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A Good Piece of Music? The Senate Releases Its "Conceptual Mark" for 2018 Tax Reform

President Barack Obama is quoted as saying, "A good piece of legislation is like a good sentence, or a good piece of music. Everybody can recognize it. They say, Huh. It works. It makes sense." Well, on November 9, 2017, the Joint Committee on Taxation released a 247-page lead sheet on the "Tax Cuts and Jobs Act," tax reform legislation being proposed by the Senate Finance Committee (Senate Tax Reform Proposals).[1] The Senate Tax Reform Proposals were not accompanied by proposed legislative language and are being described as a "conceptual mark."[2] While the Senate Tax Reform Proposals follow the beat of the House Ways & Means Committee's tax reform bill (Ways & Means Bill),[3] they certainly have their own tune. We'll leave it to our readers to decide whether these concepts constitute a one-hit wonder or a classic for the ages.

The Senate Tax Reform Proposals would implement a sweeping revision of the US Tax Code. We have divided our discussion into 10 sections: (i) business generally, (ii) international taxation, (iii) financial institutions, (iv) compensation taxation, (v) individuals, (vi) partnerships (vii) real estate, (viii) tax-exempt organizations, (ix) insurance and (x) the life settlement industry. As a quick takeaway, rates would be going down significantly for corporations and manufacturing businesses; the United States would be migrating to a territorial system in the international arena; deductions would be limited for individuals; real estate would be getting some additional tax breaks; the tax exemption for tax-exempt organizations would be limited; and the life settlement industry would become subject to significant tax reporting. From a tax policy wonk's perspective, let there be music to fill the air.

Tax Changes Proposed for Business

20 Percent Corporate Tax Rate. The Senate Tax Reform Proposals would tax income earned by C corporations at a flat 20 percent for tax years beginning after December 31, 2018. (The Ways & Means Bill would impose the same rate, but for tax years beginning after December 31, 2017.) A spokesman for the Trump administration has stated that the president would not oppose this effective date.[4] The Senate proposal would repeal the corporate alternative minimum tax in tax years beginning after December 31, 2017.

It is important to note that the delayed effective date, coupled with the new allowance for expensing equipment purchases (described below), which would apply to purchases made as early as September 21, 2017, could result in significant capital investments in the US economy. Specifically, the expensing deduction is much more valuable in a 35 percent tax rate environment than it is in a 20 percent tax rate environment. Such incremental value should compel taxable corporations considering capital investments to accelerate such investments into

the remainder of 2017 and 2018. It appears that the Senate specifically considered and approves of this arbitrage.[5]

Accelerated Tax Income Recognition. The Senate Tax Reform Proposals would require taxpayers (even if not publicly traded) who prepare financial statements to include items of income at the earlier of the time that the income accrues for tax purposes and the time that the income is taken into account for financial statement purposes. The rule would override the rules for OID (original issue discount) and interest. Income recognized on the long-term contract method of accounting would be exempt. In addition, the Senate proposal would codify the one-year deferral rule of Revenue Procedure 2004-34. These rules would apply to tax years beginning after 2017.

5-Year Expensing for New Property. The Senate Tax Reform Proposals would permit full expensing of new property placed in service on or after September 27, 2017, and before 2023. (In contrast to the Ways & Mean Bill, used property would not qualify for expensing.) The Senate proposal would allow taxpayers to elect to claim a 50 percent allowance. Public utility property and energy transportation equipment would be excluded.

Small Business Expensing. Current law permits taxpayers to expense up to $500,000 of qualifying property placed into service in a given year.[6] The deduction is phased out if the taxpayer places more than $2 million of property in service. The Senate Tax Reform Proposals would increase these amounts to $1 million and $2.5 million, respectively, beginning in 2018. In addition, the Senate proposal would expand the provision to include improvements to nonresidential real property.

Repeal of Domestic Production Deduction. The Senate Tax Reform Proposals would repeal the deduction for income attributable to domestic production activities for tax years beginning after December 31, 2017.

Revised NOL Rules. The Senate Tax Reform Proposals follow the Ways & Means Bill by proposing to (i) limit the use of net operating losses (NOLs) to 90 percent of taxable income, (ii) delete any ability to carry-back such losses and (iii) provide for an indefinite carry-forward. The 90 percent limitation would apply beginning in 2018 regardless of when the loss was incurred. The latter two rules would apply to NOLs arising after 2017.

