November 10, 2017

U.S. Tax Reform

Joint Committee on Taxation Releases Summary of Senate Finance Committee's Tax Reform Plan

SUMMARY

Late yesterday, the Joint Committee on Taxation published the Senate's proposal on tax reform (in the form of a description of the "Chairman's Mark" of the "Tax Cuts and Jobs Act"). The Senate proposal shares some similarities but also contains notable differences to the House proposal, some of which are highlighted below (the initial House proposal is discussed in more detail in Sullivan & Cromwell LLP's November 2, 2017 memorandum; certain recent amendments to the House proposal will be noted in this publication). The Senate Committee on Finance has scheduled a markup of the Chairman's Mark on November 13, 2017. There is expected to be a series of amendments and debate within the Senate Committee on Finance early next week, with additional detail and legislative text expected as early as late next week. Because the proposal is not accompanied by legislative text, the details of these proposals are often unclear.

Key Differences Between House and Senate Proposals:

- **Corporate Tax Rate.** Both proposals would reduce the corporate tax rate from 35% to 20%, but the change would apply to taxable years starting after 2017 in the House proposal and after 2018 in the Senate proposal.
- **Excise Tax on Payments to Foreign Affiliates.** The Senate proposal excludes the 20% excise tax on certain deductible payments to foreign affiliates that is included in the current House proposal. Instead, the Senate proposal includes alternative measures aimed at preventing base erosion.
- **Deemed Repatriation Rates.** Both proposals would require deemed repatriation of untaxed foreign earnings; however, the House proposal as amended last evening would tax such earnings at rates of 14% (on cash and cash equivalents) and 7% (on all other earnings), whereas the Senate proposal would tax such earnings at rates of 10% and 5%, respectively.
- **Nonqualified Deferred Compensation.** The House proposal as amended last evening retains current law, whereas the Senate proposal would cause 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).

THE SENATE PROPOSAL

Some important features described in the summary of the Senate proposal are as follows:[1]

Business Taxation:

- **Corporate Tax Rate.** The maximum corporate tax rate would be permanently reduced from its current rate of 35% to a lower 20% rate, but (unlike in the House proposal) the change would apply to taxable years starting after 2018.
- **Deduction for Passthrough "Qualified Business Income."** The Senate proposal would allow an individual to deduct 17.4% of that individual's share of any "domestic qualified business income" of a passthrough (e.g., a partnership or S corporation). Subject to the wage limitation described below, the effective marginal rate would be 31.8% in respect of such income for the highest earners. The deduction would not apply to income from certain services businesses (e.g., accounting, law, health, financial services), except in the case of individuals whose taxable income would not exceed $150,000. Also, qualified business income would not include investment-related income, other than certain dividends from REITs. Further, the amount of the deduction generally would be limited to 50% of the domestic wages paid (apparently) by the taxpayer.[2] The deduction differs from the House proposal, which favors capital owners and otherwise applies a default "70-30" split for active owners and which generally does not benefit individuals who otherwise would not face a marginal rate higher than 25%.
- **Reduced Dividends Received Deduction.** Under the Senate proposal, consistent with the House proposal as amended last evening, a corporation would only be able to deduct 65% (down from 80% under current law) of the amount of dividends received from domestic corporations in which the receiving corporation owned more than 20% of the stock, and a corporation would only be able to deduct 50% (down from 70% under current law) of the amount of dividends received from other domestic corporations.
- **Interest Deductibility Limited.** Similar to the House proposal, the deductibility of net business interest would be effectively capped at 30% of adjusted taxable income (which may differ from the House measure that references EBITDA). This limitation would not apply to certain real estate activities or public utilities, exemptions for which are also available under the House proposal.
- **Net Operating Losses.** Similar to the House proposal, 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. Unlike the House proposal, however, there is no time value adjustment to the losses that are carried forward.
- **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. This description matches the House proposal.
- **Nonqualified Deferred Compensation.** Similar to the original House proposal (since amended to provide otherwise), the Senate proposal would 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).

[1] Unless otherwise noted, the proposed changes would become effective for years after 2017.

[2] The Senate proposal apparently would apply the limitation only to income from partnerships or S corporations.

- **Limits on Compensation Deductibility.** As in the House proposal, executive compensation paid to "covered employees" of a publicly traded corporation would no longer be deductible for amounts above $1 million, 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).
- **Some Business Tax Incentives Eliminated.** The Senate proposal would eliminate some business tax incentives (e.g., the domestic production deduction), but fewer would be eliminated than in the House proposal. Consistent with the House proposal, there would also be additional limitations on the deductibility of entertainment expenses.
- **Elimination of Corporate AMT.** As in the House proposal, the Alternative Minimum Tax ("AMT") would be eliminated for corporations.
- **Taxable Year of Inclusion for Income Recognized on Financial Statements.** The Senate proposal would require a taxpayer to recognize an item of income no later than the taxable year in which such item were taken into account on GAAP or similar financial statements. The scope of this requirement is unclear, and the literal application of the proposal could have far-reaching consequences, which may not be intended (given the relatively modest revenue score).
- **Like-Kind Exchanges Limited to Real Property.** As in the House proposal, deferral of gain on like-kind exchanges would only be permitted with respect to real property.
- **Limitation on Deduction for FDIC Premiums.** As in the House proposal, 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.** The Senate proposal does not contain a provision that would eliminate the double taxation of corporate profits, referred to as "corporate integration," which had previously been championed by Senator Orrin Hatch (Chairman of the Senate Committee on Finance).

