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Written by the Tax Groups at Ballard Spahr and Lindquist & Vennum.

This publication highlights developments in areas of tax law of interest to our clients

The U.S. House of Representatives voted to approve H.R. 1, Tax Cuts and Jobs Act (the House Bill) on November 16, and on December 2 the U.S. Senate voted to approved its bill, also titled the Tax Cuts and Jobs Act (the Senate Bill). The two bills will be reconciled in a conference committee. The Tax Groups at Ballard Spahr and Lindquist & Vennum have been keeping track of recent developments in both the House and Senate Bills. In this issue of Tax Truths, we analyze certain key provisions.

IN THIS ISSUE:

TAXATION OF INDIVIDUALS

Both the House Bill and the Senate Bill would make many significant changes to the taxation of individuals. Both bills would change the tax brackets, increase the standard deduction, repeal the personal exemptions, and increase family tax credits. Unless otherwise specified, all section references are to the Internal Revenue Code of 1986.

Changes to Tax Rates and Brackets

In addition to creating a maximum 25% rate for certain business income, discussed in detail (see below), the House Bill would reduce the number of tax brackets from seven to four, effective for tax years beginning after December 31, 2017. The Senate Bill would keep seven brackets, but would change the marginal rates. The Senate Bill rate changes would expire on December 31, 2025. Neither the House Bill nor the Senate Bill would repeal the 3.8% net investment income tax imposed on certain passive investment income.

The tables below set forth the current rates and proposed rate changes:

2017 – Married, Filing Jointly

Taxable Income	2017 Current Rates
$0 to $18,650	10% of taxable income
$18,651 to $75,900	$1,865 plus 15% of the excess over $18,650
$75,901 to $153,000	$10,452.50 plus 25% of the excess over $75,900
$153,101 to $233,350	$29,752.50 plus 28% of the excess over $153,100
$233,351 to $416,700	$52,222.50 plus 33% of the excess over $233,350
$416,701 to $470,700	$112,728 plus 35% of the excess over $416,700
$470,701 and above	$131,628 plus 39.6% of the excess over $470,700

2017 – Single Filers

Taxable Income	2017 Current Rates
$0 to $9,325	10% of taxable income
$9,236 to $37,950	$932.50 plus 15% of the excess over $9,325
$37,951 to $91,900	$5,226.25 plus 25% of the excess over $37,950
$91,901 to $191,650	$18,713.75 plus 28% of the excess over $91,900
$191,651 to $416,700	$46,643.75 plus 33% of the excess over $191,650
$416,701 to $418,400	$120,910.25 plus 35% of the excess over $416,700
$418,401 and above	$121,505.25 plus 39.6% of the excess over $418,400

House Rates – Married, Filing Jointly

Taxable Income	Proposed Rates
$0 to $90,000	12% of taxable income
$90,001 to $260,000	$10,800 plus 25% of the excess over $90,000
$260,001 to $1,000,000	$53,300 plus 35% on the excess over $260,000
$1,000,001 and above	$312,300 plus 39.6% on the excess over $1,000,000

House Rates – Single Filers

Taxable Income	Proposed Rates
$0 to $45,000	12% of taxable income
$45,001 to $200,000	$5,400 plus 25% of the excess over $45,000
$200,001 to $500,000	$44,150 plus 35% on the excess over $200,000
$500,001 and above	$149,150 plus 39.6% on the excess over $500,000

Senate Rates – Married, Filing Jointly

Taxable Income	Proposed Rates
$0 to $19,050	10% of the taxable income
$19,051 to $77,400	$1,905 plus 12% of the excess over $19,050
$77,401 to $140,000	$8,907 plus 22% of the excess over $77,400
$140,001 to $320,000	$22,679 plus 25% of the excess over $140,000
$320,001 to $400,000	$65,879 plus 32% of the excess over $320,000
$400,001 to $1,000,000	$91,479 plus 35% of the excess over $400,000
$1,000,001 and above	$301,479 plus 38.5% of the excess over $1,000,000

Senate Rates – Single Filers

Taxable Income	Proposed Rates
$0 to $9,525	10% of taxable income
$9,526 to $38,700	$952.50 plus 12% of the excess over $9,525
$38,701 to $70,000	$4,453.50 plus 22% of the excess over $38,700
$70,001 to $160,000	$11,339.50 plus 25% of the excess over $70,000
$160,001 to $200,000	$32,929.50 plus 32% of the excess over $160,000
$200,001 to $500,000	$45,739.50 plus 35% of the excess over $200,000
$500,001 and above	$150,739.50 plus 38.5% of the excess over $500,000

Both bills would leave current capital gains tax rates unchanged.

Increased Standard Deduction and Elimination of Personal Exemptions

Effective for tax years beginning after December 31, 2017, the House Bill would increase the standard deduction to $24,400 for joint returns and surviving spouses, $18,300 for unmarried individuals with at least one qualifying child, and $12,200 in any other case. Such a change would be expected to materially reduce the number of individual taxpayers who itemize their deductions.

However, both the House Bill and the Senate Bill give with one hand and take away with the other. Under both bills, the deduction for personal exemptions would be entirely repealed for tax years beginning after December 31, 2017.

Similarly, effective for tax years beginning after December 31, 2017 and expiring December 31, 2025, the Senate Bill would increase the basic standard deduction for all individuals to $24,000 for joint returns and surviving spouses, $18,000 for head-of-household filers, and $12,000 for all other taxpayers, each indexed for inflation.

Significant Changes to Family, Homeowner, and Education Incentives

To assist families with children in the absence of personal exemptions, both bills would increase the child tax credit. The House Bill would increase the credit to $1,600 refundable up to $1,000, while the Senate Bill would increase the credit to $2,000 refundable up to $1,000 (indexed for inflation). In addition to the child credit, the House Bill creates a new non-child dependent credit of $300 and a family flexibility credit of $300 for a taxpayer or each spouse on a joint return. The Senate Bill would add a $500 nonrefundable credit for certain non-child dependents.

Both bills would affect homeowners by making changes that could impact home prices. Under the House Bill, the itemized deduction for mortgage interest on debt incurred after November 2, 2017 is limited to interest paid on up to $500,000 of acquisition debt on a principal residence. Acquisition debt on a principal residence incurred prior to November 2, 2017, or debt incurred after that date to refinance existing debt, as long as the debt's principal amount does not increase, is grandfathered. For grandfathered debt, the limitation will remain at $1,000,000. The Senate Bill would leave in place the deduction for interest on acquisition debt while repealing the deduction for interest on home equity debt.

Effective for tax years beginning after December 31, 2017, both bills also would change when gain must be recognized on a sale of a principal residence. Gain would be excludable if (i) a taxpayer owns and uses the property as a personal residence for at least five of the eight years before the sale, and (ii) a taxpayer uses the exclusion only once every five years. Under current law to exclude gain, (i) a taxpayer must own and use the property as a personal residence for at least two of the five years before the sale, and (ii) a taxpayer may use the exclusion once every two years. Significantly, under the House Bill, no exclusion would be available to taxpayers with adjusted gross income exceeding $500,000 ($250,000 for single filers).

Effective for tax years beginning after December 31, 2017, the bills also would impact saving and paying for education expenses. The House Bill would eliminate the above-the-line deduction for student loan interest, the above-the-line qualified tuition deduction, and exclusions from gross income for qualified tuition reductions and employer-provided education assistance. Additionally, the House Bill would eliminate the Hope Scholarship Credit and the Lifetime Learning Credit. The bills also would change the rules applicable to Section 529 plans. The House Bill would allow plans to treat an unborn child as a designated beneficiary. Both Bills would allow plans to treat elementary and high school expenses as qualified expenses up to $10,000 per year.

As is true of other changes to individual taxes, the Senate Bill provides for these changes to sunset on December 31, 2025.

Other Changes to Deductions, Exclusions, and Credits

Both bills would make some more general changes to deductions, exclusions from income, and credits against tax effective for tax years beginning after December 31, 2017 and, in the case of the Senate Bill, expiring on December 31, 2025. Both bills would repeal the above-the-line deduction or exclusion relating to moving expenses. Under the House Bill, alimony would be neither included in the payee's income nor deductible by the payor for alimony payable under divorce decrees or separation agreements executed after 2017.

Both bills would repeal the deductions for personal (non-business) state and local income and sales taxes and tax preparation services. Both bills also would repeal the income-based limitation on itemized deductions, known as the Pease limitation. The House Bill would repeal deductions for medical expenses, personal casualty losses, and certain employee expenses, but it would retain a deduction for personal state and local real estate taxes, capped at $10,000.
Like the House Bill, the Senate Bill would allow a $10,000 deduction for real estate taxes and disallow all miscellaneous itemized deductions currently subject to the 2% floor. However, the Senate Bill would permit limited personal deductions for casualty losses incurred in a declared disaster and would retain the deduction for medical expenses, and decrease the threshold to 7.5% of adjusted gross income for 2017 and 2018.

Alternative Minimum Tax

The House Bill would repeal the Alternative Minimum Tax (AMT) effective for tax years beginning after December 31, 2017. Taxpayers with AMT credit carryforwards would be allowed to claim a refund of 50% of the remaining AMT credits in the 2019, 2020, and 2021 tax years with the remainder being carried forward to the 2022 tax year. The Senate Bill retains the AMT, but increases the exemption amount from $78,750 to $109,400 for married taxpayers filing jointly and from $50,600 to $70,300 for single taxpayers and increases the income over which the exemption phases out ($0.25 for every dollar over the phase-out amount) to $208,400 from $150,000 for married taxpayers filing jointly and to $156,300 from $112,500 for single taxpayers. For many taxpayers, the AMT would minimize or eliminate the benefit of the 23% deduction for business income and expensing of capital assets.

