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House of Representatives Passes the Tax Cuts and Jobs Act (H.R. 1); Senate Finance Committee Approves Modified Version; Comparison of the Bill Passed by the House and the Modified Senate Bill

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Yesterday afternoon, the House of Representatives passed the Tax Cuts and Jobs Act (H.R. 1) (the "House bill"). The House bill is identical to the draft bill approved by the House Ways and Means Committee on November 10. Late last night the Senate Finance Committee approved its own conceptual version of the Tax Cuts and Jobs Act. An initial, descriptive version of the Senate Finance Committee bill (for which actual statutory text is still forthcoming) prepared by the Joint Committee on Taxation (the "JCT") was released on Thursday, November 9. The Senate Finance Committee subsequently revised the bill significantly, as reflected in the JCT descriptions of the modifications released on Tuesday, November 12, and a further amendment[1] released late last night (as modified, the "modified Senate bill" and generally, the "Senate bill"). The modified Senate bill varies in certain important respects from the House's bill.

The modified Senate bill introduces significant changes to the Senate bill released last week. Perhaps most significantly, the modified Senate bill would repeal the provision of the Affordable Care Act (ACA) requiring individuals without minimum health coverage to make "shared responsibility payments" (commonly referred to as the "individual mandate"). The modified Senate bill also provides for most changes to individual taxation to sunset after December 31, 2025, including the repeal of the individual AMT, the reduced rate for pass-through entities, the reductions in ordinary income tax rates and brackets, the repeal of itemized deductions, the increased standard deduction, and the expanded exemption for estate and generation-skipping transfer taxes. Notably, the reduced corporate rate cut of 20% (reduced from 35%) effective in 2019 would be permanent.

We have outlined below some of the significant changes in the latest draft of the Senate bill, and summarized the key differences between the modified Senate bill and the House bill. Because the Senate has not yet released legislative text, this summary is based only on the JCT's descriptions of the Senate Finance Committee's bill (in its original and modified form) and the November 16 amendment (as published on the Senate Finance Committee website).

The provisions discussed are generally proposed to apply to tax years beginning after December 31, 2017, subject to certain exceptions (only some of which are noted below). While we discuss some of these provisions in detail, we do not address all restrictions, exclusions, and various other nuances applicable to any given provision. The Senate legislation will likely continue to evolve when the full Senate debates the bill after the Thanksgiving recess (*i.e.*, the week of November 27). Any differences between the Senate and House bills will have to be reconciled (and the President will have to approve of the final version) before the legislation can pass into law.

Summary of significant changes in the modified Senate bill

- ***Businesses***
  - The proposed 17.4% deduction on "qualified business income" of individual owners of pass-through businesses would sunset for tax years beginning after December 31, 2025. (The 17.4% deduction produces an effective top marginal rate of 31.80% for such income.)[2]
  - The phase-out for owners of specified service businesses to benefit from the 17.4% pass-through deduction is increased to begin at taxable incomes over $250,000 for single individuals and $500,000 for married individuals filing jointly. Owners with taxable income at or below $250,000 for single individuals and $500,000 for married individuals filing jointly would not be subject to the overall cap on 17.4% deductions (measured as 50% of an individual owner's pro rata share of the pass-through entities W-2 wages paid), and this cap would begin phasing in at these same thresholds.
  - The proposed limitation on net operating loss deductions to 90% of taxable income would be further reduced to 80% of taxable income for tax years beginning after December 31, 2022. However, if the cumulative aggregate on-budget federal revenue from all sources for October 1, 2017 through September 30, 2026, exceeds $27.487 trillion by an amount greater than or equal to $900 billion, then the reduction would not occur. (All references to "a

revenue condition" or "the revenue condition" refer to this condition.) Current NOL deduction rules (*i.e.*, ability to offset 100% of taxable income, carry back 2 years, and carry forward 20 years) would continue to apply to property and casualty insurance companies.

- ???Certain research and experimental expenditures would be required to be amortized over a 5-year period for domestic activities and a 15-year period for activities conducted outside of the United States.
  o Carried interests would be subject to a 3-year holding period prior to eligibility for long-term capital gains rates.

???***Foreign income***

- ???Income deemed repatriated (and subject to the one-time 5% to 10% tax) could be offset with foreign E&P deficits; United States shareholders could use NOLs to offset inclusion or preserve NOLs for future use.
- ???The tax on global intangible low-taxed income ("GILTI") would be 10% (and not 12.5% as previously reported), and would increase to 12.5% for tax years beginning after December 31, 2025 (unless the revenue condition is satisfied).
- ???The special 12.5% "patent box" rate for foreign-derived deemed intangible income of U.S. corporations would increase to 15.625% in tax years beginning after December 31, 2025 (unless the revenue condition is met).
- ???The 10% base erosion minimum tax on very large corporations with significant deductible foreign payments would increase to 12.5% in tax years beginning after December 31, 2025 (unless the revenue condition is met).

???***Individuals***

- ???Mandatory ACA contributions (*i.e.*, the individual mandate) would be repealed entirely.
- ???The proposed ordinary income tax brackets are modified with slightly lower rates and new cut-offs.
- ???Most individual changes—including repeal of the AMT, rate changes, expanded exemption amount for the estate tax, and all other changes to itemized deductions and tax credits applicable solely for individuals—would expire for tax years beginning after December 31, 2025 (regardless of whether the revenue condition is met).
- ???The child tax credit would be increased to $2,000 per eligible child.
- ???Employee benefits and executive compensation.

- ???Removed provision that would have taxed nonqualified deferredcompensation once it was no longer subject to a “substantial risk of forfeiture.” (The original House bill had a similar provision that was removed in a later amendment.)
- ???Tax on restricted stock units and stock options granted by private companies to certain eligible employees could be deferred up to 5 years.
- ???Eliminated certain differences between 401(k) plans, 403(b) plans, and governmental 457(b) plans and provides for more coordinated aggregate limits on the contributions to such plans.
- ???Removed proposed rules for classification of workers as independent contractors for federal tax purposes.
- ???New transition rules provided for repeal of performance pay exception to $1 million limit on deductibility of compensation paid to certain employees by publicly-held and certain privately-held companies.

???***Miscellaneous***

- ???Electing small business trusts (which can own interests in S corporations) could have nonresident individuals as beneficiaries. Electing small business trusts would be subject to the same adjusted gross income (AGI) limits on charitable deductions as individuals.

Summary of key differences between the House bill and the modified Senate bill

???***Businesses***

- ???The House bill would cut the corporate rate to 20% for tax years beginning after December 31, 2017; the Senate bill delays this reduction one year to 2019.
- ???The Senate bill reduces the tax rate on pass-through business income with an individual above-the-line deduction of 17.4% (for a maximum effective rate of 31.80%), whereas the House bill provides for a maximum 25% rate for this type of income (or 9% for certain taxpayers below an income threshold). The Senate and House bills also differ in their determination of income eligible for the reduced rate, and the requirements for specified service businesses to qualify for the reduced rate, and only the Senate bill has an absolute cap on the amount deducted for W-2 wages paid. Significantly, under the modified Senate bill, the 17.4% deduction would sunset in tax years beginning after December 31, 2025.

- ***Foreign income***
    - The Senate and House bills propose different rates for the one-time tax on deemed repatriated earnings: 5% (non-cash) and 10% (cash) under the Senate bill compared to 7% and 14%, respectively, under the House bill.
    - The House bill would impose a 10% tax on the foreign high returns of U.S. corporations' foreign subsidiaries; the Senate bill would impose a 10% GILTI tax (increased to 12.5% for tax years beginning after December 31, 2025, unless the revenue condition is satisfied) based on a similar formula.
    - The Senate bill would introduce a 12.5% partial patent box regime for the deemed foreign intangible income of U.S. corporations (increased to 15.625% for tax years beginning after December 31, 2025, unless the revenue condition is satisfied).
    - The Senate bill would impose a 10% base erosion minimum tax on very large corporations (increased to 12.5% for tax years beginning after December 31, 2025 unless the revenue condition is met) with significant deductible payments to related foreign parties, whereas the House bill would impose a 20% excise tax on disproportionate deductible payments to related foreign parties.

