



Tax



Congress



Taxpayer

Tax Alert: US Tax Reform- House

November 6, 2017

On November 2, 2017, the Republican members of the House Ways & Means Committee released a draft Tax Reform Bill (the “Bill”) named the TAX CUTS AND JOBS ACT, formally commencing a tax reform process in the United States.

Process

The House Ways and Means Committee has to approve the Bill, which then goes to the floor to be voted on by the full House of Representatives. It is highly expected that the Senate will issue their own version during this week, meaning that if there are two versions a Joint Committee will be needed to reconcile the proposed changes into a unified version. If consensus is reached, then it goes back to both houses of Congress for a vote. Once the Bill passes both houses’ muster, it goes to the President for signature, eventually becoming law.

Though there is still a long way to go before the process reaches its end, this Bill represents the first definite intent for a tax reform in the US that would consequently impact Puerto Rico. In this Alert, we provide an overview of the proposed changes.

Individuals

Income Tax Rates

- the current seven (7) income tax brackets are consolidated into four (4) new brackets:

Taxable Income	Tax Rate
Less than \$90,000	12 percent
\$90,000 to \$259,999	25 percent
\$260,000 to \$999,999	35 percent
\$1MM or more	39.6 percent

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- In the case of unmarried individuals, the income thresholds are half of those applicable to married individuals, except for the one applicable to the 35 percent bracket whose taxable income threshold would be \$200,000

Standard deductions and personal exemptions

- **Standard Deduction** is increased to \$24,000 for joint filers and \$12,000 for single filers
 - by reducing the number of taxpayers who choose to itemize their deduction, the increase would result in a substantial simplification for tax returns purposes
- **Personal Exemption** is repealed while the Children and Dependents Exemption would be consolidated into an expanded child tax credit and a new family tax credit
- most of the itemized deductions would be repealed; nonetheless, the mortgage interest deduction would be kept, with the amount of allowed acquisition indebtedness being reduced from \$1 million to \$500,000.

Business income

- the Bill allows for a portion of the net income distributed by a pass-through entity to an owner or shareholder to be treated as “business income”, subject to a maximum rate of 25 percent
 - the remaining portion of the net business income would be treated as compensation and continue to be subject to the ordinary income tax rates
- net income derived from a *passive business activity* would be treated entirely as business income and fully eligible for the 25 percent rate
- in the case of entities that are engaged in any trade or business where the principal asset of such business is in the reputation or skill of one or more of its employees (i.e. health, law, engineering, architecture, accounting, etc.), the portion of the net business income that may be eligible to the 25 percent rate could be reduced to zero.

Alternative Minimum Tax and credits

- the Bill calls for the repeal of the Alternative Minimum Tax (AMT), as well as several credits currently available for individuals.

Estate and gift

Estate taxes

- the basic Estate Tax exclusion is doubled from \$5 million to \$10 million, indexed for inflation
- the estate and generation-skipping taxes will be repealed after the year 2023 while maintaining a beneficiary’s stepped-up basis in estate property

Gift taxes

- gift tax rate is lowered from 40 percent to 35 percent
- \$10 million basic exclusion is retained, as well as the annual exclusion of \$14,000, indexed for inflation

Businesses

Income Tax Rate

- The income tax rates for corporations will also be reduced as follows:

Taxable Income:	Tax rate:
\$0 to \$50,000	15 percent
\$50,001 to \$75,000	25 percent
\$75,001 to \$10,000,000	34 percent
Over \$10,000,000	35 percent

Alternative Minimum Tax

- the AMT will also be repealed for businesses, allowing for taxpayers to claim a 50 percent refund of the remaining amount of AMT Credits progressively after 2019.