Estate and Generation-Skipping Taxes

The estate and generation-skipping transfer taxes have been under debate for many years. The House Bill proposes to increase the exemption amount to $10 million per person (from the current $5.49 million per person exemption) beginning in tax years after 2017 (indexed for inflation). The estate tax and the generation-skipping tax would be repealed entirely as of January 1, 2024. Additionally, the House Bill proposes no changes to the current rules governing tax basis, so property held at death would continue to receive a step-up in basis.

The Senate Bill would increase the exemption amount to $10 million per person beginning in tax years after 2017 (indexed for inflation), but would not fully repeal the taxes. (Click here to read a Ballard Spahr legal alert that details potential changes to the estate and generation-skipping taxes).

Retirement Plan Changes

Although the contribution limits for 401(k) plans and IRAs would remain unchanged, the bills would make some minor changes, effective for tax years beginning after December 31, 2017, including:

- Under the House Bill:
    - Employees who take hardship distributions from 401(k) plans would be allowed to continue making current contributions to the plan.

- Hardship distributions could include employer contributions and plan earnings.
- Under current law, individuals can pay tax and convert a traditional IRA to a Roth IRA but retain the right to undo the conversion. Under the House Bill, such a conversion could not be undone.
- Defined benefit plans could begin making in-service distributions at age 59 1/2 (lowered from age 62).

Reduced Rates on Business Income

House Bill

Among the most discussed provisions of the House Bill is the maximum 25% rate on qualified business income.
This reduced rate would apply to income earned by individuals directly and through pass-through entities, such as partnerships, LLCs, and S corporations (Pass-Through Entities). Implementation of the reduced rates would be very complicated (see below). The maximum 25% rate would be achieved by reducing the effective rate on qualified business income to the lesser of 25% or 10% less than the individual's top marginal rate.

With respect to the maximum 25% rate, it is interesting to note who would be eligible for its benefits as well as who is not eligible, or who would have their benefits reduced. To make sure that wages or substitutes for wages are not eligible for the lower rate—the so-called guardrails—all of an individual's income from a passive business activity would be eligible for the maximum 25% rate, but the applicability of the maximum 25% rate to an individual's income from active business activities would be limited. As a result, passive investors in a business would pay lower taxes on income from the business than people who both work in and own the business.

- If an individual earns income from a business activity in which the individual is passive (under the passive activity loss rules), 100% of the qualified business income from the activity would be eligible for the maximum 25% rate. As a result, all qualified business income that passes through to a passive owner of a Pass-Through Entity, including a private equity fund, a real estate investment partnership, or operating business, would be eligible for the maximum 25% rate.
- By contrast, the percentage of an individual's business income from an active (as opposed to passive) business activity that would be eligible for the maximum 25% rate is limited to the "capital percentage." Except for certain "specified service activities" and certain capital intensive businesses, the capital percentage generally would be 30%.
    - For capital-intensive active businesses activities, an individual investor would be able to elect to use a capital percentage greater than 30%. (This election would be effective for five years.) The potentially greater capital percentage is called the applicable percentage. The applicable percentage is based on a very complicated formula. First an individual calculates the excess of (i) his or her share of the tax basis for the depreciable assets and real property (without considering 100% expensing or Section 179 deductions) used in the business, multiplied by an interest rate equal to the short term AFR plus seven percentage points over (ii) the share of interest deducted by the business for the tax year. Then, the individual divides that number by his or her net business income derived from the business for the tax year. However, the applicable percentage cannot exceed the percentage of an individual's net business income that is not wages, payments other than a distributive share of the Pass-Through Entity's income, such as guaranteed payments or payments to a partner other than in his or her capacity as a partner, or director's fees (wages or substitute wages).
    - For example, assume that an individual owns 20% of a Pass-Through Entity that operates a business that is capital intensive and is not a passive activity for the individual. Assume also that (i) the Pass-Through Entity has depreciable property and real estate used in its business that has a tax basis of $50,000,000 (without considering 100% expensing or Section 179 deductions), (ii) the Pass-Through Entity deducted $1,500,000 of interest, and (iii) the individual's share of

the Pass-Through Entity's business income was $1,000,000. The applicable percentage would be determined as follows: (1) 20% of $50,000,000 ($10,000,000) multiplied by the 8.5% (assuming the applicable short-term federal rate is 1.5%) or $850,000 less (2) $300,000 (20% of the $1,500,000 of interest) or $550,000. Then $550,000 would be divided by $1,000,000 (the individual's share of the Pass-Through Entity's income) to arrive at a specified percentage of 55%.

- Income earned from an active business activity that is a "specified service activity" would not, for the most part, be eligible for the maximum 25% rate. Specified service activities are personal service businesses—doctors, lawyers, architects, accountants, actuaries, performers, consultants, athletes, individuals providing financial services, brokers, and other businesses where the principal asset is the reputation or skill of one or more of its employees or owners. Also, explicitly included within specified service activities are investing, trading, or dealing in securities, partnership interests, or commodities. However, qualified business income earned by an individual from a capital-intensive specified service business would be eligible for the maximum 25% rate to the extent of the applicable percentage (the complicated formula, above), provided that the applicable percentage is at least 10%.
- Qualified business income would be determined based on a formula that combines net business income from passive activities, the appropriate percentage of net business income from active business activities, wages, guaranteed payments, payments to the partner other than in his or her capacity as a partner, and director's fees. Capital gains and losses, dividends, and other passive types of income are not qualified business income.

Currently, non-capital gain dividends from a REIT are subject to tax at ordinary income tax. The House Bill generally would reduce the rate applicable to such dividends to 25%.

Personal service corporations currently are subject to tax on qualified personal service income at a 35% rate. The House Bill would reduce that rate to 25%. Generally, personal service corporations are corporations principally engaged in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

The new 25% rate would be effective for tax years beginning after December 31, 2017. For fiscal year taxpayers, the 25% maximum rate would be a blended rate for 2018 based on the portion of 2018 included in the taxpayer's tax year.

Senate Bill

The Senate Bill takes a different approach from the House Bill. The Senate Bill would allow an individual to deduct 23% of his or her qualified business income earned directly or through a partnership, LLC, or S corporation, capped at 50% of the wages paid by the business allocable to the individual. For this purpose, wages are the sum of W-2 wages, elective deferrals, and deferred compensation. Distributions to partners or members of an LLC are not wages. For example, if an individual is a 50% member of an LLC that conducted a qualified business and the business paid $100,000 of wages, the individual's deduction for 23% of his or her qualified business income could not exceed $50,000.

The wage limit does not apply for a married individual whose taxable income is $500,000 or less ($250,000 for an individual who is single) and phases out entirely for income between $500,000 and $600,000 for married individuals (between $250,000 and $300,000 for single individuals).

This deduction would be available for income from specified service businesses (law, accounting, medicine, etc.) for a married individual whose taxable income is $500,000 or less ($250,000 for an individual who is single) and phases out entirely for income between $500,000 and $600,000 for married individuals (between $250,000 and $300,000 for single individuals).

Qualified business income includes qualified items of income, gain, deduction, and loss from the taxpayer's qualified U.S. businesses as well as non-capital gain dividends from a REIT. Wages, guaranteed payments and, to the extent provided in regulations, payments by a partnership to a partner other than in the capacity of a partner, are not qualified business income.

The Senate Bill would reduce the tax rate on personal service corporations to 20%.

The 23% deduction for qualified business income and the reduction in the rate applicable to personal service corporations would be effective for tax years beginning after December 31, 2017.

Carried Interests

Managers of investment partnerships and LLCs, such as private equity funds, typically receive a carried interest in such partnerships/LLCs relating to services performed for such partnerships/LLCs. Under current law, a manager's share of gain relating to its carried interest is eligible to be taxed at long-term capital gain rates. Since 2007, legislation has been proposed to tax income relating to carried interests in certain investment partnerships/LLCs at ordinary income rates.

The bills focus on interests in partnerships/LLCs received in consideration for services relating to assets (including real estate) held for investment on behalf of third-party investors. The bills specifically exclude from these rules an interest in a partnership/LLC held directly or indirectly by a corporation and capital interests in a partnership/LLC, including a partnership/LLC interest that was subject to tax upon receipt or vesting.

The House Bill and the Senate Bill would treat gain allocated to a carried interest as short-term capital gain if the asset that produces the capital gain was not held for at least three years. Short-term capital gain is taxed at ordinary income rates. Qualified dividend income that passes through to the owner of a partnership/LLC holding a carried interest would continue to be taxed at a 20% rate. Prior proposals that would have converted income passing through to the holder of a carried interest into ordinary income also would have subjected such income to self-employment tax. Neither the House Bill nor the Senate Bill would convert any short-term gain from a carried interest into income from self-employment. Such income would remain subject to the 3.8% net investment income tax, if it is passive.

The bills contain an anti-abuse rule governing transfers of an interest subject to these rules to related parties. Under the Senate and House Bills, the proposed carried interest provisions would apply to taxable years beginning after December 31, 2017.

Increased Expensing

The length and applicability of depreciation deductions have been hotly debated since depreciation deductions have been allowed. Critics have bemoaned the complexity and administrative effort it takes to track the various depreciation schedules for assets. Many forms of accelerated depreciation have been introduced into the Code, with immediate expensing being the most accelerated. Both the House Bill and the Senate Bill would expand the application of expensing in many ways, but there are different limitations.

100% Expensing

Under current law, taxpayers are entitled to bonus depreciation for "qualified property" through 2019. Currently, bonus depreciation is 50% of the cost of qualified property placed in service in 2017 and gradually phases down to 30% in 2019. Generally, qualified property is tangible property with a useful life of 20 years or less under MACRS, certain computer software, water utility property, and qualified improvement property, the original use of which begins with the taxpayer.

The House Bill allows taxpayers to expense 100% of the cost of certain qualified property (including used property) acquired and placed in service after September 27, 2017 and before January 1, 2023, provided that the use is the taxpayer's first use of the property. Property used by a regulated public utility company or any property used in a real property trade or business is not eligible for 100% expensing.

