Ways and Means Committee Release Text of Tax Reform Bill

November 2, 2017

Today, the House Ways and Means Committee released the Tax Cuts and Jobs Act (H.R. 1) to overhaul major aspects of the US tax system. Originally scheduled for release on Wednesday, November 1, Ways and Means Committee Chairman Kevin Brady (R-Tex.) postponed the bill's unveiling by one day, largely in order to negotiate with Republicans from high-tax states who threatened to oppose the bill if it eliminated the federal deduction for state and local taxes (SALT). In the bill released today, the deduction for state and local taxes is eliminated, with a limited exception for state and local property taxes up to $10,000.

The bill would cut the corporate tax rate to 20 percent. It also would apply a 25 percent rate to business income earned by owners and shareholders of certain pass-through entities. The bill would also adopt a territorial system of international taxation, an immediate tax on existing retained offshore earnings, a new tax on foreign subsidiary high returns, a new excise tax on certain payments from US companies to related foreign companies and new thin capitalization rules.

The bill is widely seen as the beginning of an ongoing negotiation. Chairman Brady indicated that he plans to release a chairman's mark as soon as tomorrow that incorporates feedback from members. The bill is scheduled for committee markup on Monday, November 6. In addition, the Senate Finance Committee is working on its own tax reform plan.

Major provisions of the legislation include:

BUSINESSES - GENERAL

- Corporate Rate
  - The bill reduces the corporate rate from 35 percent to 20 percent effective for tax years beginning after 2017, with no sunset. The bill also repeals the corporate alternative minimum tax.
- Pass-through Rate
  - Under current law, sole proprietorships, partnerships, limited liability companies and S corporations are generally treated for federal income tax purposes as "pass-through" entities subject to tax at the owner or shareholder level rather than at the entity level. Net income earned by an individual owner or shareholder of one of these entities is reported on the individual's income tax return and is subject to ordinary income tax rates, up to the top individual marginal rate of 39.6 percent.
  - The bill provides for a special maximum 25 percent ordinary income tax rate that would apply to the "qualified business income" of individuals engaged in business activities through sole proprietorships, tax partnerships, and S corporations. Business income not qualifying as such would remain subject to the normal ordinary income tax rate schedule.

- The determination of whether income is “qualified business income” depends on whether such income is derived from passive or active business activities. The determination of whether a taxpayer is active or passive with respect to a particular business activity would rely on the current material participation rules in section 469 and the underlying regulations.

- Income of passive owners would be treated entirely as qualified business income.

- A 30/70 rule would generally apply to income derived from active business activity—30 percent of such net income (the “capital percentage” portion of such income) would be treated as qualified business income, while the remaining 70 percent would be subject to ordinary income tax rates.

- Alternatively, active business owners may elect to apply a formula based on the facts and circumstances of their business to determine a capital percentage of greater than 30 percent. The formula would measure the capital percentage based on a rate of return (the Federal short-term rate plus 7 percentage points) multiplied by the capital investments of the business. The election of this alternative formula would be binding for a five-year period.

- Certain items, such as income subject to preferential rates (*e.g.*, net capital gains and qualified dividend income) and certain investment income (*e.g.*, short-term capital gains, dividends, and foreign currency gains and hedges not related to the business needs) would not be eligible to be recharacterized as qualified business income.

- A special rule would apply to prevent the recharacterization of actual wages paid as qualified business income. An owner’s or shareholder’s capital percentage would be limited if actual wages or income treated as received in exchange for services from the pass-through entity (such as a guaranteed payment) exceeds the taxpayer’s otherwise applicable capital percentage.

- The default capital percentage for certain personal services businesses (such as those involved in the performance of services in the fields of law, accounting, consulting, engineering, financial services, or performing arts) would be zero percent. However, such businesses also could elect to use an alternative capital percentage, subject to certain limitations. Such an election is intended to provide some relief to personal service businesses that, nevertheless, have significant capital investments.

- The bill also proposes to eliminate the preferential self-employment tax treatment for shareholders of S corporations and limited partners of partnerships by treating a "labor percentage" of net income derived from carrying on a business by any individual as earnings subject to the self-employment tax (whether such individual carries on such business as a sole proprietorship, a shareholder of an S corporation, or a partner of a tax partnership). The "labor percentage" is generally equal to one minus the "capital percentage" used for the special maximum 25 percent rate on qualified business income.

