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Tax News and Developments
North America

Client Alert
November 13, 2017

Senate Finance Committee Releases "Chairman's Mark" of Tax Reform Legislation; Mark Up Begins

Introduction

On November 9, the Joint Committee on Taxation (JCT) released its Description of the Chairman's Mark of the "Tax Cuts and Jobs Act" (*see* previous *Tax News and Developments* Client Alert, *Ways and Means Committee Releases "Tax Cuts and Jobs Act"* distributed on November 3, 2017). This document, typically referred to as a "conceptual mark," is Senate Finance Committee (SFC) Chairman Orrin Hatch's (R-UT) tax reform proposal. At some point, we expect Chairman Hatch to release a revised draft, referred to as the "modified mark." The SFC will begin debating and marking up the document on Monday, November 13. The mark up is expected to last most, if not all, of the week due to the number of amendments. Members of the Finance committee filed more than 350 amendments on Sunday afternoon (this does not preclude members and senators off committee from filing amendments if and when the bill is considered by the full Senate). Legislative text will not be released until after the mark up concludes, and it will reflect the outcome of the SFC debate.

The House Ways & Means Committee (W&M) passed H.R. 1, the Tax Cuts and Jobs Act, out of committee on party lines on Thursday, November 9. Unless the House Rules Committee makes further changes, the bill that passed out of W&M will be voted on by the full House. Although a vote is anticipated the week of November 13, it had not been scheduled at the time this alert was prepared.

If, as expected, the House and the Senate ultimately pass different versions of the tax bill, the House and the Senate can take two paths. First, the House can merely accept the Senate bill and vote to support it. Alternatively, the bill can go to conference to reconcile those differences. If the bill goes to conference, then both houses will vote on the conferenced bill, which cannot be amended on the floor of either house.

Below is a description of the provisions in the SFC's conceptual mark.

Individual Provisions

The SFC proposal includes more individual tax brackets than the House bill. It would establish seven income tax brackets: 10%, 12%, 22.5%, 25%, 32.5%, 35%, and 38.5%. This is the same number of brackets as the current tax code, although the highest income tax bracket starts at $1 million under both the Senate and House versions of the bill.

Like the House bill, the Senate would also double the standard deduction from $6,350 to $12,000 for individuals and $12,700 to $24,000 for married couples. The SFC proposal also expands the Child Tax Credit, but proposes a larger increase than the House (the Senate would increase the credit to $1,650, above the current $1000 credit and larger than the $1,600 credit provided in the House bill). In a departure from the House, the SFC proposal preserves many popular itemized deductions that the House bill eliminates entirely, such as the adoption tax credit, student loan interest deduction, and medical expense deduction. On the other hand, the SFC proposal fully repeals the state and local tax deduction, as opposed to the House bill's compromise position that preserved the property tax deduction up to $10,000 while eliminating the deduction for state and local income taxes. This difference may cause political difficulties for Republican members of the House from high-tax states, who have fought to retain the deduction or, at a minimum, preserve most of it.

The Senate and House also differ on the home mortgage interest deduction. The Senate proposes to retain the deduction for interest paid on existing mortgages and newly purchased homes with mortgage indebtedness up to $1 million, whereas the House bill cuts the cap for the deduction to interest on $500,000 of mortgage indebtedness.

The SFC proposal does not include changes to the tax treatment of carried interest (which were added to the House bill during the mark up process) or repeal the Affordable Care Act's individual mandate. Although the President and some Republicans in the House have advocated for repealing the mandate that individuals have health insurance or pay a penalty (repealing this provision could raise as much as $388 billion), the general consensus is that adding health care provisions to the tax bill in the Senate would make passing tax reform even more difficult.

Estate and Gift Taxes

The Senate proposal, similar to the House bill, provides immediate relief from the estate and gift tax by doubling the exclusion in 2018 to $11.2 million (the exclusion is $5.49 million in 2017 and increases to $5.6 million in 2018 as indexed for inflation). The Senate proposal does not provide that the estate tax and generation-skipping transfer (GST) tax will be eliminated after six years as the House bill provides, and therefore does not address any adjustment to the current basis rules or any adjustment to gift tax rates if the estate and GST tax were eliminated. These Senate provisions, as with the House provisions, are likely to continue to be controversial, even among Republicans, and may change substantially during the course of the legislative process.