Immediate expensing of new and used property placed in service is a welcome change to many businesses. However, the exclusion of property used in a real property trade or business will have a significant impact on the real estate industry if this provision of the House Bill were to pass unchanged because property used in a real estate trade or business will be depreciated without regard to any bonus depreciation.

The Senate Bill allows for 100% expensing for new (not used) qualified property and phases out 100% expensing between 2023 and 2025, but only excludes certain public utility property from eligibility, not property used in a real property trade or business. Although real property would not be eligible for 100% expensing, qualified improvements would be eligible. However, a real estate trade or business would be permitted to elect to deduct 100% of its interest expense (as opposed to limiting such deduction to 30% of its income) and any real estate business that so elects would not be entitled to expense eligible real estate. Instead, an electing real estate business would depreciate its residential and non-residential real estate (including qualified improvement property) using the alternative depreciation lives. The alternative depreciation system (ADS) life would be 30 years for residential real estate, 40 years for non-residential property, and 20 years for qualified improvements. Qualified improvement property is any improvement to the interior of non-residential real property if such improvement is placed in service after the date the building is placed in service. Qualified improvement property would have a 10-year class life and a 20 year ADS life. The regular recovery period for residential and non-residential real estate would be reduced to 25 years and for qualified improvements, would be 10 years.

Expansion of Section 179

Section 179 was introduced in an effort to encourage small businesses to purchase new equipment by allowing for an immediate expensing of certain property that otherwise would be subject to depreciation deductions over its useful life. Under the current Section 179, taxpayers may immediately expense up to $500,000 of the cost of any Section 179 property placed in service each taxable year. This amount is reduced by the amount by which the total cost of such property placed in service during the tax year exceeds $2,000,000. It is further reduced if the taxpayer's taxable income reaches certain thresholds. Similar to the definition of qualified property eligible for bonus depreciation, Section 179 property includes tangible personal property with a recovery period of 20 years or less under MACRS, certain computer software, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

The House Bill expands the scope of Section 179 by increasing the amount eligible for immediate expensing to $5,000,000 and the phase-out threshold to $20,000,000 for 2017 with adjustments for inflation for future tax years through 2023. The House Bill also modifies the definition of Section 179 property to include qualified energy efficient heating and air conditioning property.

The Senate Bill would increase the amount eligible for immediate expensing from $500,000 to $1,000,000 and the threshold from $2,000,000 to $2,500,000, both amounts indexed for inflation. The Senate Bill also would expand the definition of Section 179 property to include certain depreciable tangible personal property (property used to furnish lodging) and expand the definition of qualified real property to include improvements made to non-residential real property, including improvements for roofs, heating, ventilation, air conditioning, fire protection, and alarm and security systems.

Small Business Considerations

Small businesses have been hot-button policy issue for both political parties, and it is no surprise that the House Bill provides for provisions to specifically benefit small businesses. In addition to the changes to Section 179, the House Bill would expand the application of certain simplified accounting methods and exempt small businesses from the limitations of interest deductibility.

Expanded Use of Cash Method Accounting

Small businesses generally prefer to use the cash method of accounting rather than the accrual method because it is simple and easy to understand. While many businesses would prefer to use the cash method, there are situations where the accrual method is required. Under current law, a business organized as a sole proprietorship, partnership or LLC (without a corporate partner or member), and S corporations may use the cash method of accounting. A C corporation or partnership with a C corporation partner may use the cash method of accounting if its average gross receipts do not exceed $5,000,000 (including prior years for any predecessor). The House Bill would increase this threshold to $25,000,000 beginning in 2017, indexed for inflation. The Senate Bill would increase the threshold to $15,000,000, indexed for inflation, and the C corporation or partnership would be required to meet that threshold for the three prior taxable year periods.

For a business where the production, purchase, or sale of merchandize is a material income-producing factor, the use of an inventory method such as LIFO and FIFO is required. Under current law, a business required to use an inventory method also must use the accrual method of accounting unless it has average gross receipts of $1,000,000 or less or is within an exempt industry with average gross receipts of $10,000,000 or less. The House Bill would increase the $1,000,000 gross receipts threshold to $25,000,000, regardless of industry designation. The Senate Bill would increase the gross receipts threshold to $15,000,000, indexed for inflation.

Uniform Capitalization (UNICAP) Rules Restrictions

Under the UNICAP rules, certain direct and indirect costs for real or tangible personal property produced by a business or acquired by a business for resale are required to be included in inventory or capitalized into the basis of such property. Current law allows for an exemption from the UNICAP rules for businesses with $10,000,000 or less in average annual gross receipts with respect to personal property acquired for resale, but not for real and personal property manufactured by the business. The House Bill would increase the threshold to $25,000,000 and would apply to real and personal property acquired or manufactured by the business. The Senate Bill would increase the threshold to $15,000,000.

Long-Term Contracts

For long-term contracts (contracts that cover a period beyond a single taxable year), taxable income is generally recognized and expenses are deducted based on the percentage of the contract that is completed each taxable year (commonly known as the percentage-of-completion method). Under the percentage-of-completion method, income generally is recognized under the contract based on the percentage of actual costs incurred under the contract for the year compared to the estimated total contract costs. Certain businesses with average annual gross receipts of $10,000,000 or less in the preceding three years are not required to use the percentage-of-completion method of accounting (and can use the completed contract method) for contracts that are expected to be completed within a two year period. The House Bill would increase the gross receipts threshold to $25,000,000. The Senate Bill would increase the gross receipts threshold to $15,000,000.

Exemption from Limitation of Interest Deductibility

The House Bill would limit the deductibility of interest for a business to 30% of the business' adjusted business taxable income (business taxable income without regard to business interest income or deductions, NOL deductions, and any deduction for depreciation, amortization, or depletion (roughly, EBIT)). Since many small businesses rely on debt to finance their operations and growth, the House Bill exempts businesses with average gross receipts of $25,000,000 or less beginning after 2017. The Senate Bill also would limit the deductibility to 30% of a business' adjusted business taxable income (business taxable income computed without regard to business interest income or deductions, NOL deductions, and any permitted for deduction business income (roughly, EBITDA)) and would exempt businesses with $15,000,000 or less in average gross receipts beginning after December 31, 2017.

The House Bill also would exempt from the interest deduction limitation real estate trade or businesses (the trade-off for excluding the assets owned by such businesses from eligibility for 100% expensing). The Senate Bill exempts electing real property trades or business from the interest expense deduction limitation and also includes a depreciation trade-off. See above.

LIKE-KIND EXCHANGES

Under current law, while real estate may be the most common type of property exchanged, like-kind tangible personal property and certain intangible property also can be exchanged if it is used in a trade or business or held for investment. To be like-kind, tangible personal property must be of the same general class, such as automobiles.

Both the House Bill and the Senate Bill would limit property eligible for a like-kind exchange to real estate and prohibit exchanges of personal property, both tangible and intangible. This change would apply to exchanges completed after December 31, 2017. But if property is disposed of (or received) in a deferred like-kind exchange before the end of 2017, both bills would permit the exchange (if otherwise qualified) to be completed after the end of 2017.

CAPITAL CONTRIBUTIONS, GRANTS, AND OTHER NON-MEMBER CAPITAL CONTRIBUTION

Under current law, a capital contribution of money or property to a corporation from either a shareholder or from a non-shareholder is tax-free to the corporation. Likewise, a capital contribution to a partnership or LLC by a partner or member is tax-free to the partnership or LLC. It is not entirely clear whether a partnership or LLC may receive tax-free capital contributions from non-partners.

The House Bill would change this result by requiring a corporation, partnership, or LLC to recognize income upon receipt of a capital contribution that exceeds the value of the stock or the partnership or membership interest received by the contributor in exchange for the capital contribution. This provision would make all grants and cash incentives taxable to the recipient entity. The recipient entity would have a tax basis for the property it receives equal to the transferor's tax basis for the contributed property increased by (i) gain recognized by the transferor, if any, and (ii) the amount, if any, included in the income of the entity.

This provision would be effective for contributions made, and transactions entered into, after the date of enactment.

PARTNERSHIP TERMINATION

Under current law, a partnership or LLC is terminated for tax purposes (and a new partnership is deemed to be created) if there is a sale or exchange of 50% or more of the total interest in the partnership or LLC capital and profits in a 12-month period. The primary significance of this provision is that the new partnership or LLC is treated as if it had newly acquired its tangible property from a third party. The "new" partnership/LLC has the same tax basis for the property as the basis the terminating partnership or LLC had for that property. But this basis must be depreciated over the full recovery period applicable to the class of property to which the property belongs.

Other consequences can arise from such a termination, including a "bunching" of income from more than one tax year in certain cases when the partnership or LLC is using a different tax year than a partner or member, although this is rare for an individual taxpayer.

The House Bill would repeal the rule that the sale or exchange of 50% or more of a partnership or LLC causes a technical termination of a partnership or LLC. This will eliminate the mostly negative consequences that can arise by reason of a termination when an interest is sold. The change would be effective for partnership taxable years beginning after December 31, 2017.

CORPORATE TAX AND OTHER BUSINESS PROVISIONS

Reduction in Corporate Tax Rate

Under current law, the following rates apply to a corporation's taxable income:

Taxable Income	Tax Rate
$0-$50,000	15%
$50,001-$75,000	25%
$75,001-$10,000,000	34%
Over $10,000,000	35%

The 15% and 25% rates are phased out for corporations with taxable income between $100,000 and $335,000. As a result, a corporation with taxable income between $335,000 and $10,000,000 effectively is subject to a flat tax rate of 34%. Similarly, the 34% rate is gradually phased out for corporations with taxable income between $15,000,000 and $18,333,333, such that a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35%.

Personal service corporations may not use rates below 35%. A personal service corporation is a corporation in which the principal activity is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Such services are substantially performed by the employee-owners.