- The bill also would repeal the partnership technical termination rule. Thus, a partnership would be treated as continuing even if more than 50 percent of the total capital and profits interests of the partnership are sold or exchanged within a year, which would prevent partnerships from being required or being permitted to make new elections for various accounting methods, depreciation lives, and other purposes.

- The bill does not contain any specific changes to the treatment of carried interest.

- Additionally, the bill does not include any technical changes to the new partnership audit and litigation regime scheduled to take full effect in 2018. Such changes may be included as the bill works its way through the legislative process.

- International Provisions

  - *Dividend-Exemption System.* For distributions made after 2017, the bill proposes a dividend-exemption (or "territorial") system in which 100 percent of the dividends paid by a foreign corporation to a 10 percent US corporate shareholder would be exempt from US taxation. No foreign tax credit or deduction would be allowed for any foreign taxes (including withholding taxes) with respect to any exempt dividend. (However, indirect foreign tax credits would be available to offset US tax on subpart F income.) In addition, no deductions for expenses allocable to an exempt dividend would be taken into account for purposes of determining the US corporate shareholder's foreign-source income. Section 956 would be repealed. In addition, a US parent would be required to reduce the basis of its stock in a foreign subsidiary by the amount of any exempt dividends received by the US parent from its foreign subsidiary—but only for purposes of determining the amount of a loss on any sale or exchange of the foreign stock by its US parent. The dividend exemption system would be supplemented by several anti-base erosion measures, discussed below.

  - *Transition Tax.* To transition to the new system, a 10 percent US shareholder of a foreign subsidiary would be required to include in income for the subsidiary's last tax year beginning before 2018 the shareholder's pro rata share of the net post-1986 historical earnings and profits (E&P) of the foreign subsidiary to the extent such E&P has not been previously subject to US tax. To the extent the

E&P is retained in cash or cash equivalents, it would be taxed at a 12 percent rate. All other E&P would be taxed at 5 percent. Foreign tax credit carryforwards would be fully usable and foreign tax credits triggered by the deemed repatriation would be partially available to offset the US tax. The different rates reflect an acknowledgment that current tax on earnings reinvested in business assets is arguably less justified and likely harder for companies to fund. At the election of the US shareholder, the tax liability would be payable over a period of up to eight years, in equal annual installments of 12.5 percent of the total tax liability due.

- *Modifications to Subpart F.* The bill largely retains subpart F, with certain modifications, including making the look-through rule permanent, adjusting the *de minimis* exception for foreign base company income, repealing certain rules relating to foreign shipping income and foreign base company oil related income. In addition, the stock attribution rules would be modified so that a US corporation would be treated as constructively owning stock held by its foreign shareholder. The requirement that a US parent of a CFC own stock in the foreign subsidiary for an uninterrupted period of 30 days or more during the year would also be repealed.

- *Source Rules for Inventory Property.* Income from the sale of inventory property produced within and sold outside the United States (or vice versa) would be allocated and apportioned between sources within and outside the United States solely on the basis of the production activities with respect to the inventory.

- *Tax on "Foreign High Returns."* The bill would subject a US parent of one or more foreign subsidiaries to current US tax on 50 percent of the US parent's "foreign high returns." Foreign high returns would be measured as the excess of the US parent's foreign subsidiaries' aggregate net income over a routine return (7 percent plus the federal short-term rate) on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense. The provision could result in a large tax for US multinationals across a variety of industries, especially those with foreign businesses that are not capital-intensive. Foreign high returns would be treated similarly to currently-taxed subpart F income, including for purposes of allowing a foreign tax credit.