Tax-Exempt Organizations

The Senate diverges from the House on the unrelated business income tax (UBIT). The Senate proposes to subject royalty income derived from the licensing of an organization's name or logo to UBIT, and would also require an organization with more than one unrelated trade or business to compute UBIT separately with respect to each trade or business and without regard to the specific deduction generally allowed under the current section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose. Thus, a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year.

Notably, the Senate proposes to repeal the tax-exempt status for professional sports leagues and makes sweeping changes to the rules regarding the excess benefit transaction tax (the “intermediate sanctions”). The proposal imposes an additional excise tax on an organization providing an excess benefit to a disqualified person equal to 10% of the excess benefit, unless the organization’s participation in the transaction is not willful and is due to reasonable cause. No tax is imposed on the organization if it establishes that certain minimum standards of due diligence were met with respect to the transaction or establishes, to the satisfaction of the IRS, that other reasonable procedures were used to ensure that no excess benefit was provided. The Senate also proposes to eliminate the rebuttable presumption of reasonableness that an organization can obtain under current law to avoid the existing tax. Under the proposal, the organization’s actions would only serve to support an argument that it met the minimum standards of due diligence. The proposal would also expand the definition of disqualified persons to now include investment advisors to donor funds and athletic coaches for eligible educational institutions.

Finally, the SFC proposal includes a 1.4% excise tax on the net investment income of certain private college and universities, identical to the provision in the House bill. The Senate also proposes to repeal the “Johnson amendment” (which currently prohibits religious organizations from engaging in tax-exempt political speech) but expands the provision—under the Senate proposal, *all* section 501(c)(3) charitable organizations, not just churches, would be able to engage in political speech yet their donors would still be eligible to claim the charitable contribution deduction for any donations.

AMT Repeal

Similar to the House bill, the Senate would repeal the Alternative Minimum Tax (AMT) for individuals and corporations. As a conforming amendment, a taxpayer’s ability to elect to use AMT in lieu of additional depreciation is eliminated. The AMT credit can be used to offset the taxpayer’s regular tax liability for any taxable year.

Business Provisions

The SFC proposal reduces the corporate tax rate to 20% and eliminates the special tax rate for personal service corporations starting in 2019 (this is in contrast to the House bill, which would lower rates beginning immediately). Corporations will be able to deduct 50% (reduced from 70%) of dividends received from other taxable domestic corporations and 65% (reduced from 80%) of dividends received from a 20% or more owned corporation beginning in 2019.

The SFC proposal includes several provisions aimed at small businesses, including proposing to increase the section 179 maximum expense amount to $1,000,000 and increase the phase-out threshold to $2,500,000, both indexed for inflation, beginning in 2018. The Senate aims to increase the number of small businesses that can use the cash method of accounting by raising the gross receipt threshold amount to $15 million for the gross receipts test[1] and extend the cash method of accounting to more farming C corporations. Businesses that

[1] The gross receipts test is the annual average gross receipts over the prior 3 taxable years.

currently keep inventories would be able to use the cash method of accounting, so long as they do not exceed the $15 million gross receipts test. The uniform capitalization (UNICAP) rules would no longer apply to producers and resellers that meet the $15 million gross receipts test. The exception for small construction contracts from the percentage-of-completion is also expanded.

The SFC proposal limits interest deductibility by repealing section 163(j) and proposing a new provision providing that the interest deduction can't exceed "business interest income" plus 30% of adjusted taxable income. "Business interest income" is defined as the amount of interest includible in a taxpayer's gross income for the taxable year which is properly allocable to a trade or business. Investment income under section 163(d) is excluded from the definition. Adjusted taxable income is a taxpayer's taxable income, without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (2) any business interest or business interest income, (3) the 17.4% deduction for certain pass-through income; and (4) the amount of any net operating loss deduction (NOL) deduction.

As in the House bill, the SFC proposal allows for a temporary immediate expensing provision for qualified property acquired and placed in service between 9/27/17 and 1/1/23. Depreciation limits on section 280F listed property are increased over the recovery period and computer peripheral equipment is removed from the section 280F listed property definition. Certain equipment used in a farming business, originally placed in service starting in 2018, will have a shortened modified accelerated cost recovery system (MACRS) recovery period, reduced from 7 to 5 years. The MACRS depreciation recovery period for nonresidential real property and residential rental property is reduced to 25 years. Further, qualified improvement property will be on a 10-year recovery period and a 20 year alternative depreciation system (ADS) recovery period. NOL carrybacks are repealed, except for certain farming losses. For carryforwards, NOL deductions would be limited to 90% of taxable income. Nonrecognition of gain for like-kind exchanges is limited to real property not held primarily for sale.

