STROOCK
SPECIAL BULLETIN

Tax Reform: Now it's the Senate's Turn

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Overview

On November 9, 2017, the Senate Republicans released their version of the sweeping tax reform plan (the "Senate Plan" or the "Plan"). Although the Senate Plan has many proposals that are similar to those in the House Bill,[1] there are also many significant differences. Even those provisions of the Senate Plan that generally mirror the provisions of the House Bill contain many nuanced differences. The scope of the Senate Plan and the House Bill is very extensive, and, if enacted, these bills would significantly transform the current tax system affecting all U.S taxpayers, including individuals, businesses, and tax-exempt organizations. This **Stroock Special Bulletin** follows up on the previous bulletins dedicated to the tax reform[2] and highlights some of the more significant differences of the Senate Plan from the House Bill.

Changes for Individuals

The Senate Plan keeps seven tax brackets, but modifies the tax rates and the threshold amounts. The highest tax rate under the Senate Plan would be 38.5% for income over $500,000 for single taxpayers and $1,000,000 for married taxpayers filing jointly.

The Senate Plan also eliminates or limits many of the itemized deductions, and completely eliminates all state and local deductions (unless incurred in a trade or business), including the property tax deduction. On the other hand, the Senate Plan retains the existing home acquisition mortgage deduction.

The Senate Plan, like the House Bill, does not repeal the additional 3.8% Net Investment Income Tax (also known as the Obamacare or Medicare tax), although the repeal of this tax has been the target of many other proposed bills.

	House Bill	Senate Plan
Number of Brackets	4 brackets (12%, 25%, 35%, 39.6%)	7 brackets (10%, 12%, 22.5%, 25%, 32.5%, 35%, and 38.5%)
State and Local Tax Deduction	Eliminates income and sales tax deductions, and limits property tax deductions to $10,000	Eliminates all income, sales, and property tax deductions.
Mortgage Deduction	Reduced to $500,000 for new purchases	Remains at $1,000,000
Home Equity Deduction	Repealed	Repealed

[1] The Tax Cuts and Jobs Act, H.R. 1, as amended.
[2] For the previous coverage on this topic see *Stroock Special Bulletin* of February 21, 2017 and *Stroock Special Bulletin* of November 6, 2017.

	House Bill	Senate Plan
Estate Tax	Double the current exemption, and repeal after 2023	Double the current exemption, but do not repeal
Medical Expense Deduction	Repealed	Stays
Alimony Deduction	Repealed	Stays
Overall Limitation on Itemized Deductions	Repealed	Repealed
Alternative Minimum Tax	Repealed	Repealed

Change in Executive Compensation and Employee Benefits

Based on the description of the Senate Plan , the provisions of the Senate Plan regarding (i) nonqualified deferred compensation, (ii) Code Section 162(m) deduction limitations and (iii) excise taxes on compensation paid to covered employees of tax-exempt organizations, appear to be substantially identical to the provisions contained in the original House Bill.[3] Those significant changes introduced in the House Bill and followed by the Senate Plan include:

- The effective elimination of the deferral of U.S. Federal income taxation on amounts deferred under many commonly utilized nonqualified deferred compensation arrangements, including stock options and stock appreciation rights;
- Elimination of the performance-based compensation exception to the Code Section 162(m) deduction limitation for publicly traded companies; and
- Imposition of a 20 percent excise tax on amounts paid over $1,000,000 to certain covered employees and parachute payments to certain covered employees of tax-exempt organizations.

In addition, the Senate Plan eliminates catch-up contributions to qualified contribution plans, governmental Code Sections 457(b) and 403(b) plans, and IRAs for employees making wages of $500,000 or more for the preceding years, as well as applying a single aggregate limit to contributions for an employee in a governmental Code Section 457(b) plan and elective deferrals for the same employee under a Code Section 401(k) or 403(b) plan of the same employer and the imposition of a 10% early withdrawal tax to certain distributions from governmental Code Section 457(b) plans. The Senate Plan also does not appear to include the provisions regarding testing contained in the House Bill.

It should be noted that amendments have been introduced to the proposed House Bill that significantly impact the provisions relating to executive compensation in the House Bill. The most significant change introduced by the amendment is the reinstatement of the current law regarding deferred compensation arrangements. The amendment also introduced a provision allowing certain employees exercising stock options or restricted stock units of private companies, issued as compensation for the performance of services, to defer recognition of income on such compensation for up to five years.