- ***Individuals***
    - The modified Senate bill would repeal the ACA's individual mandate. The House bill does not contain this provision.
    - Apart from the ACA repeal and use of chained CPI-U to index for inflation, all changes to individual taxation would sunset for tax years after December 31, 2025, regardless of whether the revenue condition is met.
    - The Senate bill would eliminate the deduction for state and local taxes in its entirety, while the House bill retains a deduction up to $10,000 for state or local property taxes. However, the Senate bill would retain individual deductions for student loan interest and qualified tuition expense that are eliminated under the House bill.
    - The modified Senate bill would retain the current law cap on mortgage indebtedness eligible for an interest exemption at $1,000,000 while the House bill would reduce the cap to $500,000.
    - The modified Senate bill would increase the child tax credit to $2,000 (from $1,000 under current law), compared to only $1,600 under the House bill.
    - Only the House bill would repeal the estate tax entirely (for tax years beginning after December 31, 2023).

- ???*Tax-exempt organizations*
  - ???The House would repeal the exemption for interest on private activity bonds, advanced refunding bonds, and stadium-financing bonds. The Senate bill provides only for repeal of the exemption for advanced refunding bonds.
  - ???The Senate bill would impose a 10% entity-level tax on excess benefit transactions and would repeal the current law rebuttable presumption of reasonableness for transactions with disqualified persons satisfying certain procedural requirements.

Detailed discussion of the modified Senate bill provisions

I. Business Provisions.

20% tax rate on corporate income beginning in 2019; repeal of corporate AMT.

The Senate bill proposes a permanent reduction of the corporate tax rate from 35% to 20%. Unlike the House bill, which also would reduce the corporate tax rate from 35% to 20%, the Senate bill would delay the rate reduction one year until 2019. Both bills would repeal the corporate alternative minimum tax (“AMT”). A current 35% and delayed 20% rate presents planning opportunities for U.S. corporations. For example, a U.S. corporation could purchase an asset, and sell it in 2018 if it had decreased in value (and claim a deduction at the 35% rate) or hold it until 2019 if it increases in value (and benefit from the new lower rate).

Correlative adjustment to corporate dividends received deduction (“DRD”).

Under each bill, the amount of dividends received that a corporation could deduct from its taxable income would be reduced to 50%, in the case of 70% deductible dividends under current law, or 65%, in the case of 80% deductible dividends. The effect would be to reduce the rate of tax for a corporate shareholder entitled to a 70% DRD under current law from 10.5%[3] to 10%[4] and maintain it at 7% for a corporate shareholder entitled to the 80% DRD under current law. A corporation would continue to deduct 100% of the dividends received from another corporation within the same affiliated group.

Net business interest deductions limited to 30% of earnings before interest and taxes.

Under each bill, net business interest deductions would generally be limited to 30% of a taxpayer's adjusted taxable income. Adjusted taxable income under the Senate bill is calculated using a method similar to earnings before interest and taxes ("EBIT"). In contrast, the House bill uses a formula closer to earnings before interest, taxes, depreciation, and amortization ("EBITDA"), which would in many cases lead to a larger base amount of earnings and therefore increase the size of the cap. "Business interest" would include any interest paid or accrued on indebtedness "properly allocable to a trade or business" but would not include "investment interest" (as described in section 163(d)). Excluded interest deductions could be carried forward indefinitely under the Senate bill, compared to only five years in the House bill.

For a partnership, the limitation would be applied at the partnership level, applying additional rules to prevent any double counting of the deduction and to allow for an increased deduction limit for excess taxable income applying rules similar to those in current section 163(j).

The limitation would not apply to taxpayers with gross receipts of $15 million or less or to certain regulated public utilities. Additionally, real property development, construction, rental property management, or similar companies could elect not to be treated as a trade or business and, as a result, would not be subject to this limitation.

UPDATE 11/16/17: Proposed 90% limitation on net operating loss deductions reduced to 80% in 2023.

Under both the Senate bill and the House bill, deductions for net operating losses ("NOLs") would be limited to 90% of taxable income for any tax year. Under both bills, NOLs would no longer expire after 20 years but could be carried forward indefinitely to future tax years; however, the current two-year carryback of NOLs would generally be repealed.

Under the Senate bill only, the deduction for NOLs would be further reduced to 80% of taxable income for tax years beginning after December 31, 2022 (unless the revenue condition is satisfied). The 90% limitation in the House bill would apply permanently. In addition, unlike the House bill, the Senate bill does not include an inflation adjustment for amounts carried forward.

Under the modified Senate bill, the current rules for NOLs (*i.e.*, ability to carry back 2 years, carry forward 20 years, and offset 100% of taxable income) would continue to apply to property and casualty insurance companies.

Denial of nonrecognition for like-kind exchanges of personal property.

Each bill would limit nonrecognition treatment under section 1031 to like-kind exchanges of real property. Non-simultaneous transfers not completed by December 31, 2017 would be grandfathered, so long as the taxpayer has either received or disposed of the property to be exchanged on or before December 31, 2017.

UPDATE 11/14/17: Temporary full expensing of business assets; other cost recovery changes.

Temporary 100% expensing for certain business assets.

Each bill would permit 100% expensing of the cost of certain business property placed into service after September 27, 2017 and before January 1, 2023. Qualified property placed into service on or after January 1, 2023 would continue to be eligible for a 50% cost recovery deduction in the year when placed into service; the scheduled phase-down of additional depreciation for property placed into service in tax years beginning after December 31, 2017 would therefore be repealed.

Reduction of cost recovery periods for residential rental and nonresidential real property.

The Senate bill would reduce cost recovery periods for residential rental and nonresidential real property from, respectively, 27.5 years and 39 years to 25 years in both cases. The House bill does not contain an analogous provision.

Expansion of section 179 expensing.

The Senate bill permits immediate expensing for up to $1,000,000 of the cost of qualifying tangible personal property placed into service after December 31, 2017, an increase from the $500,000 cap under current law, but less than the House bill's proposal to allow expensing of up to $5 million. The benefit under the Senate bill would be reduced (but not below zero) to the extent the value of qualifying property placed into service exceeded $2,500,000 for the tax year (compared to $2 million under current law and $20 million under the House bill). The expansion would be permanent under the Senate bill but would expire for tax years beginning after December 31, 2023 under the House bill.

UPDATE 11/14/17: Required amortization for specified research and experimental expenditures.

Effective for tax years beginning after December 31, 2025, the modified Senate bill would require taxpayers to capital and amortize certain research and experimental expenditures which, under current law, are immediately deductible. The cost recovery period for these expenditures would be 5 years if related to research conducted within the United States, and 15 years if conducted outside of the United States. The House bill contains a substantially similar provision but would go into effect for tax years beginning after December 31, 2022—three years earlier than the modified Senate bill. Both the House and the modified Senate bills specifically apply to software development expenditures.

Modification of accounting methods for taxpayers with gross receipts of $15 million or less.

The Senate bill would generally permit taxpayers with gross receipts not exceeding $15 million for the three prior tax years (the "$15 million gross receipts test") to elect to use the cash method of accounting. (The House bill would increase this maximum threshold to $25 million; the maximum under current law is $5 million.) The current exceptions from the required use of accrual accounting for certain categories of taxpayers—including taxpayers that do not satisfy the $15 million gross receipts test—would remain.