New Limits on the Deduction of Interest. The Senate Tax Reform Proposals would limit the ability to deduct business interest expense to the sum of (i) business interest income and (ii) 30 percent of adjusted gross income. For this purpose, gross income would be reduced by non-business income, NOLs and business interest income. Notably, in contrast to the current Code § 163(j) and the Ways & Means Bill, "adjusted gross income" would factor depreciation and amortization deductions (i.e., the Senate Tax Reform Proposals use EBIT rather than EBITDA). This would generally result in a more stringent limitation. Any business interest disallowed in a given year could be carried forward indefinitely. Because the limitation only applies to net interest expense, financial institutions generally should not be disproportionately affected.

The limitation would apply at the partnership level when interest expense is incurred by a partnership. Rules are provided so that income is not double counted (once when earned by the partnership and again when it is passed through to the partner). In addition, income that is not counted by a partnership in determining its interest deduction may be taken into account by the partner in determining its interest expense.

Reduction in the DRD. The US Tax Code provides a tax deduction for a portion of the dividends received by a corporation, recognizing that without such a deduction, dividends would be subject to triple or greater taxation.[7] This deduction is referred to as the

dividend received deduction (DRD). The Senate Tax Reform Proposals would reduce the DRD to 50 percent for portfolio dividends (down from 70 percent), that is, dividends paid on stocks in which the recipient owns less than 20 percent of the payr. The DRD on stocks in which the recipient owns at least 20 percent but less than 80 percent would be reduced to 65 percent (from 80 percent). Both proposals would be effective for tax years ending after December 31, 2018, and have the effect of reducing the DRD to take into account the lower corporate income tax rate. The 100 percent DRD for dividends from companies owned 80 percent or more by the payee would not be affected.

Cash Method Accounting Expansion. The US Tax Code currently restricts the use of the cash method of accounting for C corporations and partnerships with C corporation partners.[8] The Senate Tax Reform Proposals would expand the ability to use the cash method of accounting to businesses with average annual gross receipts of $15 million or less for the prior three years. (Qualified personal service companies and other businesses that can use the cash method of accounting without regard to average annual gross receipts would continue to be able to use the cash method.) In addition, the proposal would expand the ability of C corporations engaged in farming to use the cash method. The Senate Tax Reform Proposals would also simplify inventory accounting, and provide exemptions from the uniform capitalization rules, for businesses eligible to use the cash method. These changes would be effective beginning in 2018.

Fringe Benefits. The Senate Tax Reform Proposals would disallow deductions for qualified transportation fringe benefits, any entertainment activities, club membership dues and facilities associated with entertainment or clubs (presumably including in-house gymnasiums) beginning in 2018. A 50 percent deduction would still be permitted for food and beverages at eating facilities that constitute a *de minimis* fringe benefit.

International Tax Proposals

Transition to a Territorial System - The Participation Exemption. Like the Ways & Means Bill, the Senate Tax Reform Proposals introduce a "participation exemption" for foreign-source dividends received from non-US subsidiaries beginning in 2018. Specifically, dividends attributable to non-US source income paid by a foreign corporation to a US corporation that owns 10 percent or more of the stock of the distributing corporation would be effectively exempt from US tax (through a 100 percent dividend-received deduction). No direct or indirect foreign tax credits would be allowed with respect to exempt dividends. To benefit from this exemption, the US shareholder must meet a minimum holding period (more than 365 days during the 731-day period beginning 365 days before the *ex dividend* date).[9] In addition, the dividend-received deduction would not be available if the payer received a tax benefit or other deduction from the foreign country (a "hybrid dividend").

The Senate Tax Reform Proposals clarify that the participation exemption would also apply to gain from the sale of stock of foreign subsidiaries to the extent such gain is characterized as a dividend under Section 1248 of the US Tax Code.

Notwithstanding the participation exemption, US corporations would still be subject to US tax on any foreign income earned through a branch or disregarded entity.

Consistent with the shift to a territorial system, the Senate Tax Reform Proposals would repeal the Section 956 "deemed dividend" rules for US corporations that are shareholders of a controlled foreign corporation (CFC), including through a domestic partnership. As a result, those US corporate shareholders would not be subject to US tax on the CFC's earnings that are

invested in US property (e.g., when a CFC holds a debt obligation of its US shareholder).

Deemed Repatriation Tax or "Toll Charge." Similar to the Ways & Means Bill, the Senate Tax Reform Proposals would impose a one-time tax on the non-previously taxed post-1986 earnings of foreign subsidiaries. The tax would apply to US shareholders that own 10 percent or more of the stock of a foreign corporation. The earnings of the foreign subsidiaries would be measured as of November 9, 2017, (or "other applicable measurement date as appropriate") and would be includible in income by the US shareholder in the last tax year that begins before January 1, 2018.