Business Tax Reform

The Senate Plan, like the House Bill, significantly expands opportunities for bonus depreciation deductions and for immediately expensing certain capital expenditures. Many of the details in the Senate Plan, however, are different from those in the House Bill. The Senate Plan increases the maximum amount of Section 179 expensing to $1,000,000, while the House Bill was much more generous with a $5,000,000 maximum. On the other hand, the House Bill's provision expires after

[3] For further detail on the House Bill see the *Stroock Special Bulletin*, "Tax Me Now; Pay Me Later? House Majority Tax Bill Includes Fundamental Changes to Common Executive Compensation Arrangements and Benefits," dated November 6, 2017.

5 years, while the Senate Plan's provision is permanent.

The Senate Plan, similarly to the House Bill, limits the business interest deduction to 30% of the taxpayer's adjusted taxable income. The Senate Plan, however, allows the unused business interest deduction to be carried forward indefinitely, unlike the House Bill that limits the carry-forward to five years. The Senate Plan provides that real estate businesses can elect out of this limitation. This limitation also does not apply to regulated public utilities providing power, water and sewage, including the transportation and distribution of natural gas or steam. Taxpayers will have to consider whether any given real-estate-related business qualifies for this exception.

Corporations

The Senate version of the tax reform plan conforms to the House version in reducing the corporate income tax rates from 35% to 20%. The Senate Plan, however, postpones this change to 2019.

The Senate Plan, like the House Bill, changes the deductibility of Net Operating Losses ("NOL"). Under the Plan, NOL carryover or carryback deductions are limited to 90% of the taxpayer's taxable income and will not expire. Unlike the House Bill, the Senate does not increase NOLs that are carried forward by an interest factor to preserve their value.

The Senate Plan, however, also reduces the corporate deduction for dividends received from another corporation. The 70% dividends received deduction is reduced to 50%, and the 80% dividends received deduction is reduced to 65%.

Pass-throughs/Partnerships/S-Corporations

The Senate Plan, unlike the House Bill, does not make the same distinction between active and passive income. Instead, the Senate Plan allows pass-through companies to deduct 17.4% of their income, regardless of the participation of the owner in the business. For many professional service businesses, the deduction is phased out starting at incomes of $75,000 for a single taxpayer and $150,000 for married taxpayers filing jointly.

The Senate Plan attempts to override a recent Tax Court case[4] and would require that, in case of a transfer of partnership interest by a foreign partner, gain or loss be treated as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value on the date of the transfer.

Additionally, the Senate Plan imposes a new withholding requirement on sellers of partnership interests. Any transferee of a partnership interest must withhold 10% of the amount realized on such sale or exchange unless the transferor certifies to the transferee that the transferor is not a nonresident alien individual or foreign corporation.

REITs

REIT dividends would also be treated as qualified income for purposes of the 17.4% pass-through income deduction.

Real Estate Industry

Like the House Bill, the Senate Plan repeals "like-kind exchange" deferral of taxation for personal property sales, but preserves this favorable treatment for real estate property. The Senate Plan preserves the Section 121 $500,000 exclusion from gain on the sale of a primary residence, but, like the House Bill, limits it to property owned for

[4] A recent Tax Court case, *Grecian Magnesite Mining Co. v Commissioner,* held that a foreign partner, in a partnership engaged in a U.S. trade or business, that sells its interest in such partnership would recognize foreign-source gain or loss, rather than U.S.-source gain or loss, and would, accordingly, not be subject to standard U.S. taxation on such gain or loss. The Tax Court's decision rejected the IRS in Revenue Ruling 91-32.

five out of the previous eight years. The Senate Plan also reduces the depreciation period for residential and commercial rental real property to 25 years. Finally, under the Senate Plan, certain real estate trades or businesses can elect out of the limitation on the business interest deduction.

International Taxation

Participation Exemption

The Senate Plan shifts the U.S. corporate tax system closer to a territorial system. Like the House Bill, the Plan provides a participation exemption for foreign-sourced dividends paid by a foreign shareholder to a 10% U.S. shareholder. The Senate Plan, however, denies this deduction to hybrid dividends (dividends that are deductible in the country of the paying company) and imposes a longer holding period of at least 365 days.