- *Limitation on Interest Deductibility for International Financial Reporting Group.* The bill would limit the deduction of interest by US corporations that are members of an international financial reporting group by limiting deductible net interest expense to the extent the US corporation's share of the group's global net interest expense exceeds 110 percent of the US's share of the group's global earnings before interest, taxes, depreciation, and amortization (EBITDA). An international financial reporting group is any group of entities that (a) includes at least one foreign corporation engaged in a US trade or business or at least one US corporation and one foreign corporation, (b) prepares consolidated financial statements, and (c) reports annual gross receipts for the three-year reporting period in excess of $100 million. The limitation would apply in addition to the

general rules for interest expense disallowance (i.e., the 30 percent of EBITDA limitation described below), with the interest disallowance determined under whichever provision denied the greater amount.

- *20 Percent Excise Tax on Payments to Related Foreign Corporations.* Payments (other than interest) made by a US corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset would generally be subject to a 20 percent excise tax, unless the related foreign corporation elected to treat the payments as income effectively connected with the conduct of a US trade or business. This provision would apply only to international financial reporting groups with payments from US corporations to their foreign affiliates totaling at least $100 million annually. The provision would be effective for tax years beginning after 2018. The provision is similar to a surtax advocated by University of Houston Law Center Professor Bret Wells in his testimony before the Senate Finance Committee on October 3, 2017.

- *PFIC Insurance Exception Modification*. Under current law, passive income for purposes of the PFIC provisions does not include income derived in the active conduct of an insurance business if the PFIC is predominantly engaged in an insurance business and would be taxed as an insurance company if it were a US corporation. This rule would be modified to apply only if the foreign corporation would be taxed as an insurance company if it were a US corporation and if loss and loss adjustment expenses, unearned premiums, and certain reserves constitute more than 25 percent of the foreign corporation's total assets (or 10 percent in certain cases). The modification would thus target certain insurance company structures linked to hedge funds. Such arrangements were targeted by Treasury and the IRS in regulations proposed in 2015 that have not been finalized.

- *Limitation on Treaty Benefits.* Under the bill, if a payment of fixed or determinable, annual or periodical (FDAP) income is deductible in the United States and the payment is made by an entity that is controlled by a foreign parent to another entity in a tax treaty jurisdiction that is controlled by the same foreign parent, then the statutory 30-percent withholding tax on such income would not be reduced by any treaty unless the withholding tax would be reduced by a treaty if the payment were made directly to the foreign parent. This provision would be effective for payments made after the date of enactment. Similar provisions have appeared in several older tax bills and have been criticized as overriding US tax treaties.

- *Rules Relating to US Territories.* The bill would also modify certain provisions related to territories of the United States, including extending the deduction allowable with respect to income attributable to domestic production activities in Puerto Rico, extending the temporary increase in limit on "cover over" of rum excise taxes to Puerto Rico and the Virgin Islands, and extending the American

Samoa economic development credit.

- Business Deductions
  - *Interest.* Under the bill, the amount of interest that can be deducted by any business with gross receipts of $25 million or more is generally limited to 30 percent of the business's adjusted taxable income. The provision would not apply, however, to certain regulated public utilities and real property trades or businesses (i.e., "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business"). Adjusted taxable income is defined as the business's taxable income computed without regard to interest, net operating losses, depreciation, amortization, and depletion. Any interest amounts disallowed would be allowed to be carried forward for five years. Disallowance would be determined at the tax filer level. The bill would repeal the existing limitations under section 163(j) but would apply in addition to the limitation on interest deductibility for international financing reporting groups, discussed above.
  - *Net Operating Losses.* The bill modifies the treatment of net operating losses by limiting the use of a net operating loss carryover or carryback to 90 percent of the taxpayer's taxable income (similar to the effect of the alternative minimum tax rule under current law). The bill also eliminates all net operating loss carrybacks except for a special one-year carryback for small businesses and farms in the case of certain casualty and disaster losses.
  - *Depreciation and Expensing.* The bill would provide for additional accelerated depreciation—immediate expensing of all the cost (instead of the present law 50 percent of cost) for property described in section 168(k)—generally property with a life of 20 years or less, computer software and certain other property. Property qualifying for immediate expensing would not include regulated public utility property or property used in a real property trade or business.
  - *Like-Kind Exchanges.* The bill would limit like-kind exchanges under section 1031 to exchanges of real property. The bill includes a transition rule to allow like-kind exchanges for personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

ENERGY

- *Production tax credits.*
  - Currently, a taxpayer may claim a production tax credit for producing electricity at a facility using qualified resources during the 10-year period beginning on the date the facility was originally placed in service. For this purpose, qualified

resources consist of wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. The base amount of the credit is 1.5 cents per kilowatt hour. Indexed for inflation, the rate for projects where construction began before 2017 is 2.4 cents for 2017 (the rate was 2.3 cents for 2016) and 1.9 cents for projects where construction begins in 2017.