This one-time tax would be imposed at a 10 percent rate for foreign earnings attributable to cash and other liquid assets and at a 5 percent rate for the remainder of the earnings (that is, earnings that are treated as reinvested in illiquid assets).[10] Foreign tax credits would be allowed for the attributable portion of the foreign subsidiaries' foreign tax pools, subject to haircuts to account for the reduced rate at which the deemed repatriation tax is imposed. US shareholders may offset the earnings of their foreign subsidiaries with post-1986 accumulated deficits of other foreign subsidiaries as of the measurement date.

As in the Ways & Means Bill, taxpayers would be allowed to pay this deemed repatriation tax in up to eight annual installments. However, while the Ways & Means Bill provided for equal payments, the Senate Tax Reform Proposals would allow taxpayers to backload the installments so that they are required to settle only 40 percent of the tax liability in the first five years.

Finally, a recapture provision would require a US shareholder that becomes an "expatriated entity" in an inversion transaction in the succeeding ten years to pay the repatriation tax at a 35 percent tax rate with no additional foreign tax credits.

Rules Relating to Intangible Income - The "GILTI" Regime. With some resemblance to the "foreign high returns" provisions in the Ways & Means Bill, the Senate Tax Reform Proposals provide that a US shareholder of any CFC would be currently taxed on its "global intangible low-taxed income" or "GILTI." (We did not make up this acronym.) Consistent with its sister provision in the Ways & Means Bill, this regime would mainly affect US multinationals earning significant income from intellectual property in low-tax jurisdictions. The Senate Tax Reform Proposals would offer a 37.5 percent deduction over the GILTI amount, resulting in the GILTI being taxed at a 12.5 percent effective rate. The deduction for "foreign-derived intangible income" included in the Senate Tax Reform Proposals would also result in a 12.5 percent effective tax rate for intangible income derived directly by a U.S. corporation from the sales of goods and services to foreign persons for foreign use.

The GILTI is any excess of (1) the shareholder's aggregate net income from its CFCs *over* (2) a "deemed tangible income return" equal to 10 percent of the shareholder's *pro rata* share of the aggregate adjusted bases of the CFCs' depreciable tangible property.

Inclusions of GILTI would carry foreign tax credits equal to 80 percent of the otherwise allowable amount. The Senate Tax Reform Proposals would create a separate foreign tax credit basket for GILTI, with no carry-forward or carry-back for excess credits.

The GILTI regime would apply for tax years beginning after December 31, 2017.

Special Rule for IP Repatriation. The Senate Tax Reform Proposals would reduce (and in some cases eliminate) the tax cost of repatriating into the US intangible property held by a CFC. This incentive seeks to

encourage US multinationals to bring their IP onshore in connection with the reduction of the US corporate tax rate.

Specifically, if a CFC distributes certain intangible property to a US shareholder, the fair market value of that property on the date of distribution shall be treated as not exceeding the adjusted basis of the property in the hands of the CFC immediately before the distribution. The US shareholder would then take a carryover basis in the intangible property. For this benefit to apply, the CFC must have held the intangible property as of the date of enactment of the proposal and the distribution must occur during the first three tax years beginning after December 31, 2017.

Expansion of Rules for Outbound Transfers of Intangibles. The Senate Tax Reform Proposals expand when outbound transfers of intangibles to foreign corporations would be taxable. In this regard, the Senate Tax Reform Proposals would generally put into law the approach recently adopted by the Internal Revenue Service (IRS) in which outbound transfers of workforce in place, goodwill and going concern value are treated as transfers of intangible property subject to tax under the "deemed royalty" regime of Section 367(d). [11] Importantly, the Senate Tax Reform Proposals also pick up transfers of domestic, as well as foreign, goodwill.

Limit on Deduction of Interest Expense for Excess Domestic Indebtedness. Along the lines of the Ways & Means Bill, the Senate Tax Reform Proposals include a provision that, beginning in 2018, would disallow interest expense deductions for US corporations that are overleveraged compared to their worldwide affiliated group. For any US corporation that is a member of a worldwide affiliated group, the Senate Tax Reform Proposals would disallow the interest expense attributable to its "excess domestic indebtedness." Excess domestic indebtedness is the amount by which the total indebtedness of the US members of the group exceeds 110 percent of the amount of indebtedness those members would hold if their debt-to-equity ratio were proportionate to the worldwide group's debt-to-equity ratio.

Similar to that of the Ways & Means Bill, this limitation based on the group's leverage ratio would only apply to the extent it is greater than the 30 percent of EBIT limitation described above. The amount of any interest disallowed as a deduction can be carried forward indefinitely.