Taxpayers satisfying the $15 million gross receipts test would not be required to comply with the specific inventory accounting rules imposed under current section 471 but could instead determine cost of goods sold applying their financial accounting method. Additionally, taxpayers meeting this test would be exempt from the uniform capitalization rules under section 263A and, if additional requirements are satisfied, from required use of the percentage-of-completion method of calculating taxable income from certain small construction contracts.

Taxpayers satisfying the $15 million gross receipts test would not be subject to the limitation on net interest expense deductions, discussed above.

Repeal of the domestic production activities deduction and other business deductions.

Both bills would repeal the deduction for domestic production activities under section 199, although the House bill would make this effective for tax years beginning after December 31, 2017, and the Senate bill would make this effective for tax years beginning after December 31, 2018.

The House and Senate bills would also repeal or substantially limit the orphan drug credit, the property rehabilitation credit, and the deduction for unused business credits.

UPDATE 11/14/17: 31.8% maximum effective rate for qualified business income of certain pass-through businesses; other changes to pass-through taxation.

17.4% deduction (equivalent to a 31.8% maximum effective rate) for "qualified business income" earned by pass-through entities.

The Senate bill provides for a maximum effective rate of 31.8% on an individual's domestic "qualified business income" from a partnership, S corporation, or sole proprietorship. The reduced rate arises from a 17.4% deduction ([100% – 17.4%] * 38.5% proposed maximum rate = 31.8%). Amounts received as dividends from real estate investment trusts (or "REITs") would also be eligible for this deduction.

The deduction would not be available to owners of “specified service businesses,” except for taxpayers with taxable income at or below a given threshold ($500,000 for married individuals filing jointly and $250,000 for single taxpayers under the modified Senate bill, phasing out completely at $600,000 and $300,000, respectively). Specified service businesses include any trade or business activity involving the performance of services in the areas of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business the principal asset of which is the reputation or skill of its employees. Qualified business income would not include most investment income.

The amount of the deduction available to a taxpayer from a partnership or S corporation could not exceed 50% of the taxpayer’s share of the W-2 wages paid by the pass-through for the tax year, and only those wages “properly allocable to qualified business income” could be taken into account. However, under the modified Senate bill, the W-2 wage limitation would not apply to individuals with taxable incomes at or below $500,000 for married individuals filing jointly or $250,000 for single individuals, and would phase-in completely over the next $100,000 or $50,000, as applicable, of taxable income.

Qualified business losses would carry forward to the next tax year, and presumably would reduce the amount of qualified business income included in determining the amount of the deduction for that year.

The Senate approach differs from that of the House, which would tax qualified business income at graduated rates ranging up to 25%. In the case of active trade or business income, the House bill would presume that 70% of income derives from labor and therefore only 30% would be entitled to the reduced rate, effectively taxing the active income at a blended 35.22% rate. In addition, the 17.4% deduction in the Senate bill is limited to domestic qualified business income. Although “domestic” is not defined in the JCT description, the word suggests that pass-through income from foreign sources would not qualify. The House bill does not contain a similar limitation.

Limitation on active pass-through losses.

Under the Senate bill (but not the House bill), deductions for “excess business losses” of flow-through taxpayers (*i.e.*, taxpayers other than C corporations) would not be permitted to offset non-business income of the taxpayer. These losses would be treated as NOLs and carried forward into subsequent tax years. An “excess business loss” is defined as the excess of a taxpayer’s aggregate deductions attributable to trades or business of the taxpayer over the sum of the taxpayer’s aggregate gross income plus a threshold amount ($500,000 for married individuals filing jointly and $250,000 for single individuals, indexed for inflation). The determination whether a net business loss exceeds the threshold amount is made at the individual partner or S corporation shareholder level.

Changes to partnership taxation.

The Senate bill (but not the House bill) modifies the definition of substantial built-in loss for purposes of section 743(d), which under current law requires certain basis adjustments upon transfer of an interest in a partnership that has significant built-in losses. Under the proposed change, a substantial built-in loss would exist if, immediately after the transfer of the partnership interest, a liquidation of the partnership would result in an allocation of loss to the transferee in excess of $250,000.

A partner’s distributive share of partnership charitable contributions and foreign taxes paid would also be limited to the partner’s adjusted basis in its partnership interest.

UPDATE 11/16/17: Extended 3-year holding period required for carried interests.

Under the modified Senate bill, as well as the House bill, holders of carried interests would be required to satisfy a 3-year holding period (rather than the one-year period under current law) to qualify for long-term capital gains rates in respect of profits interests received in exchange for services. This provision was added to the modified Senate bill by the Chairman's amendment, which contains little detail. Assuming it operates the same way as the analogous provision in the House bill, the rule would apply to a partnership that is engaged in a trade or business conducted on a regular, continuous, and substantial basis and the business consists of either the development of certain specified assets, or the investment in and/or disposition of specified assets (including identification of specified assets for investment and/or disposition). "Specified assets" include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts, and an interest in a partnership to the extent attributable to specified assets.

II. Foreign income provisions.

UPDATE 11/16/17: Current tax on deemed repatriated foreign earnings.

The Senate bill imposes a one-time tax on a U.S. shareholder's pro rata share of the accumulated, undistributed earnings of foreign corporations of which it is a 10% or more shareholder. Earnings of a foreign corporation attributable either to U.S. effective-connected income ("ECI") or to dividends received directly or indirectly from 80%-owned U.S. corporations would be excluded. The tax rate would be 10% on earnings attributable to cash assets and 5% on earnings attributable to noncash assets, compared with 14% and 7% under the House bill. The deemed repatriations giving rise to this tax would occur during the foreign corporation's last tax year beginning before January 1, 2018.

Under each bill, the tax would be payable over an 8-year period at the taxpayer's election. REITs would be permitted to elect to meet their distribution requirements with respect to accumulated untaxed foreign earnings over this same 8-year period using the same annual installment percentages. The deemed repatriated earnings would be excluded for purposes of the REIT's gross income tests.

Additionally, under the modified Senate bill, U.S. shareholders would be able to net foreign E&P deficits and qualified deficits against untaxed earnings to determine the amount of inclusion. U.S. shareholders would also be able to choose whether to offset their foreign NOLs against the amount deemed included in the repatriation, or whether to preserve these NOLs to offset future tax liability.

Recapture tax on expatriated entities.

Under the Senate bill (but not the House bill), if a U.S. corporate shareholder becomes an “expatriated entity” within the 10-year period following enactment of the proposed legislation, the reduced tax rate applicable to its share of any foreign earnings deemed repatriated by virtue of this provision would be retroactively increased to 35%. The amount of additional tax due would be computed by reference to the year of the deemed inclusion, but would be assessed in the year of the U.S. shareholder’s expatriation.

Shift to territorial system of international taxation through deduction of foreign source dividends.

The Senate bill, as with the House bill, would shift the current U.S. “worldwide” international tax system, under which U.S. companies are taxable on worldwide income, to a “territorial” system under which foreign active profits are generally exempt from tax. The mechanism under both bills would be generally to exempt the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the foreign corporation (referred to here as a “U.S. corporate shareholder”), provided the recipient satisfies a holding period requirement with respect to the underlying stock.

No foreign tax credit or deduction would be permitted for any exempt foreign-source dividend, and neither the exempt dividend nor deductions allocable to the foreign-source portion of the underlying stock would be considered in calculating the foreign tax credit limitation of the U.S. corporate shareholder. A U.S. corporate shareholder’s basis in the foreign corporation stock would be reduced solely for purposes of determining a loss on later disposition of the stock.

