Memorandum

House and Senate Conference Committee Releases Agreed Tax Reform Bill

December 18, 2017

Introduction

On December 15, 2017, the conference committee of the House of Representatives and the Senate released an agreed version of the Tax Cuts and Jobs Act (the "Bill"). The Bill is scheduled to be put to a vote this week and then is expected to be submitted to President Trump for his signature shortly thereafter. The Bill will enact significant changes to the existing tax code, including a permanent reduction in the corporate income tax rate, a limitation on the deduction of business interest expense, a temporary deduction for individuals receiving certain business income from "pass-through" entities, and a materially reduced deduction for state and local taxes for individual taxpayers. The Bill also fundamentally alters the taxation of U.S. multinational corporations by shifting to a partially territorial system. A preliminary report by the Joint Committee on Taxation indicated the Bill is expected to cost more than $1.4 trillion over the next 10 years.

Reform to Business Taxation

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

Reduction to 21% Corporate Income Tax Rate. The Bill reduces the corporate income tax rate (currently a top marginal rate of 35%) to a flat 21% tax rate. While a 20% corporate rate was originally proposed by both the House and Senate, the slight increase to 21% was negotiated to reach consensus on the reform package. The Bill also repeals the alternative minimum tax ("AMT") for corporate taxpayers and reduces the dividends received deduction for dividends received from corporations from 70% to 50% (and to 65% from 80% for dividends from 20% owned corporate subsidiaries). The 100% deduction for dividends from 80% owned corporate subsidiaries remains unchanged. This reform, which has been a fundamental aspect of the Republican legislative agenda, represents a significant reduction to the current corporate income tax, and along with repeal of the corporate AMT may encourage choice of a corporate form in certain circumstances. These changes will become effective for taxable years beginning on or after January 1, 2018.

Modified Taxation of Certain Pass-Through Businesses. The Bill provides for a deduction of 20% of certain "qualified business income" (which is limited to income effectively connected with a U.S. trade or business and excludes capital gains, dividend income, and certain compensation-related payments) received by individuals and certain trusts and estates from sole proprietorships, partnerships, and S corporations. For taxpayers with income above a certain threshold ($415,000 for joint filers) the deduction is limited to the greater of (a) 50% of the taxpayer's pro-rata share of W-2 wages paid by the business, or (b) the sum of 25% of such W-2 wages plus 2.5% of the tax basis of certain depreciable property used in the trade or business. Taxpayers with incomes above $315,000 are subject to a phase-in of the limitation. Additionally, owners of specified service businesses (i.e., businesses in the fields of law, health, accounting, financial services or brokerage services, businesses where the principal asset of the business is the reputation or skill of its employees or owners or businesses which involve the performance of services consisting of investing and investment management) are generally excluded from the deduction if their income exceeds a certain threshold ($415,000 for joint filers, subject to the same phase-in described above). Certain dividends from REITs and certain income from interests in publicly traded partnerships also benefit from the 20% deduction in some cases, without regard to the above limitations. The deduction will be effective beginning in 2018 and is set to expire after 2025.

Individuals investing in private funds that make investments in pass-through entities that conduct a U.S. trade or business, such as real estate funds and, to a lesser extent, private equity funds, may benefit from this provision, since business income could be subject to a lower effective tax rate. In addition, the legislation may make it more attractive for certain employees of pass-through businesses to become partners.

Holding Period for Carried Interest. The Bill imposes a three-year holding period requirement in order for gains allocable to carried interest to qualify for long-term capital gains rates. The limitation only applies to interests transferred in connection with the performance of services with respect to investing in securities, real estate or other specified assets, and accordingly does not impact the treatment of profits interests awarded to management of other businesses. This provision may have a limited effect on most private equity funds given their long-term investment strategies, and is expected to primarily impact activist hedge funds whose strategies often involve a shorter holding period.

Limitations on Deduction of Business Interest. The Bill imposes a general disallowance of deductions for business interest expense (even if paid to third parties) 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 income or expense, net operating losses or the pass-through income deduction described above (and for taxable years before 2022, excludes depreciation and amortization). Business interest includes any interest on indebtedness related to a trade or business, but excludes investment interest. The 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. 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. Any disallowed interest deductions can be carried forward indefinitely. The limitation is subject to certain exceptions for businesses with annual gross receipts under $25 million and would not apply to certain regulated public utilities. Additionally, real property trades or businesses may elect out of the limitation provided certain requirements are met (which is notable given the extensive use of leverage typical in the real estate industry).

These limitations could have a meaningful impact on the use of debt financing in leveraged buyouts and a wide range of other transactions.

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 80% of its taxable income determined without regard to the NOLs. The 80% limitation effectively replicates and expands on the limitation previously imposed by the AMT, which the Bill repeals as discussed above. Any unutilized NOLs can be carried forward indefinitely. 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.

