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Tax Alert: US Tax Reform-Senate

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As previously indicated on our November 6, 2017 Tax Alert, the Senate Finance Committee released its version of the U.S. tax reform on November 9, 2017. Though similar in some areas to House's bill, the Senate's proposed plan reveals key differences between the legislative bodies. It is expected that the Senate will present their plan as a bill in the coming days. In this Tax Alert we provide an overview of the changes proposed by the Senate.

Background

Income tax rates

The Senate's plan preserves all of the existing seven (7) income brackets, but instead lowers many of applicable tax rates:

Tax Rate
10 percent
15% lowered to 12%
25% to 22.5%
28% lowered to 25%
33% lowered to 32.5%
35% retained
39.6% lowered to 38.5%

The Senate plan also adjusts the bracket thresholds in several places, most notably by following the House's lead in increasing the threshold at which the top rate applies to $500,000 for single filers and $1 million for joint filers.

It leaves the top rate on capital gains and dividends unchanged at 20%.

Standard deduction and personal exemption

- the Senate plan mirrors the House bill's repeal of personal exemptions, itemized deductions and the increase of the standard deduction to $24,000 for joint filers, $18,000 for head of household filers and $12,000 for all other taxpayers
  - the Senate version retains the deduction for medical expenses
- child tax credit is increased to $1,650, and its phase-out threshold is increased to $1,000,000 for joint filers and $500,000 in the case of all other taxpayers
- while both the House and Senate retain the mortgage interest deduction, the Senate calls for the maximum amount of acquisition indebtedness to remain at $1 million, contrary to House's decrease to $500,000. The deduction for state and local tax would be repealed under the Senate bill.

Business income

- whereas the House proposed a 25% rate on qualifying pass-through business income (30% if passive income) for businesses, the Senate offers instead a 17.4% deduction which is limited to 50% of W-2 wages paid by owner.

- o deduction would not be affected by whether the owner is active or passive, but the term "qualified business income" does not comprise wages of an S corporation owner or guaranteed payments for services by partners

Alternative minimum tax

- in line with the House, the Senate also proposes the elimination of the alternative minimum tax (AMT) for tax years beginning in 2018, and allowing taxpayers to request the refund of unused AMT credits by 2022.

Estate and gift taxes

- though both legislative bodies call for the doubling of the estate and gift tax exemption amount from $5 million to $10 million, beginning in 2018, the Senate plan does not include a neither a repeal nor a reduction of estate and gift taxes like the House's.

Businesses

Income tax rate

- the Senate plan would replace the current corporate rates schedule with a flat rate of 20% for tax years beginning after December 31, 2018.
- it also proposed the elimination for the special tax rate for personal service corporations
- 70% dividend received deduction (DRD) would be reduced to 50%, while the 80% DRD would be reduced to 65%. These changes are meant to compensate for the reduced corporate tax rate of 20%

Alternative minimum tax

- the AMT is repealed for businesses and, parallel with the House's bill, allows taxpayers to claim a 50 percent refund of the unused AMT Credits in each of the years 2019, 2020, and 2021, with all remaining credits claimed in 2022.

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.
  - o Real property businesses would not be excluded.
- in addition, the Senate plan makes several favorable changes including:
  - o shortening the recovery period for both residential and nonresidential buildings to 25 years
  - o streamlining the definitions of qualified leasehold improvement, retail improvement, and restaurant property and shortening the recovery period from 15 to 10 years
  - o shortening the recovering period from 7 to 5 years for certain farm equipment
  - o increases the maximum amount a taxpayer may expense under Section 179 to $1,000,000, and increases the threshold amount to $2,500,000

Other changes

- addition of a new 8.9 billion revenue-raiser that would revise the rules for revenue recognition. Under this provision, taxpayers would be required to recognize income no later than the taxable year in which it is taken into account in the taxpayer's applicable financial statements.
- increase in the gross receipts threshold from $5 million to $15 million, to permit a business taxpayer to use the cash accounting method.
- use of the Net Operating Losses would be limited to 90 percent of the taxable income, and could be carried forward indefinitely. The proposal repeals the two-year carryback and the special carryback provisions, but provides a two-year carryback in the case of certain losses incurred in the trade or business of farming.
- interest expenses incurred with a related party would be subject to a 30% limit of the adjusted taxable income for all businesses.