  - The credit is generally available for wind facilities the construction of which begins before 2020 and for facilities using other qualified resources where construction began before 2017.

  - Under the bill, the inflation adjustment would be repealed. In addition, unless there is a continuous program of construction for a facility, the construction of that facility "shall not be treated as beginning before any date."

- *Modification of the energy investment tax credit.*

  - A taxpayer may claim an investment credit computed by reference to the basis of eligible energy property once the property is placed in service. Eligible energy property consists of solar energy, fiber-optic solar energy, geothermal energy, qualified fuel cell, qualified microturbine, combined heat and power system, qualified small wind energy, and thermal energy properties. The percentage of the credit available depends upon the type of property and the date when construction begins.

  - The bill would generally harmonize the expiration dates and phase-out schedules. Under the bill, the 30 percent credit for solar energy, fiber-optic solar energy, qualified fuel cell, and qualified small wind energy property would be available for property the construction of which begins before 2020 and would be phased out for property the construction of which begins before 2022, with no credit available for property the construction of which begins after 2021. The 10 percent credit for qualified microturbine, combined heat and power systems, and thermal energy property would be available for property the construction of which begins before 2022. The "permanent" 10 percent credit for solar energy and geothermal energy property is eliminated for property the construction of which begins after 2027.

  - The bill would clarify that the construction of any facility, modification, improvement, addition, or other property may not be treated as beginning before

any date unless there is a continuous program of construction which begins before such date and ends on the date that such property is placed in service.

- *Extension and phaseout of residential energy efficient property.*
    - A taxpayer could claim a 30 percent credit for the purchase of qualified geothermal heat pump property, qualified small wind energy property, and qualified fuel cell power plants placed in service before 2017 and could also claim a credit for qualified solar electric property and qualified solar water heating property (not used for heating swimming pools and hot tubs) placed in service prior to 2022 (subject to a reduced rate of 26 percent for property placed in service during 2020 and 22 percent for property placed in service during 2021).
    - Under the bill, the credit for residential energy efficient property would be extended for all qualified property placed in service prior to 2022, subject to a reduced rate of 26 percent for property placed in service during 2020 and 22 percent for property placed in service during 2021.
- *Repeal of enhanced oil recovery credit.*
    - Taxpayers may claim a credit equal to 15 percent of enhanced oil recovery costs. The credit is ratably reduced over a $6 phase-out range when the reference price for domestic crude oil exceeds $28 per barrel (adjusted for inflation after 1991). Based on current prices, the credit is fully phased-out.
    - The bill would repeal the credit for tax years after 2017.
- *Repeal of credit for producing oil and gas from marginal wells.*
    - Producers may claim a $3-per-barrel credit (adjusted for inflation) for the domestic production of crude oil and a 50-cents-per-1,000-cubic-feet credit (also adjusted for inflation) for the domestic production of qualified natural gas. The credit is not available for production if the reference price of oil exceeds $18 ($2 for natural gas). The credit is reduced proportionately for reference prices between $15 and $18 ($1.67 and $2 for natural gas). The credit is now phased out completely based on the current price of a barrel of oil.
    - The bill would repeal the credit for years after 2017.

- *Modifications of credit for production from advanced nuclear power facilities.*

    - A taxpayer may claim a credit for electricity produced at a qualifying advanced nuclear power facility for an 8-year period beginning when the facility is placed in service. The credit provides for a maximum 6,000 megawatts of national capacity allocated by the Secretary of the Treasury. To qualify, a taxpayer must have submitted an application with respect to a nuclear facility before February 1, 2014, and must have received an allocation from the available national megawatt capacity with respect to the facility. All 6,000 megawatts of national capacity have been allocated.

    - The nuclear production tax credit may be allocated among partners in a partnership, effectively allowing for the transfer of such credits in certain circumstances.