The "Base Erosion Minimum Tax." The Senate Tax Reform Proposals would introduce a minimum tax regime, to begin in 2018, based on a modified taxable base that adds back deductions for "base erosion payments." The Base Erosion Minimum Tax would equal the excess of (1) 10 percent of the taxpayer's "modified taxable income" for the tax year *over* (2) the regular tax liability for the year reduced by certain tax credits. The "modified taxable income" over which the minimum tax is calculated is the taxable income determined without regard to any deductions with respect to any "base erosion payments" and without regard to a proportion of the NOL carryovers equal to the "base erosion percentage."[12]

A "base erosion payment" is a payment made to a related foreign person that is deductible or includable in the basis of a depreciable or amortizable asset. Payments that are included in cost of goods sold (e.g., purchases of merchandise) would not be considered base erosion payments unless the recipient is a related "surrogate foreign corporation" (or an affiliate thereof) resulting from an inversion transaction. A payment would not be considered a base erosion payment to the extent it is subject to US withholding tax.

This base erosion minimum tax would apply to corporations that have (1) average annual gross receipts of at least $500 million in the preceding three-year period and (2) a base erosion percentage of 4 percent or higher for the tax year. Regulated investment companies,

real estate investment trusts and S corporations would be exempt from the minimum tax.

The proposed minimum tax appears to have a less draconian effect than the excise tax originally proposed in the Ways & Means Bill.

Disqualified Expenses Paid in Hybrid Transactions or to Hybrid Entities. The Senate Tax Reform Proposals would deny a deduction for any "disqualified related party amount" paid pursuant to a "hybrid transaction" or to a "hybrid entity." A disqualified related party amount is any interest or royalty paid to a foreign related party to the extent that, under the laws of such party's country of residence, there is no corresponding income inclusion or the related party is allowed a deduction for a corresponding amount. A hybrid transaction is any transaction or instrument wherein payments are treated as interest or royalties for US tax purposes but not so under the tax laws of the recipient's country of residence. A hybrid entity is any entity which is treated as fiscally transparent for US tax purposes but not for foreign tax purposes or vice versa. This proposal would be effective for tax years beginning after December 31, 2017.

Modifications to CFC/Subpart F Regime. The Senate Tax Reform Proposals would incorporate a number of modifications to the Subpart F regime. Notably, they would expand the definition of "US shareholder" to include US persons that own 10 percent of the vote *or value* of a foreign corporation (the definition under current law focuses exclusively on voting power), and would modify certain stock attribution rules in the determination of CFC status Importantly, these two changes would be effective for the 2017 tax year.

Like the Ways & Means Bill, the Senate Tax Reform Proposals would eliminate the requirement that a corporation be a CFC for 30 uninterrupted days during the year for the Subpart F regime to apply.

Foreign base company oil related income would no longer constitute Subpart F income subject to current US taxation.

The "look-through" exemption for dividends, interest, rents and royalties received from related CFCs would be made permanent (this look-through exemption is currently scheduled to expire after 2019).

Sourcing of Inventory Sales. The Senate Tax Reform Proposals would no longer treat as foreign source income up to 50 percent of the income from the sale of inventory produced within the United States and sold abroad (or vice versa). Instead, as in the Ways & Means Bill, this income would be sourced solely based on the location of the production activity.

Separate Foreign Tax Credit Basket for Foreign Branch Income. Beginning in 2018, foreign source income earned through one or more branches in one or more countries would be allocated to a separate foreign tax credit basket.

Acceleration of Election to Allocate Interest Expense on Worldwide Basis. Section 864(f) of the US Tax Code permits taxpayers to make a one-time election to allocate and apportion interest expense on a worldwide basis. The effective date of Section 864(f) has been continually postponed and is currently set for tax years beginning after December 31, 2020. However, the Senate Tax Reform Proposals would accelerate this effective date to tax years beginning after December 31, 2017.

Repeal of Fair Market Value Election for Interest Expense Apportionment. The Senate Tax Reform Proposals would no longer allow taxpayers to use the fair market value of assets to apportion interest expense between foreign and domestic source income. Instead, in

all cases taxpayers would be required to use the adjusted tax bases of assets.

Tax (and Withholding) on Disposition of Partnership Interests. The Senate Tax Reform Proposals address a long-standing controversial issue regarding the treatment of gains from the sale by nonresidents of interests in a partnership engaged in a US trade or business. The IRS had ruled that a portion of the gain from the disposition of a partnership interest may be treated as income effectively connected with the conduct of a US trade or business to the extent the gain from a hypothetical sale of the partnership's assets would be treated as such.[13] The Tax Court, however, recently rejected the ruling in the *Grecian Magnesite* case,[14] concluding that gain from the sale or exchange by a foreign person of a partnership interest shall be treated as foreign source income, even when the partnership is engaged in a US trade or business. Beginning in 2018, the Senate Tax Reform Proposals would override *Grecian Magnesite* and would treat gain or loss from the sale or exchange of a partnership interest as effectively connected with a US trade or business to the extent the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value.