Under the House Bill, the corporate tax rate would be reduced to a flat 20%. Personal service corporations would be subject to a flat 25% rate. The provision would be effective for tax years beginning after 2017. Like the House Bill, the Senate Bill would cut the corporate tax rate to a flat 20% and this rate also would apply to personal service corporations.

Notably, while the initial cuts to individual tax rates are temporary, cuts to the corporate tax rate are permanent. There had been suggestion that the cuts should be temporary, or perhaps that the rate should be set at 25% but not as low as 20%. However, both the House Bill and the Senate Bill provide for a permanent rate cut.

The House Bill would be effective for tax years beginning in 2018. The Senate Bill has a slightly delayed effective date. The reduced corporate tax rate would be effective for taxable years beginning in 2019.

Corporate AMT

Under current law, the corporate AMT is 20%. It presently does not apply to most corporations. The AMT is a separate, parallel calculation of table income and tax. Under the parallel AMT system, a tax at the rate of 20% is calculated on "alternative minimum taxable income" or AMTI. The corporation pays the higher of its regular corporate tax or regular rates (the highest being 35% under current law), or the AMT. Generally, many items of income and deductions that are treated differently in in computing AMTI (as compared with computing regular taxable income) are narrow or pertain to specific industries.

While the House Bill and earlier versions of the Senate Bill repealed the corporate AMT, the Senate Bill as passed by the Senate leaves it in place. This was a surprise. Under the Senate Bill, the proposed corporate tax rate is 20%—the same as the AMT rate. Accordingly, instead of being a parallel system of taxation that does not apply very often, should the AMT remain in place, it would effectively become the default corporate tax for many more corporations than it currently applies to.

Many already have voiced strong concerns that the corporate AMT is retained by the Senate Bill. This has led some to predict that the final bill that comes out of the conference committee will repeal the corporate AMT.

Dividends Received Deduction

Under current law, corporations that receive dividends from corporations in which they own stock are entitled to a dividends received deduction. Generally, the deduction is 70% of the dividends received, provided that those that receive dividends from a "20% owned" corporation generally are entitled to a deduction of 80%, and "qualifying dividends" received from certain members of an affiliated group are eligible for a 100% dividends received deduction.

Under both bills, the 80% dividends received deduction would be reduced to 65% and the 70% dividends received deduction would be reduced to 50%. The Senate Bill has a slightly delayed effective date for this provision, as well. It would be effective for taxable years beginning in 2019.

Modification of Net Operating Loss (NOL) Deduction

Under current law, NOLs may be carried back by corporations for two years and carried forward for 20 years and claimed as a deduction in such tax years. However, for AMT purposes, the NOL deduction is limited to 90% of the AMTI.

The House Bill would modify the NOL deduction by:

- Limiting the deduction that may be claimed with respect to NOLs to 90% of taxable income, like the current rules for AMT
- Eliminating the carryback of NOLs, except for certain eligible disaster losses
- Replacing the 20-year carryforward period with an indefinite carryforward period
- Increasing NOL carryforwards by an interest factor using the federal short-term AFR, plus four percentage points

The House Bill would retain a one-year carryback period for small businesses suffering certain disaster losses (businesses with average annual gross receipts of $5 million or less) and taxpayers engaged in the trade or business of farming.

The Senate Bill contains provisions limiting deductions for NOLs that are similar to the House Bill, except that the Senate Bill does not contain the special carryback rules for eligible disaster losses nor does it provide for an increase in post-2017 NOL carryforwards using the short-term AFR plus 4%. Additionally, under the Senate Bill, for taxable years beginning after December 31, 2022, the 90% of taxable income limitation would be reduced to 80%. Finally, under the Senate Bill, the modified NOL rules would not apply to a property and casualty insurance company.

Under both the House Bill and the Senate Bill, the proposed modifications relating to NOLs generally would apply for losses arising in tax years beginning after December 31, 2017. However, the 90% of taxable income limitation would apply for tax years beginning after December 31, 2017, and therefore would apply to deductions for NOL carryforwards arising in tax years prior to 2018 that are carried forward to tax years beginning after December 31, 2017.

Limitation on the Deductibility of Business Interest

Under current law, taxpayers engaged in a trade or business generally are allowed a deduction for interest expense when paid or accrued. The deductibility of interest expense is a key assumption underlying the use of debt financing.

Current provisions of the Code provide numerous limitations on the deductibility of interest expense, including the so-called earnings stripping rules of Section 163(j) of the Code relating to interest paid or accrued by a corporation to certain related parties exempt from U.S. tax (such as foreign affiliates).

The House and Senate Bills would replace the earnings stripping rules with a broad limitation on the deductibility of business interest. Under both bills, the deduction for interest expense generally would be limited to 30% of adjusted taxable income.

The definition of adjusted taxable income differs under the House and Senate Bills. Under the House Bill, adjusted taxable income generally is defined as taxable income without regard to (i) tax items not related to a trade or business, (ii) any business interest or business interest income, (iii) any net operating loss deduction, and (iv) any deduction allowable for depreciation, amortization, or depletion (i.e., roughly cash flow before net interest expense).

The Senate Bill is similar except that depreciation, amortization, and depletion are not added back for purposes of adjusted taxable income. This aspect of the Senate Bill is significantly less favorable for taxpayers than the House Bill, particularly in light of the expanded expensing rules contained in both bills. The difference between the House and Senate Bills is essentially the difference between EBIT and EBITDA.

With respect to partnerships and S corporations, the 30% limitation would be applied at the partnership or shareholder level and deductions for interest would be included in the partners' or shareholders' non-separately stated taxable income or loss.

Interest that is disallowed as a deduction under new Section 163(j) would be carried forward to future taxable years. Under the House Bill, the carryforward period would be limited to five years. The Senate Bill would allow the amounts disallowed to be carried forward indefinitely.

Certain small businesses and businesses in certain industries would be exempt from these rules. Under the House Bill, small businesses for purposes of the exemption would generally mean taxpayers with average annual gross receipts of $25 million or less during the three preceding years. Under the Senate Bill, the small business exemption would apply to taxpayers with gross receipts of $15 million or less during the three preceding years.

Taxpayers engaged in a real property trade or business for purposes of Section 469, taxpayers engaged in the business of performing services as an employee, and certain utilities also would be exempt from these rules. The Senate Bill also exempts certain farming businesses from the 30% limitation. Moreover, under the Senate Bill, to be exempt from the 30% limitation on the deductibility of interest under Section 163(j), a real property trade or business and a farming trade or business would need to make an election and, by making such election, the taxpayer would be required to use the alternative depreciation system to depreciate real property used in a trade or business.

Under the House and Senate Bills, the 30% limitation on the deductibility of business interest would apply to tax years beginning after December 31, 2017. Thus, as currently proposed, the limitation would apply to interest paid or accrued on indebtedness incurred prior to December 31, 2017.

Tax Accounting Changes

The Senate Bill, but not the House Bill, includes a provision that a corporation's items of income must be included no later than the year in which such items are taken into account on an applicable financial statement. This rule would not apply to long-term contract accounting, advance payments, and other specifically authorized accounting methods under the Code.

TAX CREDITS

Elimination of Certain Business Credits

The New Markets Tax Credit (NMTC) and the Rehabilitation Tax Credit (RTC), including historic tax credits, have attracted significant private investment in low-income communities and historic buildings. The House Bill would eliminate the NMTC and RTC entirely after 2017. It also would eliminate several other business credits, including the credit for clinical testing expenses for certain drugs for rare diseases or conditions, the employer-provided child care credit, the work opportunity tax credit, and the credit for expenditure to provide access to disabled individuals. However, NMTCs that already have been allocated may be used in accordance with current law, except that no amount of unused allocation limitation may be carried to any calendar year after 2022. With regard to the RTC, the House Bill would provide a transition rule for rehabilitation expenditures with respect to any building owned or leased by the taxpayer at all times after December 31, 2017 that are incurred through the end of a 24-month period, which begins 180 days after the enactment of the House Bill.

Unlike the House Bill, the Senate Bill would retain all of the business credits that the House Bill proposes to repeal, with the exception of the 10% RTC, which also would be repealed under the Senate Bill. The Senate Bill would retain the 20% RTC applicable to historic structures and allow it to be claimed ratably over a five-year period beginning in the tax year when the structure is placed in service. The Senate Bill also would reduce the credit rate and modify the amount and type of expenses upon which the credit for clinical testing expenses for certain drugs for rare diseases or conditions is calculated.

Retention of R&D Tax Credit and LIHTC

The House Bill would retain the Research and Development Tax Credit (R&D Credit) and the Low Income Housing Tax Credit (LIHTC) in their current form. However, the House Bill would significantly undercut the value and volume of the LIHTC. First, the reduction of the corporate tax rate to 20% would reduce LIHTC investors' returns (to the extent they are based on depreciation), thereby making such investments less attractive. Additionally, the House Bill would repeal the tax exemption for private activity bonds, including multi-family tax-exempt bonds, which finance more than 40% of all LIHTC-financed affordable homes annually. One analyst estimated that, in its current form, the House Bill would reduce the future supply of affordable rental housing by nearly a million units.

The Senate Bill would retain the R&D Credit in its current form. The Senate Bill would retain the LIHTC but it would modify the credit in a few ways. Under current law, a residential unit will be eligible for the LIHTC only if it is for use by the general public. There are currently three exceptions to this rule and a project will not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants (1) with special needs, (2) who are members of a specified group, or (3) who are involved in artistic or literary activities. The Senate Bill would add veterans to existing exceptions to the general public use requirement. This change would apply to all buildings placed in service before, on, or after the date of enactment of the Senate Bill.