    - Under the bill, the credit allocation process would be clarified and a credit transfer provision would be added. Beginning after January 1, 2021, the Secretary of the Treasury would reallocate any national megawatt capacity remaining under the cap, first to qualifying facilities to the extent such facilities did not receive an allocation equal to their full capacity and then to facilities placed in service after such date in the order in which such facilities are placed in service. Certain public entities would be eligible for an election to transfer advanced nuclear production tax credits to specified project participants involved in design or construction, persons providing nuclear steam supply systems or nuclear fuel, persons with an ownership interest, and partners in a partnership with an ownership interest.

INSURANCE COMPANIES

- Life insurance companies

    - The bill modifies section 805 and repeals sections 810 and 844 to make the operations loss carry over and back provisions of Section 172 applicable to life insurance companies. Thus, companies would carry operations losses back up to two (instead of three) years and forward up to 20 (instead of 15) years.

    - The bill repeals the section 806 small life insurance company deduction.

    - The bill amends the section 807 reserve computation rules. Companies would compute “reserves for future unaccrued claims” and take into account 76.5 percent of the increase or decrease in such reserves in computing taxable

income. Reserves for future unaccrued claims are the life insurance reserves, discounted unpaid losses and other reserves reported on the annual statement, but excluding deficiency reserves, asset adequacy reserves and other types of reserves identified in IRS guidance. If the year-end reserve at the end of the pre-effective date year differs from the opening reserve of the effective date year the difference is taken into account ratably over an eight-year spread period.

  - The bill amends section 807(f) to eliminate the special rule for changes in computing reserves and to require instead use of the generally applicable section 481 change in accounting method rules.
  - The bill amends section 812 to specify that for proration purposes the company's share is 40 percent and the policyholders' share is 60 percent.
  - The bill repeals section 815, which applies to distributions from a stock life insurer's pre-1984 policy holders surplus account. If a company has a remaining balance in such account at the end of the pre-effective date year that balance is brought into income ratably over eight years.
  - The bill amends the section 848 policy acquisition expense rules by replacing the three categories of specified insurance contracts with two categories: group contracts and all other specified contracts. For group contracts, the specified policy acquisition expenses are net premiums times 4 percent and for other contracts the specified policy acquisition expenses are net premiums times 11 percent.

- Non-life insurance companies
  - The bill amends section 832 to provide that, for proration purposes, the reduction in the losses incurred deduction attributable to tax-exempt interest and the dividends received deduction is increased from 15 percent to 26.25 percent of such amounts.
  - The bill amends section 846 to amend the discounting rules used to determine discounted unpaid losses. First, the applicable interest rate for determining discounted unpaid losses is the corporate bond yield curve specified by Treasury. Second, the computational rules for loss payment patterns are modified by applying the loss payment pattern for long-tailed business lines to all lines of business, but with the five-year limitation on extensions to the payment period increased to 15 years. In addition, the election to use a company's historic payment pattern is repealed. Any transition adjustment is taken into account ratably over eight years.
  - The bill repeals section 847 and the special estimated tax payment rules related to the difference between discounted and undiscounted reserves.