Like the House bill, the SFC proposal repeals section 199 in full. Also repealed are any deductions for expenses relating to entertainment, amusement or recreational activities, or facilities directly related to actively conducting a trade or business, as well as transportation fringe benefits.

The SFC proposal revises the recognition of income rules that would require a taxpayer to recognize income no later than the taxable year in which the income was taken into account as income on the applicable financial statement or another financial statement specified by the Secretary. In addition, the SFC proposal would adopt the current deferral method of accounting for advanced payments for goods and services provided by the IRS under Revenue Procedure 2004-34. Taxpayers will also need to apply the revenue recognition rules under section 451 prior to applying the section 1272 original issue discount (OID) rules.

Unlike the House bill, the SFC proposal retains and modifies the orphan drug credit and the historic rehabilitation credit. The deduction for unused business credits would be fully repealed.

The SFC proposal includes specific provisions for banks and financial instruments, and proposes to limit the deductions that can be taken for FDIC premiums paid by taxpayers with total consolidated assets under $50 million. Taxpayers with over $50 million in consolidated assets would not be allowed a deduction. The exclusion from income for interest on a bond issued to advance refunding another bond is repealed in full. The cost of any specified security sold, exchanged, or otherwise disposed of after January 31, 2018 will be required to be determined on a first-in first out- basis except to the extent the average basis method is otherwise allowed.

Finally, the SFC proposal raises the threshold for standard Form 1099 reporting of income from $600 to $1,000 in aggregate payments per year. The same $1,000 threshold generally applies to section 6050W reporting by third party networks. However, if the transactions relate primarily to the sale of goods by participating payees on a third party network, the third party network can elect to report only once the payments to the payees that exceed $5,000 or 50 in number (whichever occurs first).

Compensation and Benefits

Similar to the House bill, the SFC proposal contains significant and sweeping changes to the taxation of executive compensation and employee benefits. For a description of these proposed changes, see an alert issued by our Compensation and Employee Benefits group, *House Ways and Means Committee Revisions & Senate Mark of Tax Cuts and Jobs Act*, distributed on November 13, 2017.

Insurance Companies

The SFC proposal contains the same amendment to the insurance company exception to passive foreign investment company (PFIC) treatment as the House bill. The PFIC rules (specifically, section 1297(b)(2)(B)) currently provide that income (including investment income) earned in the "active conduct" of an insurance business by a non-US company that would qualify for taxation as an insurance company if it were domestic, will not be treated as passive income for PFIC purposes. However, there are no rules in the Code or regulations for determining when income is earned in the active conduct of an insurance business. This has led to concerns in Congress that some companies that are primarily focused on investment rather than insurance (so-called "hedge fund" reinsurance companies) are avoiding PFIC treatment by claiming that their income meets the active conduct test under section 1297(b)(2)(B). Both the SFC proposal and the House bill would amend section 1297(b)(2)(B) to provide that, to meet the active conduct test, an insurance company’s insurance liabilities must constitute more than 25 percent of its total assets as reported on the company’s applicable financial statement. The proposals also include an electable “facts and circumstances” test for insurance companies that have at least a 10% insurance liabilities to assets ratio, if the company’s failure to meet the 25% test is due solely to specified circumstances involving such insurance business (for example, if the insurance company is in runoff). This proposal mirrors legislation introduced by Senator Wyden (D-OR) in previous legislative sessions.

In addition to the proposed amendment to the PFIC insurance company exception, the SFC proposal generally contains the same provisions as the House bill proposing modifications to subchapter L rules governing the taxation of life insurance and non-life insurance companies (for example, repealing the small life insurance company deduction contained in section 806).

The SFC proposal also includes a provision related to the tax treatment of life insurance policies that are transferred for value during the insured's lifetime (known as "life settlement" transactions). The provision as described would clarify the calculation of basis after such transfers, in determining how much income would be recognized by the seller (reversing the IRS position in Revenue Ruling 2009-13) and would impose reporting requirements on most such life insurance policy sales and on payments of death benefits under transferred policies.