In addition, under current law, buildings located in a qualified census tract or a difficult development area, or are so designated by the state housing credit agency, would get a 30% "basis boost." This basis boost increases the LIHTC available to such projects. The Senate Bill would reduce the amount of the basis boost to 25% and the bill would provide an automatic 25% basis boost to LIHTC projects located in rural areas, as defined under section 520 of the Housing Act of 1949. These changes would apply to buildings placed in service after the date of enactment of the Senate Bill.

The Senate Bill would not repeal the tax exemption for private activity bonds. Nevertheless, analysts still estimate that the lower corporate tax rate would result in a loss of approximately 200,000 affordable rental homes.

Modification of Energy Credits

The House Bill generally would retain the current law phasedowns of the 30% Renewable Energy Investment Tax Credit (ITC) and Production Tax Credit (PTC). In 2015, the 30% ITC for solar energy property and geothermal property was extended and is phasing down to 10% for projects beginning construction after 2022. The House Bill would extend the 30% ITC to technologies not currently included, such as, fiber-optic solar, fuel cell, micro-turbine, geothermal heat pump, small wind, and combined heat and power property. However, it would eliminate the ITC entirely for solar and geothermal property the construction of which begins after December 31, 2027. The House Bill also would repeal the inflation adjustment for the PTC for projects that begin construction after the bill is enacted. The repeal of the inflation adjustment would be affective to taxable years ending after the date the House Bill is enacted and would result in a reduction of the baseline number for the credit from 2.4 cents per kWh to 1.5 cents per kWh.

The Senate Bill does not propose any modifications to the ITC or PTC.

BEAT Proposal and Retaining AMT

The Senate Bill also proposes a Base Erosion and Anti-abuse Tax (BEAT)—which is discussed below under International Tax Provisions—applicable to multinational corporations. To calculate the BEAT, applicable taxpayers would be required to perform two calculations: (1) 10% of the corporation's taxable income modified to include certain base erosion payments and (2) the corporation's regular tax liability minus tax credits (excluding the R&D Tax Credit). If the amount in (1) is larger than the amount in (2), then the taxpayer would owe tax equal to the excess. As the Senate Bill currently stands, the only tax credit that would not have to be backed out under the second calculation is the R&D Tax Credit. The BEAT could hinder investment because such credits could result in multinational taxpayers owing tax under the BEAT provision.

The Senate Bill also restores the AMT for individuals and corporations. While the LIHTC and the RTC applicable to historic structures can be taken against the corporate and individual AMT, the retention of the AMT in its current form could negatively impact the NMTC and the PTC. Under current law, the NMTC cannot be used to reduce the corporate or individual AMT at all, and the PTC cannot be used to reduce AMT liability in its final six years. The concern is that if the corporate tax rate is reduced to 20% and the AMT rate remains at 20%, then the AMT could become the default method of taxation for many taxpayers.

EXEMPT ORGANIZATIONS

	House Bill	Senate Bill
Clarification of Application of Unrelated Business Income Tax (UBIT)	The general rule in Section 511 of the Code imposing UBIT has been clarified to ensure that any entity that is exempt from income taxation under Code Section 501(a) is subject to UBIT. The House provision is designed to ensure that an entity that is exempt from income taxation under other Code provisions, such as government-sponsored entities exempt under Section 115(1), also have to pay UBIT.	Not addressed
Limitation on Exclusion of Certain Research Income from Unrelated Business Taxable Income (UBTI)	Currently, organizations that perform fundamental research, the results of which are freely available to the general public, may exclude all of the organization's research income from UBTI. The bill proposes limiting excludable research income for such organizations only to the income derived from the fundamental research, the results of which are freely available to the general public.	Not addressed
Creation of a Basket System for Separately Taxing UBTI of Each Trade or Business Operated	Not addressed	The bill requires that organizations that carry on more than one unrelated trade or business calculate UBTI for each trade or business separately, so that deductions from each unrelated trade or business are available to offset income only from that unrelated trade or business and not to offset income from other unrelated trades or businesses.

	House Bill	Senate Bill
Simplification of Investment Income Tax Rate	The bill proposes simplifying the application of the net investment income tax on private foundations to a single rate of 1.4%. Under current law, the general rate is 2%, but it may be reduced to 1% under certain circumstances.	Not addressed
Limitation on Private Operating Foundation Status for Certain Art Museums	Under the bill, organizations that operate art museums as a substantial activity can no longer qualify as private operating foundations, unless they are open to the public for at least 1,000 hours per year.	Not addressed
Investment Income Tax Imposed on Income of Private Colleges and Universities	The bill proposes that certain private colleges and universities that are public charities become subject to the excise tax on net investment income that historically only applied to private foundations. This rule would apply to private colleges and universities that have at least 500 students and non-charitable use assets valued at the close of the preceding tax year of at least $100,000 per full-time student. For purposes of the rule, the number of students is based on the daily average number of full-time students attending the institution. State colleges and universities would not be subject to the net investment income tax. The assets and net investment income of related organizations would be treated as the assets of the private college or university for purposes of this tax.	Generally the same as the House Bill, except that the excise tax on net investment income of certain private colleges and universities that are public charities would apply if the college's or university's non-charitable use assets valued at the close of the preceding tax year are at least $500,000 per full-time student.

	House Bill	Senate Bill
Expansion of Business Interests That Would No Longer Constitute Excess Business Holdings	Currently, private foundations generally may not own more than a 20% voting interest in a for-profit business. The bill would allow private foundations to own a greater interest in a for-profit business if all of the following requirements are met: (1) the foundation owns 100% of the voting stock of the business; (2) the foundation did not acquire its interests in the business by purchase; (3) the business distributes all of its net operating income for any given tax year to the foundation within 120 days of the close of the tax year; (4) no substantial contributors or family members of a substantial contributor are directors or executives of the business; (5) at least a majority of the foundation's board of directors are not directors or officers of the business or members of the family of a substantial contributor to the foundation; and (6) there is no loan outstanding from the business to a substantial contributor or a member of the family of a substantial contributor. Net operating income is defined for this purpose as gross income less appropriate deductions, income tax paid, and a reasonable amount reserved for working capital and other business needs. This proposal to expand interests that would no longer constitute excess business holdings would not be available for donor-advised funds, supporting organizations, and certain charitable trusts or split-interest trusts.	Same as the House bill
Tax on Excess Tax-Exempt Organization Executive Compensation	The bill proposes to impose a 20% excise tax on exempt organizations that pay compensation in excess of $1 million or certain severance payments to any of its five highest-paid employees for the tax year. Compensation for this purpose includes cash and the cash value of all remuneration (including benefits) paid in any form other than cash, except for payments to a tax-qualified retirement plan and amounts excludable from the executive's gross income.	Same as the House bill

	House Bill	Senate Bill
501(c)(3) Organizations Allowed to Make Certain Political Statements	Under current law, all organizations exempt from federal income taxation under Code Section 501(c)(3) are prohibited from participating in, or intervening in, any political campaign on behalf of or in opposition to any candidate for public office. The bill proposes that charitable organizations would not fail to qualify under Section 501(c)(3) and would not be deemed to have participated in or intervened in any political campaign solely because of statements made in the ordinary course of the organization's regular and customary activities in carrying out its exempt purpose, provided any related expenses are de minimis.	Not addressed
Additional Reporting Requirements Related to Donor Advised Funds	The bill proposes that organizations that sponsor donor-advised funds be required to disclose additional information annually, including: (1) the average amount of grants made from all their donor-advised funds expressed as a percentage of the value of assets held in donor-advised funds at the beginning of the taxable year and (2) the organization's policies on inactive donor-advised funds and the frequency and minimum level of distributions from inactive funds.	Not addressed
Denial of Charitable Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights	Not addressed	Under current law, purchases of seating rights at college athletic events are allowed as charitable deductions for up to 80% of the amount paid. The Senate Bill would prohibit any charitable deduction for amounts paid to colleges in exchange for the right to purchase tickets or seating at an athletic event.

	House Bill	Senate Bill
Repeal of Substantiation Rules for Charitable Contributions	Not addressed	Under current law, no charitable deduction is allowed for any contribution of $250 or more unless the donor receives a contemporaneous written acknowledgement of the contribution from that charity. The Senate Bill would eliminate this substantiation requirement.

INTERNATIONAL TAX PROVISIONS

Establishment of a Participation System of Taxation

The United States taxes its citizens,[1] resident alien individuals, and business entities that are organized in the United States on their worldwide income. While other countries impose taxes on worldwide income based on the concept of "residence," they generally determine the residence of entities from factors such as situs, management, and control of the businesses.

The United States taxes non-resident alien individuals and business entities organized in foreign jurisdictions only on their U.S. source income and generally only on a gross basis. Because business entities organized in non-U.S. jurisdictions do not pay tax on their non-U.S. source income while business entities organized in the U.S. do, the current U.S. system of taxation has encouraged U.S.-controlled businesses to conduct their foreign operations through non-U.S. entities. In that way, U.S. taxation of offshore earnings generally has been deferred indefinitely.

Because all non-U.S. entities are classified as "corporations" for U.S. tax purposes in default of elections to be treated as pass-through entities, the opportunities to employ this deferral strategy have few limitations. Specifically, since 1962, some types of offshore income (primarily passive forms of investment income) have not been eligible for deferral by U.S.-controlled foreign corporations (CFC) under the subpart F provisions of the Code. In situations where subpart F is applicable, 10% U.S. shareholders of a CFC currently are required to include in their taxable income certain types of income earned by the foreign corporation, regardless of whether such amounts have yet been remitted as dividends. Since 1986, similar anti-deferral provisions have existed for certain non-U.S.-controlled foreign corporations (so-called "passive foreign investment companies" or "PFICs").