INDIVIDUALS

- Individual Rates and Standard Deduction
  - Individual income tax brackets are set at 12, 25, 35, and 39.6 percent. The highest individual tax rate of 39.6 percent would apply to taxpayers with over $1 million in annual income;
  - The standard deduction is increased to $12,000 for individuals and $24,000 for married couples;
- State and Local Tax Deduction
  - The bill generally eliminates the deduction for state and local taxes, except for a limited deduction for state and local property taxes up to $10,000;
- Mortgage Interest Deduction
  - The bill would further limit the individual deduction of home mortgage interest. For mortgage debt incurred after November 2, 2017, the current loan limit of $1 million for deductible interest is reduced to $500,000.
  - The bill would also only allow interest to be deductible on a mortgage of a principal residence, rather than a principal residence and one other residence as permitted under existing law.
  - The bill would not allow interest on home equity debt incurred after November 2, 2017.
  - Under the bill, debt incurred prior to November 2, 2017 that is refinanced after November 2, 2017 is treated as incurred on the date the original debt was incurred.
  - The bill would treat debt pursuant to loans subject to a binding written contract before November 2, 2017 as incurred prior to November 2, 2017.
- Retirement Savings
  - The proposal makes no change to current 401(k) limits, which allow 401(k) plan participants to voluntarily contribute up to $18,000 per year (plus an additional $6,000 if they are age 50 or over) on a pre-tax basis.
  - Early drafts of the proposal would have limited the pre-tax contribution amount to as little as $2,400 per year, and required that additional contributions be made on an after-tax basis through a so-called "Roth" 401(k) feature, changes that were expected to raise significant revenue over 10 years. Contributing on a pre-tax basis allows 401(k) participants to avoid current Federal income taxes (and, in most cases, state income taxes), with contributions and earnings instead being taxed at retirement. Some employers also give their 401(k) plan participants the option to contribute all or a portion of their $18,000 limit ($24,000 for those 50 or over) on an after-tax basis through a Roth 401(k) feature. A Roth 401(k) feature provides for federal taxation when contributions are made, but distributions of

contributions and earnings then avoid any federal taxation at retirement.

- The 401(k) limits were dropped from the proposal after receiving criticism by the financial services industry, plan sponsors and the White House over concerns that participants would react by decreasing their contributions. Even when a Roth 401(k) feature is offered, most 401(k) participants still choose to make traditional pre-tax contributions. This may be because 401(k) participants prefer an immediate tax benefit instead of a deferred tax benefit, or they project having the benefit of a lower marginal income tax rate at retirement, or they simply are more familiar with pre-tax contributions and want to avoid added complexity. In addition, even if employers were to make a Roth 401(k) feature fully available to participants, and participants were to contribute enough to maximize employer matching contributions, there was a concern that participants would react to a mandated after-tax treatment by decreasing their unmatched 401(k) contributions in order to keep their take home pay at the same level. The proposal also would have added complexity for 401(k) plan sponsors and participants, and would have increased the need for participant education on how Roth 401(k) contributions work, particularly regarding the deferred tax benefits provided by a Roth 401(k) feature.

- Child Tax Credit
  - The child tax credit is increased to $1,600 from $1,000 per child under 17, with an additional $300 credit for non-dependent children.
  - The bill introduces a new family flexibility credit of $300 for each parent effective for taxable years ending before January 1, 2023.
- Estate Tax
  - The bill doubles the exemption from the estate tax from $5 million to $10 million (adjusted for inflation from 2011) and repeals the estate tax completely on January 1, 2024.
  - The bill also includes the basic exclusion amount for gift and generation-skipping transfers to $10,000,000 (adjusted for inflation).
  - The bill would eliminate the estate tax for decedents dying after December 31, 2023. The generation-skipping transfer tax is also eliminated for transfers after December 31, 2023.
  - Estate, gift and generation-skipping transfers made on or before December 31, 2023 would still be subject to a maximum tax rate of 40 percent (no change in rates).
  - The bill does not eliminate the gift tax. Gifts made after December 31, 2023 would be subject to a maximum gift tax rate of 35 percent (reduced from the current maximum rate of 40 percent).

  - Under the bill, the basis step up under section 1014 for property received from a decedent at death would be retained even after the estate and generation skipping transfer taxes are repealed.

EXEMPT ORGANIZATIONS

The bill proposes several modifications to the rules governing exempt organizations, including subjecting certain private colleges and universities to a 1.4% excise tax on net investment income, permitting churches to make statements relating to political campaigns in the ordinary course of religious services and activities, clarifying and expanding certain provisions of the unrelated business income tax (UBIT) rules, and imposing an excise tax on compensation of certain tax-exempt organization employees. In addition, the bill would be replace the current two-tier private foundation excise tax on net investment income with a single rate of 1.4%, require an art museum claiming the status of a private operating foundation to be open to the public for at least 1,000 hours per year, and create an exception from the private foundation excess business holdings tax for independently-operated philanthropic business holdings. Other provisions of the bill, such as the expansion of the standard deduction, the repeal of certain itemized deductions, the reduction in marginal income tax rates, and the amendment and repeal of the estate tax, would weaken incentives for charitable giving.