In addition, the Senate Tax Reform Proposals would implement a withholding regime for transfers of partnership interests (presumably, only applicable to interests in partnerships engaged in a US trade or business). Upon the transfer of the partnership interest, the transferee would be required to withhold 10 percent of the amount realized on the sale or exchange unless the transferor certifies its status as not being a nonresident alien individual or foreign corporation.[15]

Surrogate Foreign Corporations Not Eligible for Qualified Dividend Rates. The Senate Tax Reform Proposals would deny the preferential "qualified dividend income" rate to dividends distributed by a foreign corporation that is treated as a "surrogate foreign corporation" under Section 7874 (i.e., the foreign acquiror in an inversion transaction within the 60 percent-80 percent shareholder continuity range). This rule would apply to dividends paid in tax years beginning after December 31, 2017.

Repeal of DISCs and IC-DISCs. The Senate Tax Reform Proposals would repeal the special rules for Domestic International Sales Corporations (DISCs) and Interest Charge Domestic International Sales Corporations (IC-DISCs). Any DISC or IC-DISC elections would automatically terminate effective as of the first tax year beginning after December 31, 2018.

Taxation of Passenger Cruise Income. The Senate Tax Reform Proposals would create the new category of "passenger cruise gross income" and provide that such income is effectively connected with the conduct of a US trade or business to the extent of the portion of the voyage that occurs in US territorial waters. Passenger cruise income would include all income from on and off-board activities, services or sales with respect to passengers.

Tax Changes Directed at Financial Institutions

FDIC Premiums. Beginning after 2017, banks with consolidated assets in excess of $50 billion would not be entitled to deduct FDIC deposit insurance premiums. Banks with assets in excess of $20 billion, but less than $50 billion, would be required to scale back their deductions for FDIC premiums. Financial institutions with consolidated assets of less than $20 billion would remain entitled to deduct FDIC premiums in whole.

Basis Reporting. While cast as a change to the rules relating to basis reporting, the Senate Tax Reform Proposals would actually affect investors more than financial institutions. Specifically, beginning in 2018, the Senate Tax Reform Proposals would require the use of

first-in first-out basis allocation for sold securities except to the extent that the average basis method is allowed. Since longer-held securities generally have more gain than shorter-held securities, this reporting is likely to cause investors to be considered to sell lower basis securities before higher basis securities.

Changes to Compensation Taxation

Non-Qualified Deferred Compensation Plan Rules to Be Tightened. In a provision that resembles the changes made to the deferred compensation rules applicable to offshore deferred compensation, the Senate Tax Reform Proposals would currently tax deferred compensation for services performed after 2017 unless the payment of the deferred compensation is contingent upon the performance of future services. (Current law permits deferral if the deferred compensation remains subject to the risk of the employer's payment.) Compensation deferred prior to 2017 may continue to be deferred until 2026, at which time it would be taxed or it must be made contingent upon the performance of future services. Employers with existing deferred compensation plans would be required to amend their plans to take these changes into account and would be able to do so without causing an acceleration of income in the year of change.

These new rules are proposed to apply to non-qualified stock options and stock appreciation rights (SARs) as well as cash plans. Incentive stock options (ISOs) would not be affected by the new rules. Conversely, severance plans would be encompassed by the new rules.

Deduction Limits for Highly Compensated Employees of Public Companies. Current law limits the amount of annual compensation that may be deducted by a publicly traded corporation to $1 million for CEOs and the other four most highly compensated officers, except to the extent the compensation is performance-based. The Senate Tax Reform Proposals would repeal the current law exception for performance-based compensation and commissions. In addition, the Senate Tax Reform Proposals would limit the US compensation deduction for foreign corporations with stock traded in the United States through ADRs. The Senate Tax Reform Proposals would also expand the scope of the rule to encompass compensation paid to the principal executive and financial officers.