Pass-through Provisions

Income Determinations

The SFC proposal would allow individual partners or stockholders of partnerships and S corporations, respectively, to deduct 17.4% of their qualified business income. Qualified business income would not include reasonable compensation, and for owners of passthroughs businesses, the deduction is limited to 50% of the taxpayer's W-2 wages. The proposal excludes from the meaning of qualified business income certain “specified service trade or business income”, which the SFC proposal defines as income from services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

Interest Deductions

The SFC proposal provides that the limitation on interest deductions is computed at the partnership level, and is taken into account for purposes of determining a partner's distributive share of bottom line net income. Special rules will apply to prevent double counting of interest deductions by partners.

Effectively Connected Income

The IRS takes the position that a non-U.S. person's sale of a partnership interest gives rise to effectively connected income (ECI) equal to that partner's distributive share of such income if the partnership sold all of its assets and allocated income and loss to its partners. In July 2017, the Tax Court disagreed with this position, and held a non-U.S. partner's share of effectively connected income is not analyzed from an aggregate perspective.

The SFC proposal would codify the IRS position, and provides that gain from the sale or exchange of a partnership interest by a non-U.S. person is treated as effectively connected income to the extent that a transferor would have effectively connected gain or loss had the partnership sold all of its assets. The proposal requires the partnership to allocate any gain or loss from the hypothetical sale consistent with the manner in which the partnership allocates bottom line net income. Thus, a seller's share of ECI from a deemed sale should be consistent with its share of all other non-separately stated income of the partnership.

To enforce this provision, the proposal requires a purchaser to withhold 10% of the amount realized from the sale, unless the seller certifies that it is not a nonresident alien individual or foreign corporation.

Section 754 Elections

Current law requires a partnership to make a section 754 election in connection with the transfer of a partnership interest if, at the time of transfer, the partnership's assets reflect a built-in loss in excess of $250,000. The SFC proposal requires a partnership to make a section 754 election if the transferring partner would be allocated a loss in excess of $250,000 in connection with the transfer of its interest. Specifically, if at the time the partner transfers its interest, a hypothetical liquidation of the partnership assets would allocate more than $250,000 of losses to the transferring partner, then a mandatory section 754 election will be triggered.

Charitable Deductions and Foreign Taxes

Under existing law, the IRS has taken the position that a partner may take into account on its own tax return its distributive share of charitable deductions even if those deductions exceed the partner's basis in its partnership interest. The SFC proposal would limit a partner's share of charitable deductions and foreign taxes to its outside basis. Accordingly, a partner would not be able to take into account such items if they exceed the partner's outside basis.

Real Estate

The SFC proposal includes a material limitation on the ability to use excess losses (deductions from active trades or businesses over income from active trades or businesses) against non-business income, such as wages, interest or dividend income, that will be a material change for real estate professionals. This provision would provide that excess business losses (above $250,000 for single taxpayers and $500,000 for married taxpayers filing jointly) of a taxpayer other than a C corporation (e.g., losses from sole proprietorships) are not allowed for the taxable year. They are carried forward and treated as part of the taxpayer's NOL carryforward in subsequent taxable years. The provision is scored as a $175.6 billion revenue raiser.

Interaction with Passthroughs Deduction

Dividends received by partnerships from real estate investment trusts (other than capital gain dividends) are treated as qualified business income for purposes of the 17.4% deduction for individual taxpayers as discussed above.

Interest Deductibility

A real estate business can elect out of the new cap on interest deductibility, which would cap business interest expense at 30% of adjusted taxable income. If an election out is made, the real estate business must use the Alternative Depreciation System 40 year recovery period for real property and a 20 year recovery period for related improvements, i.e., no immediate expensing. Special rules will apply to corporate owners of pass through entities to avoid double counting. Any interest not allowed as a deduction is allowed as an indefinite carryforward.

As noted above in the discussion of individual provisions, the SFC proposal retains the mortgage interest deduction for residential real estate for mortgages up to $1 million, but eliminates the deductions for property taxes.

Depreciation

The SFC proposal shortens depreciable lives for real estate to 25 years and 10 years for leasehold improvements, and allows for immediate expensing for most other property. Taxpayers electing to use the real estate exception to the interest limitation do not qualify.

Like Kind Exchanges

As noted above, the SFC proposal retains like-kind exchanges only for real estate.