In order to transition to the "participation exemption" system of taxation, the Senate Plan, like the House Bill, provides for a one-time tax on all unrepatriated and previously untaxed earnings and profits of foreign subsidiary corporations. Unrepatriated earnings and profits are subject to tax at the rate of 10% for cash (12% in the House Bill) and 5% for reinvested earnings. The tax on unrepatriated income is payable over 8 years, but unlike the House Bill's equal installments, the bulk of the Senate Plan's payments are deferred into the future (five years of 8%, 15% in year 6, 20% in year 7, and 25% in year 8).

The Senate Plan does not provide an exception for untaxed foreign subsidiary earnings reinvested in United States property.

Modifications of CFC and Subpart F Provisions

The Senate Plan, for the most part, follows the House Bill in modifications to Subpart F provisions. The Senate Plan, however, makes a very slight, but very important change to the definition of "U.S. Shareholder" for purposes of the application of Subpart F provisions. Under the Plan, "U.S. Shareholder" is a person who owns at least 10% of the value of the foreign corporation, as opposed to the previous rule that required at least 10% of the vote. Many existing corporate structures would have to be reexamined and modified if this change is enacted.

Base Erosion

The House and the Senate tax reform plans attempt to address the issue of base erosion, but they do so in different manners. Both plans take a swipe at deductibility of related party interest payments. While the House attempts to tax controlled foreign corporations with "abnormally" high incomes and impose an excise tax on related party transactions, the Senate Plan, among other things, strengthens tax limitations for intangible property transferred abroad, denies deductions related to hybrid instruments, repeals domestic international sales corporation (DISC) provisions, and denies preferential qualified dividend treatment for dividends received from certain foreign corporations that were formerly U.S. corporations but changed their jurisdiction of taxation.

The Senate Plan imposes a 10% "base erosion tax," which acts almost as an alternative minimum tax for U.S. corporations making deductible payments to foreign related parties.

The Senate Plan also contains a special 10% for the so-called "global intangible low-taxed income," provides for a deduction of 37.5% for foreign-derived intangible income, and provides limitations on fair market value of intangible property distributed from foreign controlled foreign corporations.

Energy and Renewable Energy Credits

The Senate Plan is silent on the topic of renewable energy tax credits, leaving in place Congress' bi-partisan deal reached in late 2015 extending renewable energy tax credits with limitations. Under the changes reflected in the Consolidated Appropriations Act of 2016, Congress agreed to extend the 30% solar Investment Tax Credit (ITC)

through 2019, after which it will be reduced to 26% in 2020 and 22% in 2021, and then dropped to 10% in 2022 on a permanent basis. The Production Tax Credit (PTC) for wind energy was extended through 2016, after which it began to decline annually until it fully expires in 2020. Certain provisions for preserving the credits by "commencing construction" and bonus depreciations were also included in the 2015 deal. In exchange for these tax credit extensions, Congress lifted the 40-year ban on crude oil exports. The House took aim at these tax credits in its version of the tax reform plan, reducing the PTC from what is now 2.3 cents per kilowatt hour to 1.5 cents. The "commence construction" provision was changed to a requirement for "continuous construction," and the permanent 10% ITC for solar would now expire in 2027. It is uncertain how this issue will be resolved in conference.

Although minor, in what could potentially be seen as another dig at the Obama administration's push to reduce climate change impacts, the Senate is proposing to repeal the provision for qualified bicycle commuting reimbursements of up to $20 per month, which reimbursements have been excludible from gross income and wages for employment tax purposes. On the other hand, the Senate Plan, unlike the House Bill, leaves intact the $7,500 federal tax credit for electric vehicles.

Insurance Company Tax Changes

The Senate Plan, unlike the original version of the House Bill, would not take a haircut to the reserves of life companies or change the dividends received deduction methodology. However, it would lengthen the amortization period for deferred acquisition costs from 10 years to 50 years. It would also change the amount deferred from 7.7% (in the case of life premiums) or 1.75% (for annuities) to 13.97% and 3.17%, respectively.

Conclusion

Stroock tax, personal client services, and executive compensation and employee benefits attorneys have been closely monitoring the developments of the various tax reform plans. This plan advanced by the Senate Republican majority is the latest in the long line of tax reform proposals. Although many details of this bill may change in the course of the legislative process, it provides valuable insight into the possibilities that are being considered. It is clear that when the tax reform is finally enacted, individual and business tax planning will be significantly affected. We are available to discuss any questions you may have regarding this proposed tax reform (and any subsequent developments) and its effect on your tax planning.

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