Gain from the of stock of a foreign corporation by a U.S. corporate shareholder that has been held for at least one year would be treated as a dividend for purposes of calculating any foreign-source deduction. Similar rules would apply to treat gain from the sale by a CFC of stock in a lower-tier CFC as a dividend to the U.S. shareholder of the selling CFC.

Foreign-source dividend disallowed for hybrid dividends.

Under the Senate bill (but not the House bill), the deduction for foreign source dividends would not be available for "hybrid dividends" received by a U.S. corporate shareholder from a controlled foreign corporation (a "CFC"). Accordingly, repatriated hybrid dividends would be taxable. A hybrid dividend is any payment received from a foreign corporation for which the foreign corporation received a deduction or other tax benefit with respect to foreign taxes if the payment would otherwise be deductible under the proposal.

Hybrid dividends between CFCs sharing a common 10% U.S. corporate shareholder would be treated as subpart F income of the recipient CFC and included in the income of the 10% U.S. corporate shareholder in the same tax year.

Transferred loss recapture rules.

Under both bills, transferred loss recapture rules would apply to transfers of substantially all of the assets of a domestic corporation's foreign branch to a foreign corporation in which the domestic transferor is a U.S. corporate shareholder.

UPDATE 11/14/17: 10% tax on "global intangible low-taxed income" ("GILTI").

Notwithstanding the general territoriality rule, the Senate bill would tax a U.S. shareholder's share of a CFC's "global intangible low-taxed income," or "GILTI," at a special 10% rate (which would increase to 12.5% for tax years beginning after December 31, 2025 if the revenue condition is not met). Very generally, GILTI is active (non-Subpart F) income in excess of an implied return of 10% of the CFC's adjusted bases in tangible depreciable property used to generate the active income. The House bill has a similar concept but applies to income in excess of the short-term federal rate plus 7%, multiplied by the same base amount.

More specifically, a U.S shareholder's GILTI is measured as the excess (if any) of its aggregate pro rata share of "net CFC tested income" over a deemed tangible income return of 10% on its aggregate pro rata share of the CFCs' "qualified business asset investment," or "QBAI" (generally, depreciable tangible property used in the production of tested income). "Net CFC tested income" generally means the aggregate of a U.S. shareholder's pro rata share of "active" net income (or loss) from each CFC of which it is a U.S. shareholder (*i.e.*, Subpart F income, effectively-connected income, foreign oil and gas income, and certain other categories of income are excluded). The mechanism for arriving at the special 10% rate is a 50% deduction: (100% GILTI inclusion – 50% deduction) * 20% corporate tax rate = 10%.[5] This deduction would be decreased to 37.5% in tax years beginning after December 31, 2025, unless a revenue condition is met.

GILTI would be treated similarly to subpart F income (and so would be includible currently to any United States shareholder). U.S. corporate shareholder with GILTI inclusions would be permitted a foreign tax credit equal to 80% of its ratable share of foreign taxes deemed paid attributable to net CFC tested income. Non-passive GILTI would be in a separate foreign tax credit basket, with no carryforward or carryback available for excess credits.

UPDATE 11/14/17: Reduced 12.5% "patent box" rate for "foreign-derived intangible income."

Under the Senate bill (but not the House bill) a special 12.5% rate (increasing to 15.625% in tax years beginning after December 31, 2025 if the revenue condition is not met) would apply to the intangible income of a U.S. corporation derived in connection with foreign sales or foreign use (the corporation's "foreign derived intangible income," or "FDII"). The House bill does not have an analogous concept.

Mechanically, the proposal permits a 37.5% deduction for "foreign-derived intangible income" ("FDII"). A 37.5% deduction results in a net tax of 12.5% ([100% – 37.5%] * 20% = 12.5%).[6] FDII is the amount that bears the same ratio to the corporation's "deemed intangible income" ("DII") as its "foreign-derived deduction eligible income" ("FDDEI") bears to its "deduction eligible income" ("DEI").

DEI is the gross income of a U.S. corporation (after deductions), excluding any subpart F income of the corporation includible under section 951, the corporation's GILTI, dividends received from CFCs with respect to which the corporation is a United States shareholder, domestic oil and gas income, and the corporation's foreign branch income.

DII is equal to the excess of the corporation's DEI over its "deemed tangible income return," which is 10% of the corporation's qualified business asset investment (defined the same for FDII purposes as for GILTI purposes, discussed above). Finally, FDDEI is DEI that is derived in connection with (1) property that is sold by the taxpayer to any person that is not a United States person and is for foreign use or (2) services provided by the taxpayer to any person, or with respect to property, that is not located in the United States.

The provision is generally designed to provide an incentive for U.S. corporations to retain their intellectual property in the United States rather than to transfer it to a foreign affiliate, which would develop the intellectual property and license it to third parties. However, because the reduced 12.5% tax rate applicable to FDII is still not as low as the 10% applicable GILTI, an incentive would still exist under the modified Senate bill to develop intellectual property abroad rather than in the United States.[7]

An earlier description of the Senate bill published by the JCT on November 9, 2017 suggested that FDII and GILTI would be taxable at the same rate.

Under the modified Senate bill, the deduction for FDII would decrease to 21.875% (and the effective tax rate on FDII would increase to 15.625%) for tax years beginning after December 31, 2026, unless a revenue condition is met.

Three-year tax-free distribution of intangibles by CFCs.

Under the Senate bill (but not the House bill), a CFC (and therefore its United States shareholders) would not recognize gain on the distribution of intangible property to a United States shareholder that is a corporation if made by the CFC before the last day of the third tax year of the CFC beginning after December 31, 2017. This provision would allow U.S. multinationals to repatriate their intellectual property on a tax-deferred basis if within this three-year window.

“United States shareholder” to include any United States person that owns 10% or more of the value of a foreign corporation; downward attribution from a foreign person to a related U.S. person.

Under current law, a United States shareholder is defined as a United States person that owns more than 10% of the voting power of a foreign corporation. The Senate bill (but not the House bill) would change the definition so that any U.S. person that owns shares worth 10% or more of the total value of all classes of stock of a foreign corporation would be a “United States shareholder” of that corporation required to include in income its share of the corporation’s subpart F income if that corporation were a CFC. This change would represent a fundamental expansion of the CFC rules that have been in place since 1962.

Both bills would provide for expanded downward attribution from a foreign person of its stock in a foreign corporation to a related U.S. person for purposes of determining whether the U.S. person is a United States shareholder and whether the foreign corporation is a CFC. A United States shareholder’s ratable share of a CFC’s subpart F inclusion would be determined without regard to this attribution.

These changes would be effective under the Senate bill for the last tax year of a foreign corporation beginning before January 1, 2018 and for tax years of United States shareholders ending with or within the tax year of the foreign corporation. Under the House bill, the change to downward attribution would be effective for tax years beginning after December 31, 2017.

Repeal of section 956 for U.S. corporate shareholders; look-through rule for related CFCs made permanent in 2020.

The Senate bill (as well as the House bill) would repeal section 956 with respect to a corporate United States shareholder of a CFC. Accordingly, the United States shareholder would not include in income its share of the CFC’s earnings invested in “United States property.” Indirect corporate United States shareholders of CFCs that hold their CFC interests through a domestic partnership would also be eligible for this exemption.

Foreign base company oil-related income would be removed from the subpart F regime, withdrawals of excluded subpart F income from qualified shipping operations would no longer give rise to subpart F inclusions, and the amount of foreign base company income considered de minimis ($1 million in 2017) would be indexed for inflation.

The look-through rule for payments of dividends, interest and equivalents, rents, and royalties from one CFC to another CFC would also be made permanent for tax years of foreign corporations beginning after December 31, 2019.

UPDATE 11/14/17: Proposals to prevent base erosion.

Base erosion minimum tax imposed on large C corporations.