Reforming the International Tax System

Mandatory Deemed Repatriation

As anticipated, the SFC proposal includes mandatory deemed repatriation at different rates for cash and non-cash items. The proposal implements the deemed repatriation through subpart F by increasing the annual inclusion for the year after enactment to include no less than the accumulated deferred foreign income of the corporation. The measuring date for the inclusion is November 9, 2017 (the day the proposal was released) or “other applicable measurement date as appropriate.” Note that this differs from the House bill, which would require taxpayers to measure earnings and profits as of November 2, 2017 or December 31, 2017, whichever amount is higher. Accumulated deferred foreign income is defined as profits not previously taxed and not attributable to ECI of a U.S. trade or business or subpart F income. This amount is measured from 1986 to present, but only for periods during which the entity was a specified corporation.

The proposal achieves disparate rates of 10% and 5% for cash and noncash assets through deductions – *i.e.* the U.S. shareholder may deduct as much of the aggregate earnings and profits attributable to each category of accumulated deferred foreign income as is necessary to reach the designated rate. The proposal indicates that more rules will be forthcoming about the definition and counting of cash and non cash assets. Foreign tax credits will be allowed, but at a haircut rate. The disallowed portion of foreign tax credits is 71.4% for those attributable to the portion of the section 965 inclusion attributable to the aggregate cash position, and 85.7% for the remaining portion of the section 965 inclusion. Companies should be aware that the rates for mandatory deemed repatriation are one of many "dials" that Congress can turn to achieve its revenue targets, and these rates may increase as the proposal is debated if additional revenue is needed.

The SFC proposal extends the usual three year statute of limitations period to eight years for any underpayments related to the mandatory deemed repatriation. U.S. shareholders also have the ability to pay tax on the deemed repatriation over eight years. This election would require five installment payments of 8% of the liability, and then three installments of 15%, 20% and 25%, respectively. No interest would be charged on timely installment payments, and an acceleration rule would be put into place for failure to pay in a timely manner, if there is a liquidation or sale of substantially all of the U.S. shareholder’s assets, if the U.S. shareholder ceases business, or under similar circumstances. There is also a special provision for U.S. shareholders which are S corporations which allows those shareholders to defer the tax.

The tax on the deemed repatriation is also recaptured if a U.S. shareholder that paid the tax expatriates within 10 years of enactment. If the U.S. shareholder becomes an expatriated entity within the meaning of section 7874(a)(2), any deduction claimed with respect to the mandatory inclusion is denied and a 35% rate is imposed on the entire inclusion. This provision does not apply to entities that become a surrogate foreign corporation that is treated as a domestic corporation under section 7874(b).

Transition to a Territorial System

The SFC proposal transitions to a territorial system by creating a 100% dividends received deduction (DRD) for distributions from “specified 10-percent owned foreign corporations” to domestic corporations that are U.S. shareholders (as defined by section 951(b)). Any foreign corporation, other than a PFIC that is not a Controlled Foreign Corporation (CFC), which has a domestic corporation U.S. shareholder is a “specified 10-percent owned foreign corporation” for purposes of the DRD. The DRD only applies to the foreign-source portion of the dividend – *i.e.* the portion of the dividend that bears the same ratio to the dividend as the undistributed foreign earnings bears to the total undistributed earnings. “Total undistributed earnings” is the corporation’s year-end E&P not reduced by dividends distributed during the taxable year, and “undistributed foreign earnings” is the portion of undistributed earnings attributable to neither income described in section 245(a)(5)(A) nor section 245(a)(5)(B), without regard to section 245(a)(12).

The DRD is disallowed for “hybrid dividends” (dividends that are deducted or receive some other tax benefit in the local jurisdiction and which would otherwise be eligible for the DRD). Hybrid dividends received by a CFC from another CFC are treated as subpart F income of the receiving CFC. No foreign tax credit or deduction is allowed for taxes paid or accrued with respect to the dividend that qualifies for the DRD. Only domestic corporations that were 10% U.S. shareholders with respect to the distributing foreign entity for 365 days or more of the 731-day period prior to the date that is 365 days before the date on which "the share becomes ex-dividend with respect to the dividend" are permitted the DRD.

The proposal extends the DRD to amounts that would ordinarily be included in income under section 1248 for the sale by a domestic corporation of stock in a foreign corporation. A sale by a CFC of a lower-tier CFC, if treated as a dividend under section 964(e)(1), is treated as subpart F income to the extent of the foreign-source portion, the U.S. shareholder(s) includes its pro rata share of that subpart F income, and the U.S. shareholder is allowed a deduction under section 245A(a). The proposal also contains a branch loss recapture rule upon the transfer of branch assets to a specified 10-percent owned foreign corporation.