Neither the House Bill nor the Senate Bill repeals the fundamental principles of the U.S. system —worldwide taxation based on citizenship, residence, and entity place of organization. However, each bill supplements these principles with

1 Currently, the United States and Eritrea are the only two countries in the world that tax citizens on their worldwide income.

a "participation exemption system" for foreign income earned by domestic corporations, similar to that employed by other countries with worldwide systems of corporate taxation. Briefly, the House and Senate Bills would allow a 100% deduction for the "foreign-source portion" of dividends[2] received by a 10% U.S. corporate shareholder from a CFC or from a non-CFC with active business operations (that is, excluding any PFIC that is not a CFC). Both direct and indirect ownership of the foreign corporation through a foreign partnership will be taken into account when determining whether the 10% ownership threshold is satisfied by the domestic corporation. Notably, the new participation exemption system does not extend to foreign businesses operated by branches of U.S. entities. As under current law, foreign branches as nominal U.S. tax residents are subject to current U.S. taxation on the income that they earn and obtain relief from double taxation only through the allowance of foreign tax credits.

The "foreign-source portion" of dividends received is determined by the ratio of the foreign corporation's post-1986 "foreign earnings" to all of its post-1986 earnings. "Foreign earnings" are defined as all of the foreign corporation's earnings other than (1) earnings attributable to income that is effectively connected to the conduct of a trade or business in the United States and (2) earnings attributable to dividends received from domestic corporations. However, 10% corporate shareholders already are generally allowed dividends received deductions ranging from 70% to 100% under current law for dividends paid by foreign corporations from these two excluded sources (Section 245 of the Code). Likewise, although the new dividends received deduction does not apply to distributions made by a CFC out of previously taxed subpart F income, such distributions already are currently excluded from the income of a domestic corporation (Section 959 of the Code).

A similar ratio will be applied to determine the foreign-source portion of the pre-1987 earnings that are deemed distributed by a CFC after all of its post-1986 earnings have been dividended. Finally, in the event that a foreign corporation has an accumulated deficit and is deemed to make a dividend distribution out of current earnings and profits under the so-called "nimble dividend" rule, a similar calculation will be made to determine the foreign-source portion of the foreign corporation's current earnings.

Both the House and Senate Bills contain a special holding period rule to limit the use of dividend capture strategies, analogous to the one that applies to the dividends received deduction allowable under current law (Section 246 of the Code). Specifically, under the House Bill, the payee of a dividend must hold the stock of the foreign corporation paying the dividend for at least 181 days during the 361-day period beginning on the date that is 180 days before the ex-dividend date. Under the Senate Bill, the requisite holding period would be at least 366 days during the 731-day period beginning on the date that is 365 days before the ex-dividend date. Both bills require also that the foreign corporation maintain its status as a CFC or as a non-CFC that is not a PFIC and that the corporate dividend recipient maintain its status as a 10% corporate shareholder throughout the requisite holding period. Anti-abuse provisions are included in both bills to prevent diminution of the payee's risk during the required holding period.

Under the Senate Bill (but not the House Bill), the portion of the stock generating dividends eligible for the new 100% dividends received deduction will not be taken into account in allocating and apportioning deductible expense between foreign and U.S. source income.

The Senate Bill would disallow a dividends received deduction for any "hybrid dividend," which is defined to mean a dividend for which the foreign corporation received a deduction or other tax benefit. Furthermore, where any CFC with a domestic corporate 10% shareholder receives a hybrid dividend from another CFC with respect to which the

2 The Committee Report accompanying the House Bill indicates that the "dividends" eligible for the 100% deduction are intended to include dividends created within gain from the sale of CFC stock under Sections 1248 and 964(e). The Senate Bill contains express provisions to this effect.

same domestic corporation also is a 10% shareholder, the dividend is treated as subpart F income and is included in the domestic corporation's subpart F income, regardless of whether it is remitted to the U.S.[3]

A toll charge that is exacted by the House and Senate Bills for use of the new participation system is loss of credits for foreign taxes associated with the dividends received by the domestic corporation that benefit from the new participation exemption. These lost credits include both direct credits for withholding taxes paid to the source country of the dividend and indirect credits for corporate income taxes previously paid to foreign countries on the remitted earnings. In addition, dividends receiving the new 100% deduction are not treated as foreign-source income in calculating the foreign tax credit limitation applicable to the foreign tax credits that remain allowable to the domestic corporation from other sources. The Senate Bill also would create a separate foreign tax credit limitation basket for foreign branch income in determining the credits that remain allowable.

Under the House Bill, the new dividends received deduction and related provisions would apply to distributions made and deductions with respect to taxable years after December 31, 2017. Under the Senate Bill, these provisions become applicable for taxable years of foreign corporations beginning after December 31, 2017 and for taxable years of domestic corporate shareholders in which, or with which, such foreign corporate taxable years end. The new foreign branch income tax credit limitation in the Senate Bill would be effective for taxable years beginning after December 31, 2017.

Extension of Participation Exemption System to Repatriation through Investment in U.S. Property

Current Section 956 of the Code limits the current system of deferral by generally treating investments by a CFC in certain types of U.S. property as a deemed income inclusion to its 10% shareholders that are U.S. persons. Obviously, this provision would no longer be necessary to the extent it backstops a participation system that exempts actual distributions to domestic corporations from tax. Accordingly, while Section 956 would not be repealed by the House or Senate Bill (and remains an impediment to repatriation for non-corporate 10% shareholders of CFCs), domestic corporations would no longer be required to include any amounts in income under this provision. Under the House Bill (but not the Senate Bill), the IRS is authorized to issue regulations to exclude similarly the distributive share of domestic corporations in Section 956 income inclusions recognized by domestic partnerships that are 10% shareholders of CFCs.

The proposed changes to Section 956 would apply under the House Bill for taxable years of CFCs beginning after December 31, 2017. Under the Senate Bill, the changes also would apply for taxable years of 10% domestic corporate shareholders in which, or with which, such CFC taxable years end.

Anti-Artificial Loss Provision – Expanded Basis Reduction

Under current law (Section 1059 of the Code), the basis of stock held by corporate shareholders is reduced by the portion of any extraordinary dividend received for which the shareholder has received a dividends received deduction. The House and Senate Bills would require a similar basis reduction by any amount for which a dividends received deduction was allowed a domestic corporation under the new participation exemption system. Unlike Section 1059, the proposed reduction would be required regardless of whether the foreign-source dividend was an extraordinary dividend and would apply only to the extent that a loss would otherwise be recognized. However, the provision could apply in conjunction with Section 1059 in situations where a dividends received deduction would be allowable under current law for the U.S. portion of a dividend paid by a foreign corporation (Section 245). In that circumstance, the basis reduction under Section 1059 would be made first, prior to any adjustment under the House proposal.

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3 It should be noted that an actual dividend that is paid by a non-CFC to a CFC would similarly continue to be treated as subpart F income under the House and Senate proposals.

The basis reduction proposal would be effective under the House Bill for distributions made after December 31, 2017 and under the Senate Bill for dividends received in taxable years beginning after December 31, 2017.

Expanded Recapture of Foreign Branch Losses

Under current law, a domestic corporation that conducts its foreign operations directly through a foreign branch will recapture those losses if it transfers substantially all of the branch assets to a foreign corporation in a transaction that otherwise would qualify for non-recognition of gain or loss (Section 367(a)(3)(C) of the Code). The House and Senate Bills would broaden the existing recapture provision to include all such transfers to a CFC with respect to which the transferor would be a 10% shareholder after the foreign branch asset transfer was made, regardless of whether the transfer would otherwise qualify for non-recognition.

The Senate Bill would cap the amount of income recognized in any year by the amount of the dividends received deduction under the participation exemption system in that year and would carry forward any excess recapture income to the following year.

In addition, the recapture income generated under the proposed expanded provision would be treated as U.S.-source income under both provisions. Under the House Bill (but not the Senate Bill), the source of income recognized under the existing recapture provision also would be re-characterized as U.S.-source.

The expanded foreign branch recapture provision would be effective for transfers made after December 31, 2017.

Repeal of Active Trade or Business Exception

Outbound acquisitions of the assets of U.S. trades or businesses through Section 351 transactions (e.g., incorporations) or through Type A (merger) or Type C (asset transfer) reorganizations have relied upon an "active trade or business" exception to Section 367 in achieving tax-free treatment. In a surprise addition not foreshadowed in previously released descriptions by the staff of the Joint Committee on Taxation, the Senate Bill (but not the House Bill) proposes to repeal the active trade or business exception. The proposed revision generally would assure that a toll charge would be imposed on most outbound transfers of business assets from the United States. The new provision will apply to transfers after December 31, 2017.

Modification of Deemed Paid Foreign Tax Credit

As noted above, repeal of the indirect deemed paid credit attached to dividends paid by a CFC to a domestic corporation is part of the toll charge that would be paid for enactment of the House and Senate Bills. Both bills clarify that the complementary deemed paid credit allowed under current law for subpart F income inclusions would be retained to the extent it could be traced to foreign taxes imposed on a tax base that includes the subpart F income inclusion item. Likewise the current gross-up provision (Code Section 78) that adds back the deemed paid foreign taxes to the amount of the subpart F inclusion is retained, while the complementary gross-up provision required for actual CFC dividends that carry deemed paid credits is repealed.

Under the House Bill, the gross-up repeal and deemed paid credit modifications would be effective for taxable years beginning after December 31, 2017. Under the Senate Bill, these provisions become applicable for taxable years of foreign corporations beginning after December 31, 2017 and for taxable years of domestic corporate shareholders in which, or with which, such foreign corporate taxable years end.

Change in Sourcing Rule for Inventory

Under current law, gain from the sale of inventory produced within the United States and sold outside the United States or from the sale of inventory produced outside the United States and sold within the United States may be allocated and apportioned between U.S.-source and foreign-source income using one of three methods elected by the taxpayer. The House and Senate Bills would source income from the sale of inventory solely according to the place of the inventory's production and without regard to the place of title passage.

The new sourcing rule would apply to taxable years beginning after December 31, 2017.