- non-recognition of gain in the case of like-kind exchanges would continue to be allowed but only limited to real property that is not held primarily for sale.
- retention of many of the credits that the House bill would repeal

Foreign income and persons

Establishment of participation exemption system for taxation of foreign income

- like its House counterpart, the Senate proposes the 100 percent dividend received exemption (DRD) on foreign

subsidiary distributions, when the US corporate shareholder owns at least 10 percent
  - the domestic corporation must meet a 365-day holding period requirement with respect to its foreign stock.
- the Senate expands this exemption by also allowing a DRD on certain deemed income inclusions resulting from the disposition of lower-tier controlled foreign corporations.
- the DRD would not be available for hybrid dividends.

One-Time Transition Tax

With the migration from a worldwide tax regime to a territorial tax system, both legislative bodies agree on the imposition of a one-time tax to domestic companies on the pro rata share of earnings and profits (E&P) of foreign subsidiaries that have not been previously subject to U.S. tax, and their segregation between (i) E&P's retained as cash or cash equivalents, and (ii) any other E&P.

- while the House contemplates a 14% tax on the former and a 7% on the latter, the Senate recommends a 10% and a 5% respectively.
- the measurement date provided on the Senate bill is November 9, 2017, calculated on the aggregate basis, taking into account earnings and deficits of each 10 percent owned foreign subsidiary.
- the Senate proposes that this tax be paid in eight (8) installments, in the following manner:
  - 8% of the payment is due in each of the first five years
  - 15% in the sixth year
  - 20% in the seventh year
  - 25% in the eight year

The Senate is also recommending a minimum tax on certain foreign income. The U.S. shareholder of one or more controlled foreign corporations would be subject to current U.S. tax on its global intangible low-taxed income (GILTI), which is defined as "the excess of controlled foreign corporations aggregated net income over a "routine return" of 10% on certain qualified tangible assets." The plan allows for a deduction equal to 37.5% of its foreign-derived intangible income plus the amount of GILTI included in gross income (subject to a taxable income limitation).

Also, there is a provision to incentivize the repatriation of intangible assets. This incentive would only apply to distributions of intellectual property received by a domestic corporation occurring before the close of the third taxable year of the controlled foreign corporation beginning after Dec. 31, 2017.

Base erosion provisions

- Imposes a 10% minimum tax on a modified taxable income of domestic corporations which are members of a multinational group that engages in excess base erosion
- Applies to corporations other than a regulated investment company, a real estate investment trust or an S corporation which has an average annual gross receipts of at least $500 million for the three taxable year period ending with the preceding taxable year and a base erosion percentage of 4% or higher for the taxable year.

Interest Expense of U.S. shareholders which are members of worldwide affiliated groups with domestic indebtedness

- The Senate's plan limits net interest expense by an amount determined based on a "debt-to-equity differential percentage," which compares the U.S. debt-to equity ratio to the global group ratio.
- The Senate's global group interest limitation includes an indefinite carry-forward of disallowed interest expense
- whereas the House bill only applied to U.S. corporations that had a three-year average of annual gross receipts of more than $100 million, in the Senate plan it applies to all taxpayers
- The Senate bill includes a new proposal which disallows a deduction for any disqualified related party amount paid or accrued pursuant to a "hybrid transaction" or by, or to, a hybrid entity. The provision generally targets transactions and payments which result in a different characterization under U.S. law and another tax jurisdiction (often resulting in a domestic deduction with no corresponding foreign income inclusion).

Modification to Subpart F Income

- modifies the definition of US shareholder to include any US person who owns 10% or more of the total vote or value of shares or all classes of stock of a foreign corporation.

Puerto Rico considerations

- Though the Senate bill contains no version of the 20% excise tax on certain payments from domestic corporations to related foreign corporations as the version of the House does, the counterpart base erosion minimum tax, is of utmost consideration for Puerto Rico for its potential severe effect for related party transactions. In addition, the above referenced E&P's one-time tax, and the proposals to incentivize the distribution of intellectual property to the U.S. would also impact the Puerto Rico operations of the myriad of U.S. companies operating in the Island.

As noted on our previous Tax Alert, once the Senate version on the Tax Reform Bill is released and approved by the Senate, a Joint Committee will probably be organized to reconcile the legislations. This process will take a few weeks but is the intention of the Republicans to approve the Final Conference Bill before the end of the year. Business should be taking the

process and these proposals seriously since the bills would result in a dramatic transformation in the way corporations with international operations are taxed. Business that act quickly and map out a strategy stand to gain significant financial and competitive advantages.

Note: As highlighted in our July 1, 2016 Tax Alert, the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board, among other things. Virtually every fiscal decision by the Government of Puerto Rico will be made or approved by the Oversight Board created by PROMESA. On this regard, the board has authority to prevent the execution or enforcement of a contract, rule, executive order or regulation to the extent that it is inconsistent with the approved fiscal plan.

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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