Tax on “Global Intangible Low-Taxed Income”

The SFC proposal contains provisions directed at passive and mobile income which require current inclusion in the income of U.S. shareholders of “global intangible low-taxed income” (GILTI). This provision introduces several new terms:

- GILTI: “the excess (if any) of the shareholder’s net CFC tested income over the shareholder’s net deemed tangible income return.”
- Net CFC tested income: The excess of the aggregate of the U.S. shareholder’s pro rata share of the tested income of each CFC with respect to which it is a U.S. shareholder over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a U.S. shareholder.
  - CFC tested income: The excess (if any) of the gross income of the corporation determined without regard to certain exceptions to tested income:
    1. The corporation’s ECI
    2. Gross income taken into account in determining the corporation’s subpart F income
    3. Gross income excluded from foreign base company income or insurance income by reason of the high-tax exception
    4. Any dividend received from a related person
    5. Foreign oil and gas extraction income and foreign oil related income

    Over deductions (including taxes) properly allocable to such gross income.

- o CFC tested loss: The excess (if any) of deductions (including taxes) properly allocable to the corporation's gross income determined without regard to the tested income exceptions over the amount of such gross income.

- Net deemed tangible income return: 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC with respect to which it is a U.S. shareholder.

  - o QBAI: The average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under section 167.

  - o Specified tangible property: Any property used in the production of tested income or tested loss. If the property generates both tested and non-tested income, it is treated as specified tangible property in proportion to the income generated for each.

The GILTI amount is included in the U.S. shareholder's gross income in the same manner as subpart F income, though the proposal indicates that rules may be needed to coordinate the GILTI inclusion with other subpart F inclusions. The proposal also allows for a deemed-paid credit for taxes attributable to tested income equal to 80% of the product of the corporation's inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued with respect to tested income, by each of the U.S. shareholder's CFCs. Inclusion percentage is defined as the ratio of such corporation's GILTI amount divided by the aggregate amount of its pro rata share of the tested income of each of its CFCs. Tested foreign income taxes is defined as foreign income taxes paid or accrued by the CFC and attributable to the CFC's tested income. There is a separate foreign tax credit basket for GILTI, and excess credits in the basket may not be carried forward or backward.

Miscellaneous Modifications to Subpart F

The SFC proposal eliminates or modifies several other aspects of subpart F. The SFC proposal would eliminate the foreign base company oil related income category, index for inflation the $1,000,000 de minimis amount for foreign base company income, repeal section 955, and provide for downward attribution from a foreign person to a related U.S. person for purposes of section 958(b). It is worth noting that, as proposed, the downward attribution rules could potentially create CFCs for companies that are not below a U.S. entity. This could lead to the filing of numerous Forms 5471, dwarfing the compliance required for country-by-country reporting for multinational groups.

In addition, the proposal would expand the definition of "U.S. shareholder" to include any U.S. person who owns 10% or more of the total value of shares of all classes of stock of a foreign corporation (currently, only ownership of voting stock is considered in determining whether a person is a U.S. shareholder), and would eliminate the 30 day requirement for foreign corporations to be considered CFCs.

Further, the proposal makes the related party look-through rule permanent, and amends 956 to provide an exception for domestic corporations that are U.S. shareholders in the CFC either directly or through domestic partnerships.

Anti-Base Erosion Measures

A variety of anti-base erosion mechanisms accompany this switch to a territorial system of taxation. The first targets interest stripping by limiting interest deductions when a domestic corporation is part of a "worldwide affiliated group" which incurs a certain ratio of indebtedness. This proposal applies the section 1504 definition of affiliated group but at a 50% (not 80%) ownership threshold, to the worldwide group. The interest deduction for the domestic entity is reduced by the product of the domestic corporation's net interest expense multiplied by the "debt-to-equity differential percentage" of the worldwide affiliated group. For purposes of this calculation, the terms are defined as follows:

- <u>Debt to equity differential percentage</u>: the excess domestic indebtedness of the group divided by the total indebtedness of the domestic corporations that are members of the group.