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). The bonus depreciation percentage would phase down beginning with property placed in service in 2023 to 80% and continuing down to 20% (for property placed in service in 2026). This provision 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. Notably, the Bill does not require that the original use of the property begin with the taxpayer as long as it is the taxpayer's first year of use. Property of certain public utilities is not eligible for immediate expensing.

Governmental Entities Not Subjected to UBTI. The Bill does not incorporate the proposal from the House Bill subjecting all U.S. state governmental entities such as state pension plans to tax on unrelated business taxable income.

Reform to International Taxation

The Bill replaces the current regime of worldwide taxation with a modified territorial system, which includes a "participation exemption" for foreign-source dividend income and certain provisions targeted at base erosion. The Bill includes a number of important changes that could significantly impact U.S. multinational corporations, including the provisions described below:

Foreign-Source Dividend Exemption. The Bill includes a 100% deduction for the foreign-source portion of any dividend paid by a foreign corporation to a U.S. corporate shareholder (or certain controlled foreign corporations, or "CFCs") that owns 10% or more of the vote or value of such foreign corporation. The foreign-source portion of a dividend is determined by comparing the ratio of the foreign corporation's undistributed foreign earnings to its total undistributed earnings. Because those earnings are exempt from U.S. tax (and subject to tax only in the foreign jurisdiction), the Bill also prohibits a foreign tax credit or deduction for any taxes or expenses attributable to the exempt dividend. The exemption is not available for dividends received from CFCs that are "hybrid dividends" (i.e., dividends that would otherwise be entitled to the deduction under this provision and for which the foreign corporation received a deduction or other tax benefit with respect to income taxes in the foreign jurisdiction). If enacted, this reform would significantly reduce the existing incentive for U.S. corporations to accumulate earnings offshore in order to avoid tax on repatriating those earnings to the United States. Unlike the House and Senate Bills, the final Bill does not repeal Section 956 of the Internal Revenue Code of 1986, as amended (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; as a result, a U.S. corporate parent may be taxed on the earnings of its foreign subsidiary when they are reinvested in the United States but not when distributed to its domestic parent. The Bill also includes a number of modifications to the "subpart F" regime—which requires current taxation of certain income of CFCs— that could broaden its application, including expanding the definition of U.S. shareholders that may be subject to a current income inclusion under this regime to include U.S. persons owning 10% of either the vote or the value (not limited to vote, as under current law) of the CFC.

Mandatory Repatriation of Offshore Earnings. As a transition tax, the Bill provides that all accumulated foreign earnings and profits of a "specified foreign corporation" (calculated as of November 2, 2017 or December 31, 2017, whichever is higher, and taking into account the corporation's share of certain deficits in earnings and profits) are subject to a one-time deemed repatriation and taxed to certain U.S. shareholders as subpart F income at a 15.5% rate (for cash and cash equivalents) or a reduced 8% rate (for all other earnings and profits, to mitigate the cost of the deemed repatriation of illiquid earnings) in the corporation's last taxable year which begins before January 1, 2018. A specified foreign corporation is any CFC or any other foreign corporation in which a U.S. person owns at least a 10% voting interest and at least one U.S. shareholder is a corporation. U.S. shareholders (regardless of whether they are corporations) owning at least 10% of a foreign subsidiary would include their pro rata share of such income, even though the foreign-source dividends received deduction described above will only be available going forward for U.S. corporate shareholders. U.S. shareholders may elect to pay the resulting tax liability in annual installments of increasing size over eight years. Foreign tax credits resulting from the deemed distribution would be partially disallowed but can be carried forward to future tax years. If a U.S. shareholder of a specified foreign corporation inverts within 10 years following the enactment of the Bill, it is subject to a recapture tax at a higher rate.

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 mobile income to low-tax jurisdictions.

- Current Tax on Global Intangible Low-Taxed Income. The Bill provides that a U.S. shareholder of a CFC is taxed currently on its "global intangible low-taxed income" or "GILTI". GILTI is intended to capture the portion of a U.S. shareholder's income from CFCs that does not relate to returns from tangible property. This provision is intended to ensure that a U.S. corporation is paying at least approximately 10.5% of tax somewhere in the world on the earnings of its CFCs from intangible assets. However, even if a CFC is subject to the tax, it would still be subject to a reduced tax rate (from 21% to approximately 10.5%).
- Base Erosion Minimum Tax. The Bill requires U.S. corporations with average annual gross receipts of at least $500 million who make excessive deductible payments to foreign affiliates to pay a base erosion minimum tax for the taxable year equal to the excess of 10% (the rate is 5% for a one-year transitional period and rises to 12.5% beginning in 2026) of "modified taxable income" over the regular tax liability, with certain adjustments for credits. Modified taxable income is generally taxable income increased by any deductible payments made to a related foreign party. The rule applies regardless of whether the payments are made on arm's length terms or are fully taxable in the foreign jurisdiction.
- Hybrid Payments to Related Parties. The Bill disallows deductions for any "disqualified related party amount" paid pursuant to a hybrid transaction (i.e., where a payment is treated as interest or royalties for U.S. but not foreign purposes), or by/to a hybrid entity. A disqualified related party amount is interest or royalties paid to a related party to the extent (1) these amounts are not included as income in the country of the related party, or (2) the country of the related party allows it to deduct these amounts.