The Senate bill would impose a 10% “base erosion” minimum tax equal to roughly the excess of 10% over the difference between a taxpayer’s actual tax liability over the tax liability it would had if payments to foreign affiliates were not deductible, property purchased from foreign affiliates was not depreciable, and payments to foreign parents of inverted companies were not deductible. Under the modified Senatebill, the minimum tax would be increased to 12.5% in tax years beginning after December 31, 2025, unless the revenue condition is met.

Specifically, the Senate bill would require a corporate taxpayer to pay an amount equal to the excess of 10% of the taxpayer’s “modified taxable income” for the tax year over an amount of “regular tax liability,” subject to certain adjustments. “Modified taxable income” is defined as the taxpayer’s taxable income under chapter 1, determined without regard to any “base erosion tax benefit” or “payment” or the “base erosion percentage” of any allowable NOL deduction. A “base erosion payment” would generally include any amount paid or accrued by a taxpayer to a related foreign party if the payment is either deductible or subject to the allowance for depreciation, as well as any reduction in gross receipts due to a payment or accrual to a related surrogate foreign corporation or a member of its expanded affiliated group. Related parties include a 25% owner of the taxpayer, any person related to the taxpayer or the 25% owned applying the attribution rules of sections 267(b) and 707(b)(1), and any person that would be related to the taxpayer for purposes of section 482. Additional reporting requirements would also be imposed. Under the modified Senate bill, payments to related parties for services that satisfy the services cost method under the section 482 transfer-pricing rules (assuming no additional markup) would not be considered base erosion payments. (The House bill contains a similar exception to its proposed 20% excise tax, discussed below, for deductible payments made for intercompany services paid at cost.)

The base erosion minimum tax would only apply to taxpayers that are corporations (other than a RIC, a REIT, or an S corporation) with average annual gross receipts equal to or exceeding $500 million, and would only apply if at least 4% of the taxpayer’s deductions related to payments to related foreign persons.

The House bill instead would impose a 20% excise tax on certain payments made by U.S. corporations to related foreign corporations in the same international financial reporting group if the payments are deductible, includible in cost of goods sold, or eligible for depreciation or amortization. (This excise tax would not apply to a recipient corporation that elects to treat the payments received as income effectively connected with a U.S. trade or business carried on by the recipient corporation through a permanent establishment in the United States.)

Limit on disproportionate net interest expense deductions.

The Senate bill would limit the net interest expense deductions of a U.S. corporation that is a member of a worldwide affiliated group based on the amount by which the total U.S. group indebtedness exceeds 110% of the debt the U.S. group would have if all members of the worldwide affiliated group had proportionate debt-to-equity ratios. The House bill would similarly limit a U.S. corporation's net interest expense deduction to 110% of the U.S. corporation's allocable share of group EBITDA. Disallowed interest expense deductions could be carried forward indefinitely (compared with only 5 years under the House bill).

Changes to section 482 transfer-pricing rules with respect to intangibles.

The Senate bill (but not the House bill) would also modify the definition of intangible property for purposes of sections 367 (relevant to outbound restructurings) and 482 (intercompany transfer pricing) to explicitly include workforce in place, goodwill, and going concern value. The proposal would codify the "realistic alternative" principle adopted by the IRS in regulations for determining the arm's length price for intangibles in an intercompany transaction and would authorize the IRS to require an aggregate method of valuating intangibles. These changes would appear to reverse the Tax Court's recent decision in *Amazon.com v. Commissioner*[8], currently on appeal to the Ninth Circuit.

Denial of deductions for amounts paid or accrued to related parties that are hybrid entities.

Under the Senate bill, deductions for amounts of interest or royalties paid or accrued to a related party would be disallowed if the payment or accrual was either (1) not included in income under the tax law of the recipient's country of residence, or (2) deductible by the recipient under the tax law of the recipient's country of residence. The House bill instead would impose a general 20% tax on deductible payments to related foreign entities (regardless of whether deductible in the recipient country). The Senate bill authorizes the Treasury generally to issue regulations addressing hybrid transactions.

Repeal of special rules for DISCs.

The Senate bill (but not the House bill) would repeal the special rules applicable to domestic international sales corporations (DISCs). The proposal would take effect for tax years beginning after December 31, 2018, and provides transition rules for current DISC shareholders.

Dividends from surrogate foreign corporations not eligible for QDI treatment.

Dividends received by individuals with respect to stock owned in “surrogate foreign corporations” would not be eligible for reduced tax rates applicable to “qualified dividend income” (generally, long-term capital gains rates if holding periods are satisfied).

Changes to foreign tax credit system.

Both the Senate and House bills repeal the deemed-paid credit on dividends received by a 10% U.S. corporate shareholder of a foreign corporation. Instead, a deemed-paid credit would be provided for any income inclusion under subpart F (but only to the extent properly attributable to the subpart F inclusion). Foreign branch income, which generally includes business profits allocable to a qualified business unit but excludes passive category income, would be allocated to its own foreign tax credit basket.

Sources of income and expenses.

Source of inventory sales determined solely based on the location of production activities.

The determination of the source of income from inventory sales would be based solely on the location of production activities (and allocated among two or more jurisdictions, where appropriate).

Effective date of the worldwide interest allocation rules accelerated to 2018.

The long-deferred effective date of the previously enacted worldwide interest allocation rules would be advanced three years to apply to tax years beginning after December 31, 2017.

Treatment of foreign insurance companies as PFICs unless loss, loss adjustment expenses, and reserves constitute 25% of total assets.

Under the Senate bill (as well as the House bill), the determination whether a foreign insurance company is a passive foreign investment company (PFIC) would be based on the company's insurance liabilities. Under the proposal, a foreign insurance company would generally be treated as a PFIC unless (1) the foreign company would be taxed as an insurance company were it a U.S. corporation and (2) the company's loss and loss adjustment expenses and certain reserves constitute more than 25% of the foreign corporation's total assets as represented on the company's GAAP (or equivalent) financial statements. The 25% threshold could be reduced to 10% in certain situations if a U.S. owner of the company so elects and the failure to reach the 25% threshold is due to circumstances specific to the insurance business.

Codification of Revenue Ruling 91-32; treatment of gain on the sale of an interest in a partnership that is engaged in a trade or business in the United States as income that is effectively connected with a U.S. trade or business.

The Senate bill would reverse the recent Tax Court decision *Grecian Magnesite Mining v. Commissioner*[9], and would thus effectively codify Revenue Ruling 91-32, by treating gain or loss from the sale of an interest in a partnership as income that is "effectively connected" with a U.S. trade or business to the extent attributable to a trade or business of the partnership in the United State. Specifically, the Senate bill would treat the sale of a partnership interest as a sale of all of the partnership's assets for their fair market value as of the date of sale, and would determine the amount of effectively connected gain or loss allocable to the selling partner based on the amount that would be allocated to that partner in a hypothetical liquidation. The House bill does not contain a similar provision.

The Senate bill would also require the transferee of a partnership interest to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that it is neither a nonresident alien nor a foreign corporation.

III. Individuals.

UPDATE 11/14/17: Nearly all individual changes to expire after December 31, 2025; ACA individual mandate repealed.

Under the modified Senate bill, individuals lacking minimum health coverage mandated by the Affordable Care Act (ACA) would no longer be required to make shared responsibility contributions (commonly known as the “individual mandate”). This would effectively repeal the individual mandate, a central pillar of the ACA.

In addition, the modified Senate bill generally provides that all proposed changes to individual taxation will sunset in tax years beginning after December 31, 2025. (This includes generally all provisions discussed in this Part III—Individuals.) The two exceptions to this general expiration are repeal of the ACA individual mandate and the transition to “chained CPI-U” for indexing inflation. Like the House bill, the Senate bill would adjust the capital gain and ordinary income brackets for inflation based on chained CPI-U, a method generally thought to increase the brackets at a slower rate than currently and may shift taxpayers into higher brackets over time.

