November 2, 2017

U.S. Tax Reform

House Ways and Means Committee Releases Draft of Tax Reform Bill

SUMMARY

Earlier today, Republicans in the House of Representatives unveiled the long-anticipated first draft of their tax reform bill.

For the most part, the draft bill is consistent with the broad policy goals provided in the framework released by the "Big Six" on September 27, 2017. However, the language released earlier today provides some detail in a few areas that had previously been left open and diverges from the proposals in the framework in several key respects. Most of the proposed changes would become effective for years after 2017.

Some important features of the draft legislation are as follows:

Business Taxation:

- **Corporate Tax Rate.** The maximum corporate tax rate would be reduced from its current rate of 35% to a lower 20% rate. Personal services corporations would be subject to a 25% corporate tax rate. There appears to be no sunset provision for this tax cut, as was previously rumored.
- **New 25% Tax Rate on Passthrough "Business Income."** Owners of passthroughs (e.g., partnerships and S corporations) who do not materially participate in the business would be taxed at a 25% rate. Under a series of default rules, those actively involved in the business would only qualify for the 25% rate for 30% of their share of the passthrough's income. The remaining 70% would be taxed at the owner's ordinary individual income tax rate, creating an effective marginal rate of 35.22% for the highest earners. Certain owners of capital-intensive businesses would be able to apply a larger percentage to determine the portion of income subject to the reduced 25% rate, using a ratio calculated based on a return of capital (deemed to be the Federal short-term rate, plus 7%). The default rule for active owners of professional services firms (e.g., accounting, law, health, financial services, and investing or trading in securities) would tax 100% of income at the owner's individual income tax rate. However, passive owners of professional services firms would be entitled to the reduced 25% rate.

- **Immediate Expensing of Capital Expenditures.** There would be immediate deduction for the cost of capital expenditures for property (other than real estate) acquired or placed in service after September 27, 2017 and before January 1, 2023, subject to phase-out.
- **Interest Deductibility Limited.** For tax years after 2017, the deductibility of net business interest would be effectively capped at 30% of adjusted taxable income, an amount similar to EBITDA. The net interest expense disallowance would be determined at the entity level (e.g., at the partnership level instead of the partner level). Any disallowed amounts would be carried forward for five years. Real estate firms and small businesses (with $25 million or less of gross receipts) would be exempt from this limitation. There appears to be no grandfathering for preexisting debt.
- **Net Operating Losses.** Net operating losses would be deductible only to the extent of 90% of the taxpayer's taxable income (similar to the current AMT rules), and could be carried forward indefinitely but generally could not be carried back. Amounts carried forward would be increased by an interest factor to preserve the value of those amounts.
- **Non-Qualified Deferred Compensation.** The proposed bill would repeal Section 409A and cause any compensation deferred under a nonqualified deferred compensation plan to be included in income by the employee when the deferred compensation vests (rather than when the compensation is paid).
- **Limits on Compensation Deductibility.** Executive compensation paid to "covered employees" of a publicly traded corporation would no longer be deductible for amounts above $1,000,000, even for performance-based pay. Covered employees, for this purpose, would mean the CEO, the CFO and the three other highest paid officers (for any tax year after 2016 as long as that person continues to receive remuneration).
- **Many Business Tax Incentives Eliminated.** Most business tax incentives (e.g., the domestic production deduction) would be eliminated in the proposed legislation. Three notable exceptions to this rule are the R&D credit, the credit for the production of electricity from renewable resources (e.g., solar), and the low-income housing credit. There would also be additional limitations on the deductibility of entertainment expense.
- **Elimination of Corporate AMT.** The Alternative Minimum Tax ("AMT") would be eliminated for corporations.
- **Real Estate Investment Trust Dividends.** The maximum rate on certain dividends from real estate investment trusts would be 25%.
- **Like-Kind Exchanges Limited to Real Property.** Deferral of gain on like-kind exchanges would only be permitted with respect to real property.
- **Limitation on Deduction for FDIC Premiums.** A percentage of amounts paid by insured depository institutions pursuant to an assessment by the FDIC to support the Deposit Insurance Fund would not be deductible for institutions with total consolidated assets in excess of $10 billion. The percentage gradually declines to zero in proportion to the institution's consolidated assets.
- **No Provision for Corporate Integration.** There is no provision in this bill which would eliminate the double taxation of corporate profits, referred to as "corporate integration."