Expansion of Subpart F for 2017 Taxable Years – One-Time Repatriation

The primary toll charge for the transition to the participation exemption regime is the imposition of one-time repatriation taxes on the 10% shareholders of "specified foreign corporations." Specified foreign corporations include CFCs and other foreign corporations in which a domestic corporation is a 10% shareholder (taking into account actual and constructive ownership). 10% shareholders of PFICs that are not CFCs are not subject to this toll charge because their anti-deferral system remains in place.

Each 10% shareholder of a specified foreign corporation is required to include in its subpart F income for its last taxable year beginning after January 1, 2017 but before January 1, 2018 its pro rata share of the greater of its accumulated post-1986 earnings and profits determined as of November 2, 2017[4] and its accumulated post-1986 earnings and profits determined as of December 31, 2017. Earnings and profits effectively connected to the conduct of a trade or business within the United States or attributable to previously taxed subpart F income are excluded from the repatriation inclusion because they already have been subject to U.S. tax. However, all post-1986 accumulated earnings and profits of specified foreign corporations are taken into account, even if they arose in years in which the domestic corporation was not a 10% shareholder. Dividends paid in the measurement taxable year will not be allowed to reduce accumulated earnings and profits.

Accumulated earnings and profits are reduced by accumulated deficits existing in specified foreign corporations owned by the same 10% shareholder as of the November 2, 2017 and December 31, 2017 determination dates. The earnings and profits deficits are allocated among the profitable corporations based upon their relative contributions to the total deferred foreign income of the shareholder. Under the House Bill (but not the Senate Bill), intragroup netting of deficits that remain unused after the application of the general earnings reduction rule with the remaining earnings of specified foreign corporations within the same affiliated group also is permitted. The IRS is authorized to issue U.S. Department of the Treasury regulations to limit reduction of the amount of accumulated earnings and profits through the use of retroactive check-the-box elections.

The Senate Bill (but not the House Bill) permits REITS that are 10% shareholders to elect to exclude the repatriated amount from gross income in determining whether they satisfy the REIT qualification tests or to include the repatriated amount over eight years.[5]

Once the amount of accumulated post-1986 deferred foreign income inclusion is determined for a domestic corporate shareholder, a notional 14% (14.49% in the Senate Bill) tax is imposed under the House Bill on the portion of the subpart F income inclusion that represents the "aggregate cash position" of the shareholder with respect to each specified

4 November 2, 2017 was the date of introduction of the House proposal. The Senate proposal would make this determination as of November 9, the date of introduction of the Senate Finance Committee Chairman's Mark.

5 The amounts included in gross income each year are identical to the installment payment percentages specified for the same year period in footnote 9.

corporation, and a notional tax of 7% (7.49% in the Senate Bill) is imposed on the remainder of the income inclusion.[6] Under the Senate Bill, the deductions[7] allowed to any 10% domestic shareholder to achieve its applicable notional repatriation tax rates will be recaptured and taxed at a 35% rate if the domestic shareholder becomes an expatriated entity (other than one that is still treated as a domestic corporation) within 10 years of the date of enactment. Other deductions, including the net operating loss carryover deduction, may be allowable after the special inclusion deductions are taken. The Senate Bill (but not the House Bill) permits the 10% domestic corporate shareholder to elect to forego the use of the net operating loss deduction for the repatriation taxable year.

In the House Bill, the aggregate cash position represents the average of the shareholder's indirect, prorated ownership of cash and cash equivalents of the specified foreign corporations on November 2, 2017 and the last day of their two most recent taxable years ending before November 2. The Senate Bill determines the aggregate cash position as the greater of such prorated amounts on (1) the last day of the taxable year of the specified foreign corporation beginning before January 1, 2018 and (2) the average of such amounts as of the close of the last two taxable years ended before November 9, 2017. Both bills take into account the cash position of non-corporate foreign entities that would be specified corporations if classified as corporations in determining the appropriate amount of repatriation tax. Reductions to the shareholder's aggregate cash position are made to eliminate double-counting and (under the House Bill only) for income blocked from repatriation by foreign jurisdictions. The excess of the subpart F income inclusion over the aggregate cash position presumably represents the illiquid assets held by each specified foreign corporation, although the amount is defined only as a residual category.

The deemed paid foreign tax credits that otherwise would be allowable for the subpart F inclusion under Code Section 960 are reduced under the House Bill by 80% to the extent they are attributable to the aggregate cash position portion and by 60% to the extent attributable to the remainder of the inclusion. Under the Senate Bill, the corresponding percentages are 78.6% and 58.6%.[8] Under the House Bill (but not the Senate Bill), the remaining deemed paid foreign tax credits arising from the inclusion may be carried forward for 20 years to the extent they exceed the applicable limitation for the 2017 taxable year, in lieu of the normal 10-year carryforward.

Under the House Bill, a domestic corporation may elect to pay the net tax liability resulting from the deemed repatriation inclusion over eight years in equal, non-interest bearing installments beginning with the taxable year of the subpart F inclusion. The Senate Bill provides for payment for unequal non-interest bearing installments, permitting deferral of a greater amount of tax.[9] A failure to pay an installment, a corporate liquidation or bankruptcy, a sale of substantially all the corporate assets, a cessation of business, or the occurrence of any similar event will accelerate the remaining payments due.

A special rule applies under both the House and Senate Bills for shareholders of S corporations that have subpart F income inclusions by reason of the proposed repatriation provision. An S corporation shareholder may elect, on or prior to the due date of the shareholder's return for the taxable year that reports the S corporation's subpart F repatriated income inclusion, to defer his portion of the net tax liability resulting from the repatriation until a triggering event occurs. If a shareholder makes the tax deferral election, the S corporation will become jointly and severally liable for its eventual payment. Triggering events include (1) a loss of S corporation status; (2) a corporate liquidation, bankruptcy, sale of substantially all the corporate assets, or a similar event and, (3) a complete or partial transfer[10] of the S corporation

6 Technically, both the House and Senate proposals accomplish this result in a highly complex manner by allowing the domestic corporation to deduct amounts sufficient to produce the specified percentages of tax on the amount of each inclusion (as determined before the deduction). As explained in the text, however, further deductions may be taken before the ultimate corporate tax liability is determined for the repatriation taxable year.

7 That is, the deductions referenced in footnote 6 that achieve the repatriation tax rate.

8 The Senate Bill reduction percentages correspond to the deduction amount percentages described in footnote 6.

9 Specifically, the Senate installments are 8% for each of the five years, 15% for the sixth year, 20% for the seventh year, and 25% for the eighth year.

10 In the case of a partial transfer, deferral would end only with respect to the portion of the tax liability allocable to the shares transferred.

shares unless the transferee agrees to assume the transferor's deferred net tax liability. In the case of a type (1) or type (3) triggering event (but not—except with the consent of the IRS—an event falling within type (2)), the shareholder may elect to pay the triggered liability in eight installments (in percentages corresponding to those prescribed under the general installment payment election) beginning with the due date of the tax return

The Senate Bill adds some additional teeth to its repatriation proposal by extending the statute of limitations on assessment to six years from the filing of the tax return for the taxable year in which the repatriation income was to be reported.

The House repatriation proposal is effective for the last taxable year of a foreign corporation that begins before January 1, 2018 and for the taxable year of domestic corporate 10% shareholders in which the taxable year of any affected foreign corporation ends. The Senate repatriation proposal is effective for the last taxable year of a foreign corporation that begins before January 1, 2018, and for all subsequent taxable years of the foreign corporation and for the taxable years of domestic corporate 10% shareholders with which, or within which, such taxable years end.

Certain Other Modifications of Subpart F Rules

Both the House Bill and the Senate Bill modify certain other rules relating to the subpart F provisions. The bills include:

- The repeal of the current taxation of previously excluded qualified investments under Section 955 of the Code
- The repeal of foreign base company oil-related income as subpart F income under Section 954
- The elimination of the 30-day rule in Section 951(a)(1). Currently, a foreign corporation must otherwise be a CFC for an uninterrupted period of 30 days or more before it is classified as a CFC for federal income tax purposes.
- The application of an inflation adjustment to the de minimis exception threshold for foreign base company income. Under current law, if the subpart F income of a CFC is less than the lesser of 5% of the CFC's total gross income or $1 million, then the U.S. shareholders need not include any subpart F income in taxable income. The $1 million figure would be inflation adjusted.
- The modification of stock attribution rules for determining CFC status. Under current law, Section 958(b)(4) prevents the attribution of stock ownership from a foreign person to a U.S. person. Under both the House Bill and the Senate Bill, a U.S. corporation would constructively own stock held by its foreign shareholder.

The Senate Bill would expand the definition of a "U.S. shareholder." Under current law, a U.S. shareholder is defined as a U.S. person (as defined in Section 957(c)) who owns (within the meaning of Section 958)), or is considered as owning by applying the rules of Section 958(b), 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. The Senate Bill would expand the definition of U.S. shareholder to include a U.S. person who owns 10% or more of the total value of shares of all classes of stock of a foreign corporation.

Current Year Inclusion of Certain Foreign High Returns or Global Intangible Low-Taxed Income

Under current law, a U.S. shareholder of a CFC is not subject to current U.S. tax on many forms of active business income earned by such CFC, including active business income relating to intangible assets. This can allow U.S. shareholders to defer U.S. tax on income related to valuable assets, such as intangibles, held offshore.

The House Bill would add a new provision (Section 951A) that would require 10% shareholders of CFCs to include in income, on a current basis, 50% of such 10% shareholder's foreign high return amount (FHRA).

FHRA essentially is a 10% shareholder's pro rata share of tested income in excess of an assumed reasonable return on the depreciable tangible property held by a CFC, less interest expense. The reasonable return is computed using the federal short-term AFR plus 7% multiplied by the adjusted tax basis of the depreciable tangible property held by a CFC.