Work Classification Safe-Harbor. The Senate Tax Reform Proposals would create a safe-harbor allowing workers and service recipients to avoid classifying the worker as an employee. This would alleviate the requirement that the service recipient withhold and pay applicable federal income and employment taxes. Service recipients and workers would be able to take advantage of this safe-harbor if the following requirements, which are stringent to the point of being of limited utility, are met:

1. The worker is an individual (natural person) or an entity, provided services are performed by a natural person who owns an interest in the entity;
2. The worker cannot own an interest in the service recipient (an exemption would be provided for stock in publicly traded service recipients);
3. The worker must incur expenses, a significant portion of which are reimbursed by the service recipient;
4. The worker must be employed for a particular amount of time or a specific task;
5. The worker must have made a significant investment in assets or training and not be under an obligation to provide exclusive services to the service recipient;
6. The worker's compensation must not be primarily tied to the number of hours worked;

7. The worker must not have been an employee performing substantially the same services within the past year; and
8. There must be a two-year or shorter contract, containing specified information, between the service recipient and the worker (which can be renewed).

The proposal would apply beginning in 2018 and new reporting requirements would take effect for payments made in 2019 and after.

Tax Changes Proposed for Individuals

Lowering of Top Marginal Rate. AMT Repeal. The Senate Tax Reform Proposals would lower the top marginal rate, beginning in 2018, from 39.6 percent to 38.5 percent. The new top marginal rate would apply to taxable incomes of $500,000 or more for single filers and $1 million for married couples filing joint returns (up from $418,400 and $470,700, respectively). The "kiddie tax" would be simplified by applying the rates for trusts and estates instead of the parents' marginal rate. The standard deduction would be increased to $24,000 for married individuals and $12,000 for all other taxpayers and the personal exemption deduction would be repealed. The individual AMT would be repealed beginning in 2018.

Pass-Through Income. The Senate Tax Reform Proposals would provide a 17.4 percent deduction for "domestic qualified business income" earned from a partnership, S corporation or sole proprietorship. Service income is not eligible for the deduction if the taxpayer has taxable income in excess of $150,000. Qualified business income is any income other than specified services income, which includes, among others, health, law, engineering, architecture, accounting and financial services. If the taxpayer earns the qualified business income through an S corporation or partnership and has W-2 income, the deduction is limited to 40 percent of the W-2 wages.

Repeal of State and Local Tax Deduction. The Senate Tax Reform Proposals would deny deductions to individuals for any state or local taxes, unless such taxes are incurred in connection with the conduct of a trade or business or a for-profit activity. It appears that the Senate Tax Reform Proposals would allow state and local tax deductions for partners in professional service firms, in contrast to the Ways & Means Bill, which as amended would deny such deductions.

Repeal of Miscellaneous Itemized Deductions. The Senate Tax Reform Proposals would deny deductions for all miscellaneous itemized deductions, beginning in 2018. The repeal would deny deductions for investment management fees, including fees charged by hedge funds, and would deny deductions for transactions entered into for profit, including losses from swap (notional principal contract) transactions and from foreign exchange transactions that taxpayers had not elected to treat as capital transactions.

Gift and Estate Tax Exclusion. The Senate Tax Reform Proposals would increase the unified credit from $5 million to $10 million for tax years in 2018 and thereafter. Interestingly, the credit would be indexed for inflation from 2011, there by increasing the exclusion from the stated amounts.

Partnerships

Expansion of Built-In Loss Rules. The built-in loss rules force a mandatory basis step-down when a partnership interest changes hands and the partnership has a net built-in loss. These rules (essentially a mandatory Section 754 election) prevent two taxpayers from claiming the same economic loss as a tax loss. The Senate Tax Reform Proposals would test the existence of a built-in loss at the partner and partnership level, so even if the

partnership did not have a built-in loss, if there was a built-in loss in a partnership interest, the mandatory basis step-down would occur.

Expansion of Basis Limitation Rules. A partner may not claim losses from a partnership to the extent that the losses exceed the partner's basis in his partnership interest. Charitable contributions and foreign taxes are not within the category of items that are treated as losses. The Senate Tax Reform Proposals would expand the items that cannot be claimed by a partner in excess of his basis to include charitable contributions and foreign taxes.

Tax Changes Directed at Real Estate

Reduction in Depreciable Life. The Senate Tax Reform Proposals would shorten the depreciable life for both residential and non-residential real property to 25 years (from 27.5 and 39 years, respectively) for property placed in service in 2018. The Senate Tax Reform Proposals would also end distinctions among various types of improvements and provide for a 10-year recovery period for qualified improvement property. In addition, qualified improvement property would be eligible for small business expensing (Section 179 expensing).

Like-Kind Exchanges (LKEs). The Senate Tax Reform Proposals, like the Ways & Means Bill, would limit the ability of taxpayers to engage in LKEs to only non-inventory real estate for exchanges occurring after 2017. This change could adversely impact the high-end art market as many of the participants in such market have used LKEs.