International Taxation:

- **Shift From "Worldwide" Taxation to "Territorial" Taxation.** U.S. businesses that operate through foreign subsidiaries would only be taxed on their U.S.-source income, rather than on all of their worldwide income. This would be effected by means of a 100% participation exemption for the foreign-source portion of dividends paid by a 10% or more owned foreign corporation to a U.S. corporate shareholder. However, in tandem with the 10% tax on high profit foreign subsidiaries (see next bullet), the system would more resemble a hybrid between a worldwide and a territorial system. In addition, unlike most participation exemption regimes, there appears to

be no exemption for gain on the sale of a foreign subsidiary. The rules that require income inclusions of certain U.S. shareholders of controlled foreign corporations that invest in certain U.S. property (e.g., loaning cash to or purchasing shares of the U.S. parent) would effectively be repealed for corporate shareholders of foreign subsidiaries. However, the Subpart F regime (which requires immediate taxation of certain passive or portfolio income of foreign subsidiaries) would be largely preserved. This shift to a territorial system would not change the treatment of U.S. corporations that operate abroad through branches.

- **New 10% Tax on High Profit Foreign Subsidiaries.** A U.S. parent of a "controlled foreign corporation" could be subject to a 10% tax on certain "high returns" of such subsidiaries (50% of the high returns would be taxed at the 20% U.S. corporate rate). High returns would be measured as the excess of the subsidiary's income over a routine return (7% plus the Federal short-term rate) on the subsidiary's adjusted basis in its tangible property, adjusted downward for interest expense. This appears to be the 10% minimum tax about which there was much speculation in the press.
- **20% Excise Tax on Payments to Foreign Affiliates.** Domestic corporations would be subject to a 20% tax on payments to a foreign affiliate that are deductible, includible in cost of goods sold, or includible in the basis of a depreciable or amortizable asset (but not interest or certain commodities transactions), unless the foreign corporation elected to treat the payments as effectively connected income or if there is no markup on a payment for services.
- **Mandatory Deemed Repatriation of Offshore Earnings and Profits.** The foreign earnings of subsidiaries of U.S. corporations that have not been repatriated to the United States, and which have therefore not yet been subject to U.S. taxation, would be deemed distributed to its U.S. parent corporation. All earnings held in cash and cash equivalents would be taxed at a 12% rate and all other earnings would be taxed at a 5% rate. At the election of the taxpayer, this tax could be paid over a period of eight years, payable in equal 12.5% installments. The amount of earnings would be determined as of November 2, 2017 or December 31, 2017 (whichever is higher). Foreign tax credit carryforwards would be fully available, and foreign tax credits triggered by the deemed repatriation would be partially available, to offset the U.S. tax resulting from the deemed repatriation.
- **Interest Deductibility Limited for U.S. Member of Multinationals.** The deductible net 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 group's global net interest expense exceeds 110% of the U.S. corporation's share of the group's global EBITDA.
- **Anti-Conduit Rule.** If a payment of income otherwise subject to 30% withholding (such as interest, rent, or other "fixed and determinable" payments) is deductible in the United States and made by an entity that is controlled by a foreign parent to another entity controlled by that same foreign parent, such payment would not qualify for treaty benefits unless it would have qualified if paid directly to the foreign parent.
- **Source of Income From Sales of Inventory.** Income from the sale of inventory produced within the United States and sold outside the United States (and vice versa) would be sourced solely based on the production activities with respect to the inventory.

Individual Taxation:

- **Simplified Individual Tax Rates.** The seven current marginal tax rates for individuals would be simplified into four primary rates of 12%, 25%, 35%, and 39.6%. The current top rate of 39.6% would be preserved for income in excess of $500,000 for individual taxpayers and $1,000,000 for married couples. A special "catch-up" provision would phase out the benefit of the 12% rate on the lowest tranche of income for the highest earners.
- **Doubled Standard Deduction and Eliminated Personal Exemptions.** The current standard deduction would be doubled, such that the first $12,000 of income for an individual would be tax-free ($24,000 for married couples). Personal exemptions, on the other hand, would be eliminated.