Active Insurance Exception to the PFIC Rules. The Bill limits the exception to the passive foreign investment company ("PFIC") rules (which generally require current tax on certain passive income of foreign corporations) for active insurance businesses by requiring that insurance liabilities constitute more than 25% of its total assets.

Gain from Sale of Partnership Interests by Foreign Partners. In the recent case *Grecian Magnesite Mining Co. v. Commissioner*, the Tax Court held that the capital gain recognized by a foreign partner in connection with the redemption of its interest in a domestic entity treated as a partnership for U.S. federal income tax purposes was not taxable because the gain was foreign-source income and not "effectively connected income" ("ECI"). The Bill effectively overrules the Tax Court's decision in *Grecian* by providing that gain or loss from the sale or exchange of a partnership interest by a foreign partner is ECI and therefore subject to U.S. tax to the extent that the foreign partner would have been allocated ECI if the partnership sold all of its

assets at fair market value as of the date of the sale or exchange. The Bill requires the transferee of a partnership interest to withhold 10% of the amount realized unless the transferor certifies it is not a nonresident alien individual or a foreign corporation (and the partnership is required to withhold from future distributions to the transferee if the transferee fails to properly withhold). This provision is applicable to sales and exchanges occurring after November 27, 2017 (although the withholding requirement is only applicable for sales and exchanges occurring after December 31, 2017).

Limitation on Interest Deduction for Certain International Groups Not Adopted. The House and Senate Bills contained provisions that would, in addition to the limitations on business interest deductions discussed above, limit the interest deductions of a U.S. corporation that is a member of an “international financial reporting group” or a “worldwide affiliated group.” The final Bill does not adopt either of those provisions.

Reform to Individual Taxation

The Bill also includes a number of important reforms to the taxation of individuals. In order to comply with Senate rules prohibiting long-term deficits, the individual reforms in the Bill generally sunset in 2026. The material changes include the following:

Reduction in Individual Rates. The Bill retains seven tax brackets but generally reduces rates for individuals, including reducing the top marginal rate to 37% from the current highest rate of 39.6%. The AMT for individuals is retained with a temporarily increased exemption. These changes will become effective on January 1, 2018.

Increased Standard Deduction. The Bill increases the standard deduction to $24,000 for joint filers (from $12,700) and $12,000 for single filers (from $6,350).

Preservation of Deduction for Home Mortgage Interest with Some Limitations. The Bill generally retains the deduction for home mortgage interest, but decreases the amount of acquisition indebtedness on which interest is deductible to $750,000 for joint filers from $1 million for mortgages (other than certain refinancings) that are obtained after December 15, 2017. The Bill temporarily eliminates the deduction for interest on home equity indebtedness through 2025.

Significant Limitation on Deduction for State and Local Taxes. The Bill would eliminate the individual deduction for state and local real property and sales taxes not incurred in connection with a trade or business and would eliminate the deduction for state and local income taxes, with a limited exception for a combined $10,000 in sales, real property, and/or income taxes. The House and Senate versions of the Bill previously repealed the deduction for state and local income tax entirely. Like the other individual reforms, this limitation would apply through 2025.

Increased Estate Tax Exemption. The Bill doubles the exclusion from the estate and gift tax (from $5 million to $10 million, indexed for inflation) for decedents dying or gifts made after 2017 and before 2026.

Repeal of Affordable Care Act Individual Mandate. The Bill permanently reduces to zero the tax for failure to maintain minimum health insurance coverage beginning in 2019.

Certain Reforms Related to Section 162(m)

Notably, the Bill modifies 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 commonly-used exceptions for commissions and performance-based compensation and clarifies that "covered employees" subject to the limitation include the chief executive officer, the chief financial officer, and the three other highest paid employees. Importantly, the Bill provides that if an individual is a covered employee for any year beginning in 2017 they remain a covered employee for all future years.

Conclusion

With Congress having reached a consensus, the Bill will likely be enacted into law in the coming days. The Bill represents the most significant overhaul of the U.S. tax system in over thirty years, and once passed will dramatically alter the existing framework of U.S. corporate and individual income taxation, as well as the taxation of U.S. multinational corporations. While many provisions of the Bill will have immediate consequences for various business transactions and industries, the broader implications of the Bill's reforms may take time to unfold. We will continue to monitor developments in this area.

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