Memorandum

House Republicans Release Promised Tax Bill

November 3, 2017

Introduction

House Ways and Means Committee Chairman Kevin Brady (R-TX) released the long-awaited tax reform bill on November 2, 2017. The bill, titled the Tax Cuts and Jobs Act (the "Bill"), proposes fundamental changes to the existing tax code and, if enacted, would have significant implications for the taxation of businesses, individuals and tax-exempt entities. Among the numerous changes included in the Bill, which are generally effective for tax years beginning after 2017, are a permanent reduction to the corporate income tax rate, a partial limitation on the deductibility of business interest expense, a new maximum tax rate for individuals receiving certain business income from "pass-through" entities, and significant changes to deductions for individual taxpayers including a repeal of the deduction for state and local income taxes. The Bill also partially shifts the taxation of multinational corporations from a tax on worldwide income to a territorial system. The cost of the Bill is expected to be $1.5 trillion or more over the next decade.

Proposed Reform to Business Taxation

The Bill includes a number of proposed changes to the taxation of business income:

Reduction to 20% Corporate Income Tax Rate. The Bill reduces the corporate income tax rate (currently a top marginal rate of 35%) to a flat 20% tax rate. The alternative minimum tax ("AMT"), discussed further below, would also be repealed for corporations. These changes would be effective for the 2018 tax year and would be permanent. The reduction in corporate income tax rates has been a fundamental component of President Trump and the House Republicans' tax reform agenda, motivated by the goal of making U.S. multinational corporations more competitive abroad. This change would reduce the corporate rate to a historic low.

Modified Taxation of Certain Pass-Though Businesses. The Bill imposes a maximum rate of 25% on certain business income (which includes wages, rents and royalties but excludes investment income) received by

individuals from sole proprietorships, partnerships, and S corporations. Both income from a passive business in which the taxpayer does not materially participate and active business income are eligible for this favorable treatment, although the 25% rate applies only to the "capital percentage" of any active business income. In general, the capital percentage is equal to 30%, with the following exceptions:

- Taxpayers may elect to apply a formula to determine a capital percentage that is greater than 30% based on the profile of their business.
- Certain service businesses where the principal asset of the business is the reputation or skill of its employees (e.g., law, accounting or financial services firms) will be subject to a default 0% capital percentage. Taxpayers may elect to apply the formula described above, however, if it results in a capital percentage that is at least 10%.
- If the actual wages or salary received by a taxpayer exceed the business income multiplied by the non-capital percentage, then the capital percentage is reduced.

Individuals investing in private equity and real estate funds may benefit meaningfully from this proposal, since business income that would otherwise be subject to a 39.6% maximum rate may be eligible for the 25% rate. In addition, partners of partnerships earning investment income would still be eligible for reduced rates on long-term capital gains or dividend income and the Bill does not include a provision modifying the current treatment of carried interest income.

The Bill would also apply a maximum 25% rate to certain dividends received from REITs by individuals.

Limitations on Deduction of Business Interest. The Bill replaces the existing limitations on deductions for certain related party interest under Section 163(j) of the Internal Revenue Code of 1986, as amended (the "Code") with a general disallowance of deductions for interest expense in excess of the sum of a taxpayer's business interest income and 30% of the adjusted taxable income of the business, which is its taxable income computed without regard to business interest expense or business interest income, net operating losses, or deductions for depreciation, amortization, and depletion. This calculation is similar to the calculation of adjusted taxable income for purposes of computing the 50% limitation under the current Section 163(j). The proposed limitation would apply regardless of whether the business is in corporate or pass-through form and is computed at the corporate or partnership (rather than the partner) level. Any disallowed interest deductions can be carried forward for five years. In the case of partnerships, the Bill includes special rules to allow a partner to utilize its distributive share of the partnership's excess interest deduction. The limitation is subject to certain exceptions for certain small businesses and would not apply to certain regulated public utilities or real property trade or businesses (which is notable given the significant use of leverage typical in the real estate industry).

Limitations on Carryback and Carryforward of Net Operating Losses. The Bill limits a corporation's ability to deduct a net operating loss ("NOL") carryforward to 90% of its taxable income determined without regard

to the NOLs. The 90% limitation effectively replicates the limitation previously imposed by the AMT, which the Bill repeals as discussed further below. Any unutilized NOLs can be carried forward indefinitely and NOLs carried forward to tax years beginning after 2017 are increased by an annual interest charge. The carryback of NOLs is essentially eliminated, subject to limited exceptions. These changes are generally effective for NOLs arising in tax years beginning after 2017 and, in the case of the 90% limitation, apply to NOLs utilized in such years.