- **Changes to Itemized Deductions.** The limitation on the total amount of itemized deductions for high-income taxpayers would be repealed (although it would be less significant with the proposed limitations on the state and local tax and mortgage interest deductions). Most itemized deductions would be eliminated (e.g., moving expenses, medical expenses, personal casualty losses). However, the following would be retained, in some form:
  - **State and Local Property Tax Deduction.** Would allow individuals to deduct state and local property taxes up to $10,000. Would not allow individuals to deduct state and local income or sales taxes.
  - **Charitable deduction.** Would preserve the charitable deduction, with several minor changes.
  - **Mortgage interest deduction.** Would preserve the mortgage interest deduction for existing mortgages, and maintain the deductions for newly purchased homes up to $500,000 (but only for the taxpayer's principal residence).
- **Further Limits on Exclusion of Gain From Sale of Principal Residence.** The exclusion would be allowable only if the taxpayer lived in the residence for five of the previous eight years, and would be phased out by one dollar for every dollar by which the taxpayer's adjusted gross income exceeds $250,000 ($500,000 for married couples).
- **Application to Self-Employment Tax to Allocations of Partnership and S Corp Income.** The exception to self-employment tax (including the 3.8% portion applied without limitation of income) on allocations of income to a limited partner of a partnership would be repealed. In addition, self-employment tax would be applied to the portion of income of partnerships and S corporations (whether or not distributed) that would not benefit from the reduced 25% rate for business income of passthroughs (as described above).
- **No "Rothification" of Retirement Accounts.** Would preserve tax treatment of traditional defined contribution plans (e.g., 401(k)'s), which allow the employee to invest pre-tax money (only subject to tax on withdrawal).
- **Elimination of Individual AMT.** The Alternative Minimum Tax ("AMT") would be eliminated for individuals.
- **Estate and Generation-Skipping Transfer Taxes.** Would double the exemption, then repeal the estate and generation-skipping transfer taxes after six years. Would retain the step-up in basis at death. Would lower the gift tax to a top rate of 35% and retain a basic exclusion amount of $10 million and an annual exclusion of $14,000.
- **Elimination of Deduction for Alimony.** Alimony payments would no longer be deductible to the payor nor would alimony be taxable to the recipient.
- **Elimination of Employee Exclusions and Deductions.** Exclusions for employee achievement awards, employer-provided education assistance programs, dependent care assistance programs, and qualified moving expense reimbursement would be eliminated. The deduction for expenses attributable to the trade or business of being an employee would also be eliminated.
- **"Carried Interest" Treatment Not Eliminated.** In its current draft, carried interest appears to be untouched.

Changes Applicable to Tax-Exempt Organizations:

- **Excise Tax for Compensation in Excess of $1 Million.** Tax-exempt organizations would be subject to a 20% tax on compensation in excess of $1 million paid to any "covered employee," which, for this purpose, includes the organization's five highest paid employees for the tax year and any person that was a "covered employee" for any tax year after 2016.
- **Application of UBIT to Public Pension Plans.** State and local government pension plans, which are generally exempt from tax, would be subject to the "unrelated business income tax," which

applies to income derived from a trade or business that is not substantially related to the performance of the organization’s tax-exempt function.

- **Investment Income Excise Tax on Private Foundations and Private Colleges and Universities.** Private foundations would be subject to a 1.4% excise tax on net investment income, which tax would not be subject to reduction on account of distributions. Certain large private college and university endowments would also be subject to a 1.4% excise tax on net investment income.

The House Ways and Means Committee will begin acting on the bill on November 6, 2017. Many of the details that still remain to be fully drafted should be clarified as that markup progresses. Separately, the Senate Finance Committee is working on draft tax reform language, which is expected to be released by Thanksgiving. However, that timeline could change if House Republicans fail to first act on the bill in their own chamber.

Questions regarding the tax reform bill may be directed to any member of the Tax Group. Contact information is available on the final page of this memorandum.

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