 withholding to the extent the gain is allocable to a foreign partner. The rate under Section 1446 is the highest applicable rate, with certain exceptions.

Under the bill, the 35-percent rate is reduced to 20 percent for the following:

- Gains from USRPI realized by US partnerships, trusts and estates that are allocable to foreign persons or trusts (or portions thereof) treated as owned by foreign persons.
- Distributions to foreign persons by foreign corporations that are treated as gain from the disposition of USRPI.
- Distributions to foreign persons by RICs or REITs that are treated as gain from the sale or exchange of USRPI.

Observation: This provision of the bill does not change the substantive application of FIRPTA, but reduces the rate of applicable tax that must be withheld from certain types of transactions to be consistent with the lower 20 percent tax rate that would be imposed under the bill.

Withholding and reporting provisions related to nonqualified deferred compensation plans

As noted above, the bill would impose tax on certain types of nonqualified deferred compensation as soon as there is no substantial risk of forfeiture of the compensation. As part of that provision, the bill would add language to Section 1441 specifying that such nonqualified deferred compensation paid to nonresident aliens is subject to the statutory gross basis withholding tax rate of 30 percent and must be reported on Forms 1042, *Annual Withholding Tax Return for US Source Income of Foreign Persons*, and 1042-S, *Foreign Person's US Source Income Subject to Withholding*, as otherwise required under Chapter 3. The bill also would add language to Section 6041 that extends the Form 1099 series information reporting requirements of Chapter 61 to such compensation.

Observation: The changes to Section 1441 and 6041 would be in keeping with a goal of reducing the amount of deferred compensation that is exempt from income tax, both for US and non-US employees and independent contractors.

The takeaway

The release of tax reform legislation by Ways and Means Committee Chairman Brady marks a critical step in the legislative effort to overhaul the US tax system. Significant political hurdles must be overcome in order for Congress to succeed in enacting sustainable reform of US tax laws, providing a more competitive tax system for business taxpayers and improved economic opportunities for individuals and families.

Stakeholders considering the effects of business and individual tax reform proposals noted in this summary will need to consider the overall benefits of reforms intended to boost US competitiveness and productivity through lower business tax rates, a modernized international tax system, and incentives to invest in the United States.

For more information

- House Ways and Means Committee statutory language (as introduced)
- House Ways and Means Committee staff section-by-section summary (as introduced)
- Joint Committee on Taxation technical explanation (as introduced)
- Joint Committee on Taxation revenue estimates of revised Chairman's bill (JCX-47-17)

Of further interest

- Visit our Policy on the move website to understand how policy change could impact your business.
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Let's talk

For a deeper discussion of how this might affect your business, please contact:

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