- <u>Excess domestic indebtedness</u>: The amount by which the total indebtedness of the U.S. members exceeds 110% of the total indebtedness those members would hold if their total indebtedness to total equity ratio were proportionate to the ratio of total indebtedness to total equity in the worldwide group.

- <u>Total equity</u>: The excess (if any) of (1) the money and all other assets of such corporations, over (2) the total indebtedness of such corporations.

For purposes of these calculations, all U.S. members are treated as one member, and intragroup debt and equity interests are disregarded.

The SFC proposal next addresses outbound transfers of intangibles, stating that workforce in place, goodwill and going concern value, and the residual category are intangible property within the meaning of section 936(h)(3)(B), and removes the flush language at the end of that provision. This proposal also allows the Commissioner to specify the method to be used to determine the value of intangible property for outbound transfers and intercompany pricing. In particular, the proposal blesses valuing multiple transferred intangible assets in the aggregate, and codifies the realistic alternative principle.

The proposal also denies deductions for amounts paid or accrued in a hybrid transaction, but leaves substantial authority to the Secretary to issue regulations and other guidance to carry out the proposal. In particular, the SFC proposal delegates rulemaking authority to address conduit arrangements, application to foreign branches, structured transactions, preferential tax regimes, participation exemption systems, determining tax residence, and general exceptions.

The foreign tax credit system would be modified under the SFC proposal by repealing section 902 indirect foreign tax credits and granting the Secretary authority to issue regulations on section 960 credits, which are also to be altered

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under the proposal. In addition, the proposal requires foreign branch income to be allocated to a specific foreign tax credit basket, and accelerates the effective date of the worldwide interest allocation rules to apply to taxable years beginning after December 31, 2017, not 2020. The SFC proposal would also alter the sourcing rules for income from sales of inventory that is produced partly in and partly outside the United States to allocate and apportion it based on the location and production with respect to the property.

The Senate responded to the House excise tax with a base erosion minimum tax (the BEAT) that is targeted at inbound companies. This proposal was championed by Professor Itai Grinberg at the Senate Finance hearing on October 3, 2017. The base erosion minimum tax amount is the excess of 10% of the taxpayer's "modified taxable income" over the taxpayer's "regular tax liability" (defined in section 26(b)) reduced by the excess (if any) of credits allowed under Chapter 1 over the general business credits allocable to the section 41(a) research credit. The relevant terms are defined as follows:

- <u>Modified taxable income</u>: Taxable income of the taxpayer computed under chapter 1, without regard to any base erosion tax benefit with respect to any base erosion payment, or the base erosion percentage of any net operating loss deduction allowed under section 172.

- <u>Base erosion payment</u>: Any amount paid or accrued to a foreign related person for which a deduction is allowable, including amounts paid in connection with an acquisition of property subject to the allowance of depreciation or amortization. The tax would not require the add-back of cost of goods sold, which is in stark contrast to the House excise tax. This also includes payments that reduce gross receipts and paid to a related surrogate foreign corporation and foreign persons in the same expanded affiliated group as the surrogate foreign corporation.

- <u>Base erosion tax benefit</u>: Any deduction allowed with respect to a base erosion payment.

  Note: this does not include payments on which tax is imposed by sections 871 or 881 or withheld under section 1441 or 1442. However, there is a proration in the event that withholding taxes are partially reduced.

- <u>Base erosion percentage</u>: The percentage determined by dividing the aggregate amount of base erosion tax benefits by the aggregate amount of the deductions allowable to the taxpayer under Chapter 1 for the taxable year, taking into account base erosion tax benefit for which a deduction is allowed under Chapter 1 and by not taking into account any deduction allowed under sections 172, 245A or 250.

This provision applies to taxpayers other than Regulated Investment Companies (RICs), Real Estate Investment Trusts (REITs), and S corporations with average annual gross receipts of at least $500 million for the past three years. The provision also includes additional reporting requirements under section 6038A.

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Conclusion

The week of November 13 will be the busiest week for tax reform in recent memory, and has the potential to be highly productive. The SFC will debate the conceptual mark, with the goal of issuing legislative language soon after the completion of the mark up. Meanwhile, the House is trying to schedule a vote on the tax reform bill passed out of W&M, to satisfy their self-imposed deadline of passing a tax bill by Thanksgiving.

While many taxpayers have been analyzing the proposals and determining how their business would be affected, the window for Congressional outreach is closing. As a result, taxpayers interested in participating in the legislative process should take action sooner rather than later.