Expensing

- taxpayers would be able to fully and immediately expense 100 percent of the cost of qualified property acquired after September 27, 2017, and before January 1, 2023
 - the current Internal Revenue Code allows certain “expensing” but only up to a maximum of 50 percent in 2017 (decreasing to 40 percent in 2018 and 30 percent in 2019), but prohibits such deduction in the case of property where the taxpayer is not the original owner

Other Changes

Other significant changes that are proposed by the Bill:

- increase in the gross receipts threshold from \$5 million to \$25 million, to permit a business taxpayer to use the cash accounting method, extending this election also to businesses that manage inventory
- use of the Net Operating Losses would be limited to 90 percent of the taxable income, and could be carried forward indefinitely. However, the carryback alternative would be eliminated
- interest expenses incurred with a related party would be subject to a 30% limit of the adjusted taxable income for all businesses with more than \$25 million in average gross receipts
- like-kind exchanges would continue to be allowed but only limited to real estate
- repeal of various business tax credits

Foreign income and persons

Under current law, US citizens, resident individuals, and domestic corporations generally are taxed on **all** income, whether earned in the United States or abroad. Foreign income earned by a foreign subsidiary generally is not taxed in the US until an actual distribution is made from the foreign subsidiary to its US parent company. Currently, the law permits the use of the foreign tax credits to mitigate the double taxation. This is known as a *worldwide tax regime*.

The Bill proposes:

- the transition from a worldwide tax regime to a territorial tax system

- the current taxing of US corporations on the foreign earnings of their foreign subsidiaries when these earnings are distributed would be replaced with a 100 percent dividend exemption, when the US corporate shareholder owns at least 10 percent of the foreign subsidiary
 - these exempt dividends would reduce the basis of the stock in its foreign subsidiary for purposes of determining a loss on any sale or exchange of the foreign subsidiary stock by the US parent
- repeal of the current tax on US shareholders with respect to untaxed foreign subsidiary earnings reinvested in the United States property
- Special 3%/12% “Tollgate Tax” for US shareholders owning at least 10 percent of a foreign subsidiary on their pro rata share of earnings and profits (E&P), that have not been previously subject to US tax.
 - The E&P would be classified as either E&P retained as cash or cash equivalents, and any other E&P
 - Cash or Cash Equivalents – taxed at a 12 percent rate
 - Remaining E&P’s – taxed at a 3 percent rate
 - taxpayer may elect to pay this E&P-related tax in 8 equal annual installments

- **Subpart F Income**

- current imposition of US tax on previously excluded shipping income of a foreign subsidiary, if there is a net decrease in qualified shipping investment, as well as on foreign base company oil related income, would be repealed
- current attribution rules state that a US corporation cannot not consider the ownership held by its foreign shareholder to determine the classification of the foreign corporation as a CFC. However, the Bill proposes to eliminate this by treating the US Corporation as constructively owning the stock held by its foreign shareholder.

- **Base Erosion Measures**

- the Bill proposes that a US parent of one or more foreign subsidiaries would be subject to US tax on 50 percent of the US parent’s foreign high returns
- imposition of a new 20 percent excise tax on certain payments from domestic corporations to related foreign corporations, unless the related foreign party elects to treat such payment as income effectively connected with the conduct of a US trade or business, thus subject to US taxation

Exception: intercompany services for which the US corporation elects to pay only for their cost (with no markup) and certain commodities transactions

Puerto Rico considerations

The Bill makes no change to the treatment of Puerto Rico entities as foreign, which would incidentally subject Puerto Rico operations to the proposed new excise tax mentioned above.

On the other hand, the deduction allowable with respect to income attributable to domestic activities is still provided for Puerto Rico and extended so that it would be applicable retroactively to tax years beginning after December 31, 2016 and before January 1, 2018. The current law allows this deduction for Puerto Rico (as part of the definition of “United States” for these purposes exclusively) for tax years beginning before January 1, 2017.

Though the process for a US Tax Reform has only begun and we are still long ways from its fruition, in this historical juncture Puerto Rico cannot afford to remain a spectator and hope for a favorable outcome, but become an active voice in legislation process to guarantee that the appropriate business and investment conditions are in place for the well-being of the Island and its residents.

Please contact our Tax Department should additional information is required regarding this or any other tax issue. We will be glad to assist you.



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