Immediate Expensing of Certain Costs for Five Years. The Bill permits taxpayers to expense 100% of the cost of certain "qualified property" (certain tangible personal property currently eligible for bonus depreciation) that is placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain property). This proposal would increase the ability of taxpayers to immediately expense certain costs when compared to the current bonus depreciation rules, which allow additional depreciation (between 50-30%) in the year in which certain qualified property is put into service if the original use begins with the taxpayer (and the Bill would repeal the requirement that the original use of the property begin with the taxpayer, as long as it is the taxpayer's first use). This provision does not apply to certain regulated public utilities or real property trade or businesses which are otherwise exempt from the limitation on interest deductibility described above.

Certain Governmental Entities Subject to Unrelated Business Taxable Income. The Bill provides that all entities exempt from tax under Section 501(a) of the Code are required to pay tax on unrelated business taxable income ("UBTI"), regardless of whether they are exempt from tax under any other provision of the Code. This would be a material change for public pension plans and other tax-exempt entities that currently take the position they are exempt from tax under Section 115 of the Code and therefore not subject to the UBTI rules, and could have a significant impact on how such investors hold their interest in private investment funds.

Proposed Reform to International Taxation

The Bill represents a notable shift toward a "territorial" or "participation exemption" system of international taxation for U.S. corporations—a departure from the current regime which taxes U.S. corporations on their worldwide income.

Foreign-Source Dividend Exemption. The fundamental element of the proposed territorial system is an exemption for dividends paid by foreign corporations to a U.S. corporate shareholder that owns 10% or more of the foreign corporation. As a result, that income will be exempt from U.S. tax and subject to tax only in the foreign jurisdiction. Because those earnings are exempt from U.S. tax, the Bill also prohibits a foreign tax credit or deduction for any taxes or expenses attributable to the exempt dividend. If enacted, this reform would largely eliminate the existing incentive for U.S. corporations to accumulate earnings offshore to avoid tax on repatriating those earnings to the United States (commonly known as the "lock-out effect"). The Bill

also provides that Section 956 of the Code, which generally subjects U.S. shareholders to tax on any undistributed earnings of a foreign corporate subsidiary that are reinvested in U.S. property, would not apply to domestic corporations, so under the Bill a U.S. corporate parent is not taxed on the earnings of its foreign subsidiary whether they are distributed or reinvested in the United States. A number of modifications to the "subpart F" regime—which requires current taxation of certain income of controlled foreign corporations—are also proposed.

Mandatory Repatriation of Offshore Earnings. The Bill provides that all historical offshore earnings and profits of a controlled foreign corporation as of November 2, 2017 or December 31, 2017 (whichever is higher) are subject to a one-time deemed repatriation and taxed at a 12% rate (for cash and cash equivalents) or a reduced 5% rate (for all other earnings and profits, to mitigate the cost of the deemed repatriation of illiquid earnings). U.S. shareholders owning at least 10% of a foreign subsidiary would include their pro rata share of such income. U.S. shareholders may elect to pay the resulting tax liability in equal installments over eight years. Foreign tax credits resulting from the deemed distribution would be partially disallowed but can be carried forward to future tax years.

Prevention of Base Erosion. In connection with the adoption of a participation exemption system, the Bill also includes a number of provisions intended to prevent the use of tax planning strategies that would erode the U.S. tax base and shift profits to low-tax jurisdictions.

- <u>Current Tax on "High Return" Foreign Subsidiaries</u>. The Bill provides that U.S. shareholders of a controlled foreign corporation are taxed currently on 50% of such shareholder's "foreign high return amount" for the taxable year, in a manner similar to the current treatment of subpart F income. The foreign high return amount for a U.S. shareholder is the excess (if any) of the foreign subsidiary's net income over a routine return (7% plus the applicable federal short-term rate) on the foreign subsidiary's qualified business asset investment (i.e., its aggregate adjusted bases in depreciable, tangible property), subject to certain adjustments. This tax would apply regardless of whether the earnings remain offshore or are repatriated to the United States.
- <u>Limitation on Interest Deduction by Domestic Corporations in Certain International Groups</u>. Under current law, U.S. corporations that borrow from third parties and capitalize foreign subsidiaries with debt or borrow from foreign subsidiaries are generally able to deduct the interest expense while deferring U.S. tax on the offshore earnings. They may also be able to reduce or eliminate the withholding tax on the interest income paid to the foreign subsidiary by relying on favorable rates under income tax treaties. Under the newly proposed dividend-exemption system described above, the amounts contributed to or borrowed from the foreign subsidiary could earn foreign income that is exempt from U.S. tax while simultaneous generating interest deductions to the U.S. corporate parent. The Bill eliminates this arbitrage by providing that the deductible interest expense of a U.S. corporation that is a member of an "international financial reporting group" would be limited to the