UPDATE 11/14/17: Retains seven bracket structure with adjustments (10%; 12%; 22%; 24%; 32%; 35%; 38.5%).

The Senate bill would retain a seven bracket structure, as currently, adjusting the brackets and modestly and reducing the top rate from 39.6% to 38.5%. The modified Senate bill reduced rates modestly in several brackets (from 22.5%, 24.5%, and 32.5% to 22%, 24% and 32%, respectively). Taxpayers currently in the 10% bracket would remain in the 10% bracket. (The House bill would reduce the number of brackets from seven to four, increase the rate applicable to lowest bracket from 10% to 12%, and retain the top bracket at 39.6%.) Unlike the House bill, the Senate bill does not contain the 6% “surtax” (*i.e.*, the recapture of the 12% rate) for high income taxpayers. The Senate bill also retains a separate rate structure for heads of household; the House bill does not. A comparison of the proposed rate structures in the House and Senate bills to current law is illustrated in the chart below.

Single individuals

Current Law		**Senate Bill (updated 11/14/17)**	
Taxable income between:	**Marginal tax rate**	**Taxable income between:**	**Margin**
0 – $9,525	10%	0 – $9,525	10%
$9,526 – $38,700	15%	$9,526 – $38,700	12%
$38,701 – $93,700	25%	$38,701 – $60,000	22%

$93,701 – $195,450	28%	$60,001 – $160,000	24%
		$160,001 – $200,000	32%
$195,451 – $424,950	33%	$200,001 – $500,000	35%
$424,951 – $426,700	35%		
Over $426,700	39.6%	Over $500,000	38.5%

Married filing jointly

Current Law		**Senate Bill (updated 11/14/17)**	
Taxable income between:	**Marginal tax rate**	**Taxable income between:**	**Margi**
0 – $19,050	10%	0 – $19,050	10%
$19,051 – $77,400	15%	$19,051 – $77,040	12%
$77,401 – $156,150	25%	$77,041 – $140,000	22%
$156,151 – $237,850	28%	$140,001 – $320,000	24%
$237,951 – $424,950	33%	$320,001 – $390,000	32%
$424,951-$480,050	35%	$390,001 – $1,000,000	35%
Over $480,050	39.6%	Over $1,000,000	38.5%

The current maximum rates for net long-term capital gains (including qualified dividend income) would be retained, as would be the 25% rate applicable to unrecaptured section 1250 gain and the 28% rate on 28%-rate gain. The 3.8% tax on net investment income (also known as the “Medicare tax”) is retained.

Increased standard deduction; repeal of personal exemptions.

The Senate bill would increase the 2018 standard deduction from $6,500 to $12,000 for individuals, from $9,350 to $18,000 for heads of household, and from $13,000 to $24,000 for married couples, to be adjusted for inflation based on chained CPI-U starting in tax years after December 31, 2017. (The House bill would increase the brackets to $12,200 and $24,400, respectively.) Like the House bill, the Senate bill would repeal personal exemptions ($4,150 for each exemption in 2018 under current law). Taxpayers with gross income below the applicable standard deduction would not be required to file U.S. federal income tax returns.

This increase in the standard deduction is expected to simplify tax filings for millions of low-and middle-income families. However, because the charitable deduction is available only for taxpayers who itemize, the increased standard deduction would tend to reduce charitable contributions.

UPDATE 11/14/17: Expanded child tax credit; new non-child dependent credit.

The modified Senate bill would further increase the child tax credit to $2,000 (compared to $1,650 in the original Senate bill) from $1,000 under current law. (The House bill would increase the credit to $1,600.) Under the modified Senate bill, the phase out for the credit would begin at incomes equal to or exceeding $500,000 for married individuals filing jointly ($250,000 for single individuals), rather than the $1 million threshold for joint filers previously proposed. However, the reduced threshold is considerably more generous than the thresholds under both current law and the House bill ($115,000 and $230,000, respectively, for married individuals filing jointly). The Senate bill would provide a $500 nonrefundable credit for all non-child dependents which would not expire (compared to a $300 credit per member of the household under the House bill, which would expire after 2022).

Repeal of Individual Alternative Minimum Tax (AMT).

Both the Senate bill and House bill would repeal the alternative minimum tax (AMT) on individuals in its entirety.

Limitations, repeals, and other changes to individual itemized deductions.

Repeal of the “Pease” Limitations on Deductions.

Both the Senate bill and House bill would repeal the Pease limitation on deductions, which under current law effectively amount to a 1.18% marginal tax (3% x 39.6%) for certain high-income taxpayers.

Increased Charitable Deductible.

Under current law, cash contributions to a public charity are deductible only to the extent of 50% of the taxpayer’s adjusted gross income (AGI). Both the Senate bill and House bill would increase this limit to 60% of AGI.

Repeal of deduction for state and local taxes paid.

The Senate bill repeals the individual deduction for state and local taxes entirely. (The House bill would permit a deduction of up to $10,000 for state and local property taxes paid.) The loss of deduction for state and local income taxes would have the greatest impact on individuals living in high-tax states and municipalities, such as New York City, New York State, California, Massachusetts, and New Jersey.

Taxes paid or accrued in carrying on a trade or business or section 212 activity (relating to the production of income) that are presently deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F would continue to be deductible. (These taxes include real estate and personal property taxes on business assets, highway use taxes, licenses, regulatory fees, and similar items.)

Limitation on home mortgage interest deduction.

The Senate bill retains the deduction for home mortgage interest accrued on acquisition indebtedness of up to $1 million. (The House bill would have reduced the cap on principal to $500,000.) Both the Senate and House versions would repeal the deduction for interest on home equity indebtedness.

Repeal of casualty and theft loss deduction except for presidential declared major disasters.

The Senate bill generally repeals individual deductions for personal casualty and theft losses, with limited exceptions for certain officially recognized disasters. The House bill would eliminate this deduction entirely except with respect to individual personal casualty losses arising from hurricanes Harvey, Irma, and Maria.

Wagering loss limitation.

Under both bills, deductions for wagering losses would only be allowed to the extent of wagering gains from the same tax year.

Repeal of miscellaneous itemized and other deductions; student loan interest deductions.

The Senate bill would generally repeal miscellaneous itemized deductions subject to the 2% AGI floor under current law (*e.g.*, deductions for the production or collection of income, unreimbursed expenses attributable to the trade or business of being an employee, repayments of income received under a claim of right, repayments of Social Security benefits, etc.). The House bill does not repeal miscellaneous itemized deductions. The deductions for tax preparation expenses and moving expenses would also be repealed.

Unlike the House bill, the Senate bill retains the deductions for student loan interest.

Repeal of certain individual exclusions from income.

The Senate bill would repeal the exclusions from income under current law for qualified moving expense reimbursements and qualified bicycle commuting reimbursements. (The House bill would retain the exclusion for qualified moving expenses for members of the armed services.)

The current law exclusion of gain on sale of a personal residence ($250,000 for a single individual, $500,000 for married individuals filing jointly) would only be available to individuals who have owned and used the residence as a principal residence for at least 5 of the 8 years preceding the sale (subject to certain exceptions), compared with a 2-year use and ownership requirement under current law. The House bill would retain the current-law 2-year use and ownership requirement, but would phase out the exclusion beginning at incomes greater than $250,000 for a single individual or $500,000 for married individuals filing jointly. Both bills would limit the availability of the exclusion to one sale or exchange during a 5-year period.

The denial of an income exclusion for discounted tuition benefits received by university employees and their family members, proposed in the House bill, does not appear in the Senate bill.