Tested income for purposes of these proposed rules generally is defined as gross income, excluding effectively connected income, subpart F income, active financing and insurance income excluded from subpart F, and certain related party payments, less deductions properly allocable to such income.

FHRAs included in income under proposed new Section 951A generally would be treated in the same manner as subpart F income for purposes of other provisions of the Code, including Sections 959, 960, 961, 962, and 1248.

However, deemed paid foreign tax credits relating to FHRAs would be limited to 80% of the foreign taxes paid or accrued. In addition, foreign taxes relating to FHRAs would be treated as a separate "basket" under Section 904 that would only be creditable against other FHRA inclusions. Moreover, under the House Bill, foreign tax credits relating to FHRAs would not be allowed to be carried back or carried forward under Section 904(c).

The Senate Bill contains a provision similar to the House Bill that would require 10% shareholders of CFCs to include in income currently "global intangible low-taxed income" (GILTI) with respect to such CFCs. Under the Senate Bill, foreign earnings generally would be subject to current tax to the extent such earnings exceed 10% of the aggregate tax basis of depreciable property held by a CFC. However, unlike the FHRA provision in the House Bill, which requires inclusion of 50% of FHRAs, the Senate Bill would require inclusion of 100% of the GILTI. As discussed below, the Senate Bill provides for a deduction for U.S. corporate 10% shareholders relating to GILTI inclusions that would reduce the effective rate of tax with respect to such GILTI inclusions.

The House Bill relating to FHRAs and the Senate Bill relating to GILTI would apply to taxable years beginning after December 31, 2017.

Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

The Senate Bill would allow U.S. corporations to claim a deduction equal to 37.5% of "foreign derived intangible income" plus 50% of the GILTI amount included in income, but not to exceed taxable income (which percentages would be reduced to 21.875% and 37.5% respectively after December 31, 2025). Foreign derived intangible income is essentially income in excess of 10% of the corporation's "qualified business asset investment" that relates to property sold to any person who is not a U.S. person or services provided to any person, or with respect to property, not located within the United States. Qualified business asset investment generally is the adjusted tax basis of certain specified tangible property used in a trade or business as determined under the alternative depreciation system under Section 168(g) of the Code.

The House Bill does not contain a similar provision.

Under the Senate Bill, this deduction would apply to taxable years beginning after December 31, 2017.

Limitation on Deductions of Interest by Members of an International Financial Reporting Group or Worldwide Affiliated Group

Under current law, U.S. corporations generally are allowed to deduct interest expense paid to related foreign affiliates, subject to certain limitations under the Code, such as the earnings stripping rules of Section 163(j). If such interest is paid to a foreign affiliate that is eligible for benefits under an income tax treaty with the U.S., such interest often would not be subject to U.S. tax, and would provide an opportunity to reduce the U.S. corporation's U.S. tax base without a corresponding income inclusion in the U.S.

The House Bill proposes to add new Section 163(o) that would provide an additional limitation on deductions for interest expense paid or accrued by U.S. corporations that are part of an international financial reporting group as defined in proposed new Section 163(o) (an 163(o) IFR Group).[11] An 163(o) IFR Group is defined as a group of entities that prepares consolidated financial statements, that has aggregate annual gross receipts in excess of $100 million over a three-year period, and that includes at least one foreign corporation engaged in a U.S. trade or business or at least one domestic corporation and one foreign corporation.

Under the House Bill, interest deductions for a U.S. corporation that is part of an 163(o) IFR Group generally would be limited to 110% of U.S. corporation's allocable share of the net interest expense of the 163(o) IFR Group, computed on the basis of the relative EBITDA of the U.S. corporation compared to the EBITDA of the 163(o) IFR Group. EBITDA would be determined from the consolidated financial statement of the 163(o) IFR Group for the taxable year.

The proposed limitations of new Section 163(o) would apply in addition to the 30% business interest limitation contained in proposed new Section 163(j). Under the House Bill, the provision that denies the greatest amount of interest deductions would apply for such taxable year. Interest that is disallowed as a deduction under proposed new Section 163(j) or proposed new Section 163(o) would be carried forward for five years.

The Senate Bill would provide a similar limitation on deductions for interest expense for U.S. corporations that are members of a worldwide affiliated group. A worldwide affiliated group is defined similarly to the definition of an affiliated group under Section 1504, except that the ownership threshold is modified to 50% instead of 80% and foreign corporations would be includable corporations for purposes of this definition. Unlike the House Bill, the Senate Bill generally would apply to all U.S. corporations that are members of a worldwide affiliated group without regard to income or gross receipts, whereas the House Bill generally is limited to groups with annual gross receipts in excess of $100 million over a three-year period.

The Senate Bill generally would limit interest deductions to U.S. members of a worldwide affiliated group to a phased-in percentage (130% in 2018, 125% in 2019, 120% in 2020, 115% in 2021, and 110% in 2022) of the total debt the U.S. members of such group would hold if their debt-to-equity ratio was proportionate to the debt-to-equity ratio of all members of the worldwide group.

Under the Senate Bill, interest disallowed as a deduction for any taxable year would be carried forward indefinitely.

The provisions of the House and Senate Bills relating to interest expense would apply to taxable years beginning after December 31, 2017.

Excise Tax on Certain Payments to Related Foreign Corporations

The House Bill proposes to add Section 4491 to the Code that would impose an excise tax on certain deductible payments (specified amounts) by a U.S. corporation to a foreign corporation that is a member of the same international financial reporting group as defined in proposed new Section 882(g) (a 882(g) IFR Group).[12] The excise tax would be computed using the highest rate of tax imposed on U.S. corporations under the Code (20% under both bills).

The House Bill would allow the foreign corporation to elect to treat the specified amounts received from the U.S. corporation effectively as connected income subject to tax on a net basis tax under the Code. Because this election would

11 Under the House Bill, the definition of "international financial reporting group" for purposes of proposed new Section 163(o) is different than the definition of "international financial reporting group" for purposes of proposed new Section 882(g).

12 Under the House Bill, the definition of "international financial reporting group" for purposes of proposed new Section 882(g) is different than the definition of "international financial reporting group" for purposes of proposed new Section 163(o).

allow a foreign corporation to take into account deductions in computing the U.S. tax relating to specified amounts, most foreign corporations likely would make this election.

The specified amounts that would be subject to the proposed new rule are amounts allowable as a deduction to the payor or included in the costs of goods sold, inventory, or the basis of a depreciable or amortizable asset. Specified amounts would exclude interest, amounts paid to acquire securities, FDAP taxable under Section 881(a), and payments for services where the payor has elected to use the services cost method.

An 882(g) IFR Group would be defined as a group of entities that prepares consolidated financial statements in which the average annual payments of specified amounts over a three-year period exceed $100,000,000.

A foreign corporation that has elected to pay tax on a net basis with respect to specified amounts received from U.S. members of an 882(g) IFR Group would be allowed to deduct deemed expenses related to the specified amounts. Deemed expenses are an amount of expenses that would cause the net income ratio related to the specified amounts to equal the net income ratio of the 882(g) IFR Group with respect to the product line to which the specified amount relates. The net income ratio would be determined using the consolidated financial statements of the 882(g) IFR Group without regard to interest income, interest expense, and income taxes.

A foreign corporation would be allowed foreign tax credits under Section 906(a) with respect to the specified amounts subject to tax under proposed new Section 882(g). However, such credits would be limited to 80% of the amount of taxes paid or accrued.

Each U.S. member of an 882(g) IFR Group would be jointly and severally liable for any underpayment of tax, interest, and penalties of any foreign corporation that is a member of such group that has made an election to pay tax on a net basis with respect to specified amounts.

The House Bill also would add annual reporting requirements with respect to the payment of specified amounts under proposed new rules.

These provisions of the House Bill relating to specified amounts paid to members of an 882(g) IFR Group would apply to amounts paid or incurred after December 31, 2018.

Tax on Base Erosion Payments

Instead of the excise tax on certain "specified amounts" paid to foreign affiliates (discussed above), the Senate Bill contains a provision—the base erosion anti-abuse tax or BEAT provision—that would require certain applicable taxpayers to pay a tax equal to the base erosion minimum tax amount (BEMTA) for the taxable year.

Essentially, BEMTA is the excess of 10% (12.5% for tax years beginning after December 31, 2025) of the taxpayer's taxable income, modified to exclude certain base erosion payments over the taxpayer's regular tax liability reduced by credits other than the research credit. A base erosion payment generally is an amount paid or accrued to a foreign person that is a related party for which a deduction is allowed, including amounts paid or accrued to acquire depreciable property. Relatedness for purposes of these rules is tested based on a 25% ownership threshold, applying the constructive ownership rules under Section 318 of the Code with certain modifications. A base erosion payment also includes any payment that constitutes a reduction in gross receipts that is paid or accrued to a surrogate foreign corporation under Section 7874(a)(2) that is a related party to the taxpayer or a foreign person that is a member of the same expanded affiliated group as the surrogate foreign corporation.

A base erosion payment for which gross basis tax is imposed, and with respect to which tax has been deducted and withheld under Sections 1441 or 1442, generally would not be taken into account in computing modified taxable income.

Under the Senate Bill, an applicable taxpayer is a corporation (other than a RIC, REIT, or S corporation), with average annual gross receipts of at least $500 million for the three-year period ending with the preceding taxable year and which has a base erosion percentage of 4% or higher for the taxable year. The base erosion percentage generally is the percentage determined by dividing deductions for base erosion payments for the taxable year by the aggregate amount of deductions allowable for such taxable year (excluding certain deductions, such as the NOL deduction and the deduction for foreign-derived intangible income and GILTI inclusions). For banks and dealers in securities, the base erosion minimum tax would be 11%, increasing to 13.5% for taxable years beginning after December 31, 2025.

Under the Senate Bill, the tax on base erosion payments with respect to applicable taxpayers would apply to amounts paid or incurred after December 31, 2017.

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