Reduction in Tax Rate for REIT Dividends. The Senate Tax Reform Proposals would provide a deduction of 17.4 percent of the amount of ordinary dividends received from a real estate investment trust (REIT), beginning in 2018. Specifically, the REIT dividend is treated as an item of qualified business income. Accordingly, it appears that the deduction for REIT dividends is subject to the limitations imposed on qualified business income generally, including that the aggregate amount of the deduction may not exceed 50 percent of W-2 wages.

Principal Residence Gain Exclusion. The Senate Tax Reform Proposals would increase the length of time that a taxpayer must have resided at his or her principal residence before the taxpayer can take advantage of the $500,000 gain exclusion from two of the last five years to five of the last eight years.

HELOCs. The only change to the home mortgage interest deduction rules in the Senate Tax Reform Proposals would be to deny deductions for interest paid on home equity lines of credit (HELOCs) beginning in 2018, regardless of when amounts on the HELOC had been drawn.

Tax Changes Directed at Tax-Exempt Organizations

Excise Tax for Compensation Payments over $1 Million. The Senate Tax Reform Proposals include a provision that would impose a 20 percent excise tax on compensation paid in excess of $1 million to any "covered employee" in 2018 or after. A covered employee is one of the five highest paid employees for the year. In addition, the excise tax would apply to employees of taxable entities if such entity controls, or is controlled by, the tax-exempt entity. (No excise tax is imposed if the taxable entity is limited in the deductibility of the payment under the $1 million rule discussed above.) The excise tax also applies to excess parachute payments.

Excise Tax on Income of Large Educational Foundations. The Senate Tax Reform Proposals would impose a 1.4 percent excise on the income earned by large private foundations maintained by private colleges and universities beginning in 2018. The excise tax

would apply only if the value of the endowment is at least equal to $250,000 per student.

Expansion of Unrelated Business Income Taxes (UBIT) Rules. The Senate Tax Reform Proposals would treat royalty income from the licensing of a tax-exempt organization's name or logo as unrelated business taxable income beginning in 2018. As a result, tax-exempt organizations would be required to pay the full US corporate income tax on such revenues.

Segregation of Unrelated Businesses. The Senate Tax Reform Proposals would require tax-exempt organizations subject to the UBIT to silo each trade or business beginning in 2018, with the result that losses from one trade or business could not be used to shelter income from another trade or business. NOLs from a trade or business could be carried over to shelter income from that trade or business in years after the NOL was generated.

Increase in Charitable Contribution Limit. The Senate Tax Reform Proposals would increase the limit up to which taxpayers can deduct cash contributions to public charities from 50 percent to 60 percent of the contribution base, beginning in 2018.

Professional Sports Teams. The Senate Tax Reform Proposals would strip the National Football League of its tax exemption beginning in 2018.

Excess Benefit Transactions.
"Intermediate sanctions" is an excise tax penalty regime applicable to tax-exempt Code Section 501(c)(3) charitable organizations (other than private foundations). The intermediate sanctions penalties apply to "excess benefit transactions"—compensation and property transactions between a covered exempt organization and a "disqualified person" in which the amount paid or the economic benefit provided to the disqualified person is determined to be excessive.

If an excess benefit transaction is found to have occurred, a tax of 25 percent of the excess benefit (e.g., the excess amount of compensation paid to a disqualified person) is imposed on the disqualified person. An additional tax of 200 percent is imposed on the disqualified person's excess benefit if the violation is not corrected. The Senate Tax Reform Proposals would substantially toughen intermediate transactions by (i) eliminating the rebuttable presumption that a transaction is reasonable if certain procedures are followed (lowering the bar for the IRS to prevail), (ii) imposing new intermediate sanctions penalties on the covered exempt organizations themselves and (ii) extending intermediate sanctions to additional exempt organizations.

Under the Senate Tax Reform Proposals, if the initial 25 percent intermediate sanctions tax is imposed on a disqualified person for a transaction determined to be an excess benefit transaction, the exempt organization involved will be subject to an excise tax equal to 10 percent of the excess benefit unless the organization's participation was not willful and was due to reasonable cause. An exempt organization will avoid the tax if it establishes that it met "minimum standards of due diligence" (a rather novel concept for due diligence) in engaging in the transaction or it used other reasonable procedures to ensure that no excess benefit was provided.

Currently, investment advisors to charities that sponsor donor advised funds are not disqualified persons. Under the Senate Tax Reform Proposals, an investment advisor of any organization subject to intermediate sanctions will become a disqualified person. In addition, the definition of investment advisor is broadened to include any person compensated by a covered organization who is primarily responsible for providing investment advice with respect to, or managing, the organization's assets. The intermediate sanctions provisions of

the Senate Tax Reform Proposals would be effective for tax years beginning after December 31, 2017.