extent the U.S. corporation's share of the net interest expense of the group exceeds 110% of its share of the group's EBITDA. For this purpose, an international financial reporting group is a group of entities that (i) includes at least one foreign corporation engaged in a trade or business in the United States or at least one domestic corporation and one foreign corporation, (ii) prepares consolidated financial statements, and (iii) has annual gross receipts of more than $100 million. This provision is in addition to general limitations on the deduction of business interest expense described above. Any disallowed interest expense would carry forward for five years. Given the scope of this provision, it could have broad and perhaps unintended consequences.

- <u>Excise Tax on Certain Payments to Related Foreign Corporations</u>. The Bill subjects certain payments (other than interest) made by a U.S. corporation to a related foreign entity that are deductible, includible in cost of goods sold or could give rise to depreciation or amortization deductions to a 20% exercise tax. The excise tax does not apply if the related foreign corporation elects to treat the payments as income that is subject to U.S. tax and is only applicable to international financial reporting groups with significant payments to foreign affiliates (i.e., totaling at least $100 million annually). This provision reduces the incentives for U.S. corporations to invert (as the excise tax will apply whether the parent corporation is U.S. or foreign) or otherwise attribute profits to foreign affiliates that are not subject to U.S. tax. The excise tax applies regardless of the intent of the arrangement so this provision could impact service or other arrangements between U.S. corporations and affiliate foreign entities.

Repeal of the Alternative Minimum Tax

The Bill repeals the AMT for both corporate and individual taxpayers. The AMT currently requires taxpayers to compute an alternative tax liability based on an AMT base (which begins with regular taxable income, subject to certain adjustments and increases). The taxpayer's liability is equal to the greater of its regular income tax liability or AMT liability. Credits for AMT paid can be carried forward and utilized to offset regular income tax liability in future years. The Bill would permit a taxpayer to claim a refund of excess AMT credit carryforwards over the next four years.

Proposed Reform to Individual Taxation

The Bill also includes a number of important reforms to the taxation of individuals. The material changes include the following:

Reduction in Number of Individual Tax Brackets. The Bill reduces the number of individual tax brackets from seven to four—12%, 25%, 35%, and 39.6%. While 39.6% remains the top marginal rate, the income threshold for which it applies has doubled and would be $1 million for joint filers. As described above, the Bill also repeals the AMT for individuals.

Increased Standard Deduction. The Bill proposes to increase the standard deduction to $24,000 for joint filers (from $12,700) and $12,000 for single filers (from $6,700).

Preservation of Deduction for Charitable Contributions and Home Mortgage Interest with Some Limitations. The Bill generally retains the deductions for charitable contributions and home mortgage interest, but decreases the amount of mortgage debt on which interest is deductible to $500,000 from $1 million for mortgages (other than certain refinancings) that are obtained after November 2, 2017.

Repeal of Deduction for State and Local Income Taxes. The Bill would eliminate the deduction for state and local income taxes.

Increased Estate Tax Exemption; Repeal of Estate Tax After 2023. The Bill doubles the inflation-indexed exclusion from the estate tax (from $5.49 million for 2017 to $10.98 million) and eliminates the estate and generation-skipping transfer taxes entirely beginning in 2024, while retaining the beneficiary's ability to obtain a step-up in tax basis.

Certain Compensation Related Reforms

The Bill includes a number changes relevant to the treatment of compensation related income. One notable proposal is the modification to the $1 million annual limitation on deductions for compensation for certain covered employees of public companies pursuant to Section 162(m) of the Code. The Bill repeals the exceptions for commissions and performance-based compensation and would clarify that "covered employees" subject to the limitation include the chief executive officer, the chief financial officer, and the three other highest paid employees. For a more detailed description of compensation related changes to the Code as contemplated by the Bill, see our Client Alert on these provisions here.

Conclusion

The Bill includes a number of proposed changes that would materially alter the existing framework of corporate and individual taxation in the United States, and many of these proposals have already begun to spark intense debate. While the release of this legislation represents a key step toward the comprehensive tax reform promised by Republican leadership, there is a long road ahead and whether and in what form the Bill will be enacted into law remains to be seen. The House Ways and Means Committee is scheduled to begin its markup of the Bill next week, and the Senate's proposed tax reform bill is still forthcoming. The House and Senate will need to quickly resolve any differences between the bills in conference if they hope to meet the stated goal of passing final legislation in 2017.

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