Estate and generation-skipping transfer taxes retained with increased exemption amount.

Unlike the House bill, which would repeal the estate tax fully after 2024, the Senate bill would retain the tax but double the estate and gift tax exemption amounts from $5 million per person under current law to $10 million (both current and proposed exemption amounts indexed for inflation occurring after 2011). The proposal would be effective for generation-skipping transfers, gifts made, and estates of decedents dying after December 31, 2017.

The income tax basis of inherited property would continue to be adjusted to fair market value at death under both the House and Senate bills.

UPDATE 11/14/17: Roth Recharacterization.

The current version of both bills would eliminate the ability of an individual to recharacterize either a traditional IRA contribution as a Roth IRA contribution or a Roth IRA contribution as a traditional IRA contribution (which, under current law, is permitted for a limited period of time after the contribution is made).

IV. Employee benefits and executive compensation.

UPDATE 11/16/17: Loss of deduction for performance pay over $1 million.

The Senate bill, like the House bill, would amend section 162(m), which under current law imposes a $1 million limit on the annual compensation deduction for any “covered employee,” in several significant ways. First, both proposals eliminate the exemption for “performance-based” compensation currently relied upon by a majority of publicly held corporations paying executive officers annual compensation exceeding $1 million.

Second, the Senate bill, like the House bill, modifies the definition of “covered employee” to include the principal executive officer and principal financial officers of the company at any time during the tax year, as well as the three highest paid employees of the company (excluding the principal executive office and principal financial officer). An individual who becomes a covered employee for any taxable year beginning after December 31, 2016 would continue to be a covered employee in subsequent years, even if the individual is no longer an employee of the company or is deceased.

Third, the Senate bill, like the House bill, expands the number of corporations subject to the limitation to include all domestic publicly traded corporations and all foreign companies publicly traded as American depository receipts (ADRs). While the limit in section 162(m)(1) is currently applicable to publicly held corporations only, the Senate bill suggests that the limitation may also apply to “certain additional corporations that are not publicly traded, such as large private C or S corporations,” although details are not specified.

The modified Senate bill provides transition relief by grandfathering remuneration paid under a written, binding contract in effect on November 2, 2017, provided that the contract has not been materially modified since that time. (Initially, the modified Senate bill also required that the covered employee’s right to the remuneration no longer be subject to a substantial risk of forfeiture on or before December 31, 2016 for the transition relief to apply; this requirement was removed in the Chairman’s amendment.)

20% excise tax on excessive compensation paid by tax-exempt organizations.

The Senate bill, like the House bill, would impose a 20% excise tax on any compensation paid by most exempt organizations to their five highest paid employees in any given year (“covered employees”) to the extent exceeding $1 million for the year. An individual who becomes a covered employee for any taxable year beginning after December 31, 2016 would continue to be a covered employee in subsequent years. Compensation for this purpose includes all cash and non-cash remuneration (including most benefits other than designated Roth contributions) as well as payments from persons or organizations related to the employer.

Certain “excess parachute payments” to covered employees would also be subject to the 20% excise tax to the extent in excess of the base amount allocated to the payment. A “parachute payment” is defined for this purpose as a payment to a covered employee (other than a payment under certain specified retirement, pension, and deferred compensation plans) that is contingent on the employee’s separation from the organization, if the aggregate present value of all such payments equals or exceeds three times the base amount of the employee’s compensation. The excise tax on excess parachute payments could therefore apply even if the covered employee’s remuneration did not exceed $1 million for the year.

UPDATE 11/14/17: Proposed changes to taxation of nonqualified deferred compensation removed; new 5-year deferral election for certain forms of equity compensation.

The modified Senate bill removed a proposal in original earlier Senate bill that would have taxed nonqualified deferred compensation once no longer subject to a “substantial risk of forfeiture.” (An earlier version of the House Bill contained a similar provision that was subsequently removed.)

The modified Senate bill also contains a provision, similar to a provision contained in the current version of the House bill, allowing “qualified employees” to make an elective 5-year deferral on income inclusion for equity compensation in the form of restricted stock units and certain stock options issued by private companies whose stock is not readily tradable and which have a written plan under which at least 80% of U.S. employees are granted equity compensation. Generally, an individual would not be a “qualified employee,” and would instead be an “excluded employee,” if the individual is or was a 1% owner of the corporation at any time during the last 10 years, is or was the CEO or CFO, or is or was one of the 10 highest paid officers of the corporation at any time during the last 10 years (or is a family member of an individual in one of these categories). The election to defer would have to be made within 30 days of the employee’s right to stock becoming substantially vested or transferable, whichever is earlier, and would be made in a manner similar to an 83(b) election. Under the Senate bill, if a qualified employee makes an election to defer income inclusion on a restricted stock unit or stock option, earlier income inclusion would still be required if certain events occur (*e.g.*, the stock becomes transferable, the individual becomes an “excluded employee,” or the company has an IPO).

UPDATE 11/14/17: Standardized contribution limits for employer retirement plans.

The Senate bill removes certain differences between 401(k) plans, 403(b) plans, and governmental 457(b) plans and provides for more coordinated aggregate limits on the contributions to such plans. The Senate bill would generally maintain the current employee elective deferral contribution limits for 401(k) plans and 403(b) plans and limits on contributions for employees in governmental 457(b) plans ($18,000 in 2017), but would also impose a single aggregate limit for all such contributions.

In addition, the Senate bill would place a single aggregate limit on contributions for an employee to any qualified defined contribution plan (such as a 401(k) plan), any 403(b) plan, or any governmental 457(b) plan maintained by the same employer, including any members of a controlled group or affiliated service group. Thus, under the Senate bill the total employee and employer contributions to a 401(k) plan, a 403(b) plan, or a governmental 457(b) plan maintained by the same employer could not exceed the limit set under Code section 415(c) ($54,000 for 2017) or, if less, the employee's compensation). The House bill does not contain similar provisions.

Under the Senate bill, special rules allowing for certain additional catch-up contributions under governmental 457(b) and 403(b) plans would be eliminated; the same allowances for catch-up contributions applicable to 401(k) plans would also apply to 403(b) plans and governmental 457(b) plans. The House bill does not contain a similar provision.

The modified Senate bill removed provisions that would have subjected early withdrawals from governmental 457(b) plans to a 10% early withdrawal tax and disallowed catch-up contributions to highly paid employees.

UPDATE 11/16/17: Limitation on deductions associated with fringe benefits and entertainment expenses.

Both bills would generally disallow deductions with respect to entertainment and recreation activities, membership dues, and facilities used in connection with recreation or membership activities even if directly related to the active conduct of the taxpayer's trade or business. Deductions for expenses associated with providing any qualified transportation fringe or commuter transportation would generally be disallowed.

The Senate bill would limit the deduction for certain meals provided to employees for the convenience of the employer to 50% of the expenses incurred. The modified Senate bill would disallow the deduction entirely in tax years beginning after December 31, 2025, unless the revenue condition is met.

V. Miscellaneous provisions.

Acceleration of accruals to conform with financial accounting.

Under the Senate bill, taxpayers would be required to recognize income no later than the tax year in which it is taken into account for financial accounting purposes on an audited financial statement (or similar statement as provided in regulations). Certain long-term contract income would not be subject to this rule. Taxpayers could continue to defer recognition of income associated with certain advance payment contracts as currently provided in Revenue Procedure 2004-34. The House bill does not contain a similar provision.

UPDATE 11/16/17: First-in, first-out method used to determine basis in securities sold or exchanged.