Insurance Provisions

Modification of the PFIC Exception for Insurers. Current law provides an exception to the passive income treatment for purposes of the passive foreign investment company (PFIC) rules for income from the active conduct of an insurance business, provided that the company is predominantly engaged in the insurance business. The Senate Tax Reform Proposals would replace the predominantly engaged test with a requirement that the company's "applicable insurance liabilities" exceed 25 percent of the company's total assets as reported on financial statements. If the non-US company fails the 25 percent test, the exception may still apply if the insurer meets at least the 10 percent threshold and failed the 25 percent test due to "specified circumstances involving such insurance business," such as the fact that the company is in run-off.

Increase in the DAC Capitalization Rates. Under current law, insurance companies with premiums from "specified insurance contracts" (primarily life and annuity contracts) are required to capitalize a certain percentage of their otherwise deductible ordinary and necessary business expenses and spread those deductions over 10 years. The Senate Tax Reform Proposals would increase those capitalization percentages from 1.75 percent to 3.17 percent for annuities, from 2.1 percent to 3.72 percent for group life contracts and from 7.7 percent to 13.97 percent for all other specified insurance contracts. The Senate Tax Reform Proposals would extend the amortization period from 120 months to 600 months.

Life Settlement Provisions

Reportable Policy Sales. Purchasers of interests in life settlements in 2018 or after who do not have a familial or business relationship to the insured must report a sale of a life insurance policy to the seller, the insurer and the IRS. (It appears that the reporting would be made on IRS Form 1099.)

Insurer Basis Reporting. The Senate Tax Reform Proposals would require each insurer under a life insurance contract, following receipt of a reportable policy sale notice, to report the seller's basis in the life insurance contract to the IRS and the seller. Reporting is also required upon the transfer of a life settlement to a non-US person.

Death Benefit Reporting. If an insurer has received a notice of a reportable policy sale, when death benefits are paid on the life insurance policy, the insurer would be required to report (1) the gross amount of the death benefits, (2) the TIN (taxpayer identification number) of the payee and (3) the insurer's estimate of the holder's basis in the life insurance contract.

Reversal of IRS Position in Revenue Ruling 2009-13. In Revenue Ruling 2009-13, the IRS ruled that an insured's basis in an insurance policy is reduced by the cost of insurance, that is, the portion of the premiums allocable to insurance coverage. The Senate Tax Reform Proposals would reverse this position and allow insureds to count such charges in their basis in the insurance policy retroactively to August 25, 2009 (the date of issuance of Rev. Rul. 2009-13).

Modification of Transfer for Value Rules. The statutory exceptions to the transfer for value rules allow certain transferees to exclude the death benefits from income. The Senate Tax Reform Proposals would make these exceptions inapplicable to reportable policy sales beginning in 2018.

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Endnotes

[1] Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* JCX-51-17 (Nov. 9, 2017).

[2] Glover, Moroses and Cooper, "*Senate GOP Tax Reform Plan Increases Brackets, Keeps Credits*" 2017 TNT 217-1 (Nov. 10, 2017).

[3] For the Mayer Brown coverage of the Ways & Means Bill, see https://www.mayerbrown.com/The-2017-Federal-Tax-Legislation-A-First-Look-11-03-2017/.

[4] Basu, "*Senate Proposes Corporate Tax Cut in 2019*" 217 DTR G-6 (Nov. 10, 2017).

[5] See statements attributed to Office of Management and Budget Director Mick Mulvaney published in Glover, Moroses and Cooper, *supra*.

[6] Code § 179.

[7] Code § 243.

[8] Code § 446.

[9] This is longer than the 181-day holding period in the Ways & Means Bill.

[10] After the latest amendments, the Ways & Means Bill currently contemplates rates of 14 percent for earnings held in cash and liquid assets and 7 percent for the remainder.

[11] *See* T.D. 9803 (Dec. 16, 2016).

[12] The "base erosion percentage" for a tax year results from dividing the amount of the taxpayer's base erosion deductions by the aggregate number of its allowable deductions (without taking into account any NOL carryovers).

[13] Rev. Rul. 91-32, 1991-1 C.B. 107.

[14] *Grecian Magnesite Mining v. Comm'r*, 149 T.C. No. 3 (July 13, 2017).

[15] As a backstop, to the extent the transferee fails to withhold the correct amount, the partnership would have a withholding obligation in future distributions to the transferee.

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