HOUSE AND SENATE CONFERENCE COMMITTEE RELEASES FINAL TAX BILL

Federal and International Tax Alert
December 18, 2017

On December 15, the final version of the "Tax Cuts and Jobs Act" was released, which reflects a compromise between the House and Senate versions of the tax reform legislation. Republican leaders expect both the House and Senate to vote on the Conference Bill (the "Bill") early this week, with the goal of having President Trump sign it by Wednesday, December 20.

Changes affecting individuals. The Bill would, generally effective January 1, 2018, modify individual income tax rates and eliminate many itemized deductions, but provide a higher standard deduction amount. Notably, these provisions generally would be temporary and would sunset following the 2025 tax year. Some of the changes are as follows:

- Individual income tax rates. The Bill would retain seven income tax brackets, but modify the rates to 10%, 12%, 22%, 24%, 32%, 35%, and 37%. For taxpayers filing jointly, the 37% bracket would apply to income over $600,000 (over $500,000 for single individuals). Notably, the agreement does not repeal the 3.8% net investment income tax.
- Standard deduction. The standard deduction would increase to $24,000 for joint filers and $12,000 for individual filers, indexed for inflation.
- State and local tax deduction. The Bill would allow taxpayers to claim a deduction for aggregate domestic state and local taxes, not paid or accrued in carrying on a trade or business or an activity engaged in for profit, of up to $10,000. The provision also would preclude an individual from claiming an itemized deduction in 2017 for a prepayment of state income tax attributable to a future tax year.
- Mortgage interest deduction. The home mortgage interest deduction would be limited to $750,000 of principal for new home purchases. The provision also would suspend the deduction for interest on home equity indebtedness for tax years before 2026.
- Alimony deduction. The Bill generally provides that, for any divorce or separation instrument executed after December 31, 2018, alimony and separate maintenance payments would not be deductible by the payor spouse and would not be includible in the recipient spouse's income.

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- Personal exemptions. The Bill would temporarily suspend the deduction for personal exemptions.
- Alternative minimum tax. The Bill would retain the alternative minimum tax, but would temporarily increase both the exemption amount (to $109,400 for joint filers and $70,300 for individuals) and phase-out thresholds (to $1,000,000 for joint filers and $500,000 for single filers) for the individual AMT.

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

- Corporate tax rate. The Bill would eliminate the current corporate tax rate structure that has a maximum rate of 35% and replace it with a flat 21% corporate tax rate.
- Deduction for pass-through "Qualified Business Income". For tax years beginning after December 31, 2017 and before January 1, 2026, the Bill would allow an individual owner to deduct 20% of the owner's share of the pass-through entity's "domestic qualified business income." Additional rules would limit the amount of such income and the amount of the deduction, such as a wage limitation. The deduction generally would not apply to individual owners of certain service businesses (*e.g.*, health, law, accounting, consulting, financial services, brokerage services), except for individuals whose taxable income would not exceed $315,000 (joint filers) or $157,500 (single filers).
- Increased expensing. The provision would allow immediate expensing of 100% of the cost of qualifying property acquired and placed in service after September 27, 2017 and before January 1, 2023. Notably, this additional first-year depreciation deduction would apply to new and used property.
- Expansion of section 179 expensing. The section 179 small business expensing limit would increase to $1 million and the phase-out amount would be increased to $2.5 million, both indexed for inflation.
- Interest deductions. The Bill generally would limit the deduction of net interest expense to 30% of the business's adjusted taxable income (businesses with average annual gross receipts of $25 million or less would be exempt from this rule). For tax years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income will be computed without regard to deductions allowable for depreciation, amortization, or depletion.
- Net operating loss deduction. The deduction of a net operating loss (NOL) would be limited to 80% of a business's taxable income, and NOL carrybacks generally would be eliminated, effective for losses arising in tax years beginning after 2017.
- Like-kind exchanges. Like-kind exchanges would be allowed only for real property that is not held primarily for sale, effective for transfers after 2017.
- Tax-exempt private activity and advance refunding bonds. The Bill retains the current treatment of private activity bonds, while it would repeal the exclusion from gross income for interest on a bond issued to advance refund another bond.

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

- Participation exemption for U.S. corporate shareholders owning 10% or more of a foreign subsidiary. For tax years beginning after December 31, 2017, U.S. corporations that receive dividends from 10%- or greater-owned foreign

corporations (other than from a "passive foreign investment company" ("PFIC") that is not a "controlled foreign corporation" ("CFC")) will be eligible for a 100% dividends received deduction ("DRD"), provided a one-year holding period is satisfied. The DRD is denied, however, for certain "hybrid dividends". Surprisingly, the rules applicable to a CFC's "investments in U.S. property" (which includes but is not limited to a loan from a CFC to its U.S. corporate shareholder) are retained, even for U.S. corporate shareholders that will be entitled to the DRD on actual dividends. The retention of these rules will cause a great deal of unnecessary complexity and leave a trap for the unwary.

- One-time transition tax on existing undistributed earnings and profits of foreign subsidiaries. As a transition from our current system to the participation exemption system, effective for tax years beginning before January 1, 2018, U.S. corporate shareholders owning at least 10% of the voting power of a foreign corporation and U.S. individual shareholders owning at least 10% of the voting power of a CFC, or at least 10% of the voting power of a foreign corporation that also has a U.S. corporate shareholder, generally will have to include in income the proportionate share of the foreign corporation's undistributed earnings and profits ("E&P"). Such E&P will be taxed at a reduced rate of either 15.5% or 8%. At the election of the U.S. shareholder, the tax liability can be paid over a period of up to 8 years. Special rules, however, apply to subchapter S corporation shareholders and real estate investment trusts. Importantly, new attribution rules for testing whether a foreign corporation is a CFC included in the Bill are effective for tax years beginning before January 1, 2018, i.e., the new attribution rules will apply for purposes of this one-time transition tax.

- New anti-deferral provision. For tax years beginning after December 31, 2017, a minimum tax will be imposed on foreign earnings that exceed a routine return, so-called global intangible low-tax income ("GILTI")), on a current basis at a full 21% rate. The GILTI, however, is subject to a 50% deduction as well as a reduced (80%) foreign tax credit. Thus, an overall foreign effective tax rate of at least 13.125% generally will prevent the imposition of residual U.S. tax. The GILTI deduction is reduced after 2025.
- Foreign-sourced intangible income. For tax years beginning after December 31, 2017, U.S. taxpayers are permitted a 37.5% deduction for income earned directly from serving foreign markets, so-called foreign derived intangible income. The deduction will result in a 13.125% effective tax rate on foreign derived intangible income. The deduction is reduced after 2025.
- Anti-base erosion. For tax years beginning after December 31, 2017, the Bill does not include the House proposal's controversial excise tax on certain payments to related foreign parties. Instead, the Bill generally follows the Senate proposal's base erosion and anti-abuse tax ("BEAT") approach by imposing a new alternative minimum tax at a rate of 10%. The BEAT is somewhat more narrowly drawn, applicable to a more limited subset of multinational groups and, in most cases, not applicable to cross-border purchases of inventory includible in cost of goods sold. Moreover, the Bill does not include the interest deduction limitation rules that were included in both the House and Senate proposals.
- No deductions for hybrid payments. For tax years beginning after December 31, 2017, the Bill includes the Senate proposal's anti-hybrid rule denying deductions for interest and royalties paid to related foreign persons, where the payments either are not includible or are deductible in the hands of the recipient in its residence country.

The Bill also would immediately double the estate tax exemption amount to $10 million (indexed for inflation), while retaining the step-up in basis of assets received from a decedent.

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