Under the Senate bill, a taxpayer's basis in securities for purposes of calculating the gain or loss on the sale or exchange of securities would be determined on a first-in, first-out basis (subject to limited exceptions). Under current law, a taxpayer that is able to adequately identify the shares being sold is allowed to use the cost basis of the shares identified (known as "specific identification"). The specific identification method would no longer be available. The House bill does not contain a similar provision.

Regulated investment companies (RICs) would be exempt from this rule. Additionally, dispositions of securities currently eligible for the average basis method could continue to use this method to calculate gain or loss.

UPDATE 11/14/17: Proposed rules for classifying workers as independent contractors removed.

The modified Senate bill removed proposed rules for classifying certain service providers to be treated as independent contractors.

Limitation on deduction for FDIC premiums.

Under both the Senate and House bills, deductions for FDIC premiums paid by financial institutions with total consolidated assets worth $10 billion or more would be reduced by an increasing percentage based on the amount of total consolidated assets, with 100% of the deduction being disallowed for financial institutions with assets worth $50 billion or more. FDIC premiums are generally fully deductible under current law as ordinary and necessary business expenses.

UPDATE 11/14/17: Eligible beneficiaries of electing small business trusts to include nonresident aliens.

Under the modified Senate bill (but not the House bill), a nonresident alien would be eligible to be a potential current beneficiary of an electing small business trust ("ESBT"). While a nonresident alien is not permitted to hold an interest in an S corporation directly under current law, an ESBT can be a shareholder of an S corporation. Thus this change could allow nonresident aliens to hold indirect interests in S corporations.

The modified Senate bill also clarifies that the limits for charitable contributions applicable to individuals (including, for example, limits on percentage of income and carry forwards of deductions) apply to ESBTs.

VI. Tax-exempt organizations.

Excise tax on large private colleges and universities.

Both the Senate bill and the House bill would impose a 1.4% excise tax on the net investment income of private tax-exempt colleges and universities with at least 500 full-time students and assets with an aggregate fair market value of at least $250,000 per student (excluding those assets used directly for purposes of educating students).

Entity-level tax and new due diligence procedures for transactions with disqualified persons.

Under the current rules governing "intermediate sanctions," an excise tax is imposed on an excess benefit payment received by a disqualified person from a tax-exempt organization. The Senate bill (but not the House bill) would impose an additional excise tax on the organization making the payment equal to 10% of the excess benefit conferred, unless the organization's participation in the transaction was not willful or due to reasonable cause. An organization that satisfies specified minimum standards of due diligence or otherwise establishes that reasonable procedures to avoid an excess benefit transaction were in place would not be subject to this 10% tax.

The rebuttable presumption procedures under current law would not create a rebuttable presumption of reasonableness with respect to a transaction under the Senate bill but would instead only show that the organization satisfied minimum standards of due diligence, and would not provide any benefit to the disqualified person or to the managers who approved the transaction.

In addition, the definition of “disqualified persons” would be expanded to specifically include athletic coaches performing coaching services for an eligible educational institution and investment advisors of donor advised funds. Section 501(c)(5) and 501(c)(6) organizations would also be subject to the intermediate sanctions rules.

Royalty income from names and logos subject to tax on UBTI.

The Senate bill (but not the House bill) would treat royalty income derived from the licensing of a tax-exempt organization’s name or logo (including related trademarks and copyrights) as unrelated business taxable income (“UBTI”). Under current law, royalty income generally is excluded from UBTI. Additionally, the sale or licensing of logos would be treated as an unrelated trade or business of the organization, which, if substantial, could cause the organization to lose its tax-exempt status.

Separate netting required for unrelated trade or business activities.

The Senate bill also includes a provision requiring the computation of UBTI separately for each unrelated trade or business of the organization. (Under current law, income from all of an exempt organization’s unrelated trade or business activities is calculated on an aggregate basis.) This change would prevent a tax-exempt organization from using expenses related to one trade or business to offset UBTI generated from another trade or business. Net operating losses could only be deducted against income from the specific trade or business from which the losses arose.

Repeal of tax-exempt status for professional sports leagues.

The Senate bill would eliminate the tax exemption for professional all sports leagues. Since 1966, U.S. tax law has specifically exempted professional football leagues from tax under section 501(c)(6); the IRS has historically applied this exemption to all professional sports leagues. The House bill does not include a corresponding provision.

Repeal of exemption for advanced refunding bonds; exemption for private activity bonds retained.

The Senate bill ends the tax exemption for interest earned on "advanced refunding bonds," which under current law are used to refinance tax-exempt bonds issued by state and local governments and certain charitable activities of section 501(c)(3) organizations. The repeal would apply to advanced refunding bonds issued after December 31, 2017.

The Senate bill, unlike the House bill, does not include a general repeal of the exemption for interest earned on private activity bonds.

UPDATE 11/14/17: Exception to private foundation excess business holdings rules for philanthropic businesses.

Under current law, a 5% excise tax is imposed on the value of certain "excess business holdings" held by a private foundation if not disposed of within a set period. This tax may increase to 200% if the 5% tax is imposed on a private foundation and the foundation does not dispose of the excess business holdings within the applicable tax year. The modified Senate bill, like the House bill, proposes an exception to this tax for certain philanthropic business holdings if the following requirements are satisfied: (1) the private foundation acquires the business under a will or testamentary trust and owns 100% of the interests in the business at all times in the relevant tax year; (2) the business distributes an amount equal to its net operating income to the private foundation within 120 days of the close of the tax year; and (3) the business and private foundation are independently operated.

[1] Hatch modification to Amendment #25 (Hatch #25), https://www.finance.senate.gov/download/hatch-amendment-25-as-modified-to-provide-modifications-clarifications-and-additions-to-the-chairmans-mark-of-the-tax-cuts-and-jobs-act.

[2] (100% – 17.4%) * 38.5% = 31.80%.

[3] (100% – 70%) * 35% = 10.5%.

[4] (100% – 50%) * 20% = 10%.

[5] The JCT description of the original Senate bill released on November 9, 2017 provided for a 37.5% deduction of GILTI. However, the JCT Description of the Modification to the Chairman's Mark released on November 14, 2017, states that the deduction for GILTI will be 50% for tax years after December 31, 2017 and before January 1, 2026, decreasing to 37.5% for tax years beginning on or after January 1, 2026. Although not entirely clear, we assume that the more recent publication is correct and that a 50% deduction would initially apply to tax years beginning on or after December 31, 2017. This would result in an initial effective rate of 17.5% [(100% – 50%) * 35% = 17.5%] as the proposed corporate tax rate of 20% would not take effect until tax years beginning after December 31, 2018.

[6] For tax years beginning after December 31, 2017 and before January 1, 2019, the effective rate would be 21.875% ([100% – 37.5%] * 35% = 21.875%).

[7] Under both the House bill and the modified Senate bill, royalty income received by a CFC from third parties would continue to be treated as "active" non-Subpart F income—so long as the CFC had added substantial value to the underlying intangible property and is regularly engaged in the development of similar intangibles through the activities of its office, staff, or employees located in a foreign country (*see* Treas. Reg. § 1.954-2(d)(1)(i))—and would therefore be currently taxable at a reduced 10% rate under the House bill's "foreign high return" provision and under the Senate bill's GILTI tax. Therefore, under both bills, U.S. multinationals may still prefer to have their CFCs hire employees abroad to develop intangibles for sale or license to third parties outside of the United States to achieve the 10% rate on foreign high returns (rather than develop the intangibles in the United States and be taxed at either of the 20% general corporate rate under the House bill or the 12.5% FDII rate under the modified Senate bill.

[8] 148 T.C. No. 8 (Mar. 23, 2017).

[9] 149 T.C. No. 3 (July 13, 2017) (holding that a foreign partner's sale of a partnership engaged in a U.S. trade or business generated solely foreign-source gain). The JCT description of the Senate bill refers to this decision specifically.

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