International Taxation:

- **Shift From "Worldwide" Taxation to "Territorial" Taxation.** Similar to the House proposal, subject to certain minor differences, U.S. corporations that operate through foreign subsidiaries would only be taxed on those subsidiaries' U.S.-source income. This "territorial" system would be effectuated by means of a 100% dividends-received deduction for the foreign-source portion of dividends paid by a 10% or more owned foreign corporation to a U.S. corporate shareholder.
- **New Tax on Foreign Income From Intellectual Property.** The Senate proposal would identify certain global intangible low-taxed income ("GILTI") and require that a U.S. parent corporation include such income currently, even if such income were earned in a foreign subsidiary. Credits for foreign taxes imposed on such income would be reduced by 20%. GILTI would be defined for this purpose as the excess of active foreign source income (e.g., not including subpart F income, or income subject to a high rate of foreign tax) over a 10% return on the adjusted tax basis of active foreign tangible assets. A U.S. corporation would be entitled to deduct 37.5% of the lesser of its taxable income or certain of its foreign-derived income attributable to intangibles (including GILTI), resulting in an effective 12.5% rate for such income (a proposal that is sometimes described as "patent-box lite").
- **Incentive for IP Migration to the United States.** A separate proposal eliminates the potential tax on distributing IP back to the United States, which may in some cases encourage relocation of intangibles back to the United States if there are no foreign tax consequences to such a distribution.
- **No Excise Tax on Payments to Foreign Affiliates.** Under the most recent amended version of the House proposal, domestic corporations would be subject to a 20% tax on various related-

party cross-border transactions unless the related party elected to treat the payment as effectively connected income subject to net basis U.S. taxation. The Senate proposal excludes this provision.

- **New Base Erosion Minimum Tax.** The base erosion minimum tax is essentially a 10% minimum tax calculated on a base equal to the taxpayer's income determined without tax deductions or other tax benefits arising from "base erosion" payments. A "base erosion payment" is generally an amount paid or accrued by a taxpayer to a related foreign person that is deductible to the taxpayer. This provision would only apply to corporations that have average annual gross receipts of at least $500 million (for the three prior tax years) and that have a "base erosion percentage" of at least 4%. The base erosion percentage means, for any taxable year, the percentage determined by dividing the corporation's base erosion tax benefits by the total deductions allowed with respect to the corporation.
- **Mandatory Deemed Repatriation of Offshore Earnings and Profits.** Consistent with the House proposal, the foreign earnings of subsidiaries of a U.S. corporation 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 the U.S. parent corporation. All earnings held in cash and cash equivalents would be taxed at a 10% rate (14% in the amended House proposal) and all other earnings would be taxed at a 5% rate (7% in the amended House proposal). At the election of the taxpayer, this tax could be paid over a period of eight years. The amount of earnings would be determined as of November 9, 2017 (or other applicable measurement date). Foreign tax credits triggered by the deemed repatriation would be available to partially offset the tax resulting from the deemed repatriation. The benefits of the reduced rates upon repatriation would be recaptured if the U.S. company engages in an inversion transaction within 10 years (i.e., where U.S. shareholders hold an inversion percentage in the 60-80% range).
- **U.S. Tax on Sale of Certain Partnership Interests.** Overturning a recent case decided by the Tax Court in favor of the taxpayer, but consistent with the IRS's position at least since its revenue ruling in 1991, the Senate proposal provides that a non-U.S. partner in a partnership would recognize gain or loss treated as "effectively connected" to a U.S. trade or business upon the sale of the partner's partnership interest, to the extent that the partner would be treated as having effectively connected income in a hypothetical sale of all the assets of the partnership. The transferee in such transaction would be required to withhold 10% of the amount realized, unless the transferor certifies that it is not a nonresident alien or foreign corporation. This proposal would apply to sales and exchanges occurring after December 31, 2017.
- **Interest Deductibility Limited for U.S. Members of Multinationals.** The deductible interest expense of U.S. corporations that are members of a worldwide affiliated group would be limited to the extent that the worldwide affiliated group's total debt is disproportionately held by the group's U.S. members. The U.S. corporation's deduction for interest would be reduced by the product of the corporation's net interest expense and the "debt-to-equity differential percentage" of the worldwide affiliated group. The debt-to-equity differential percentage of the worldwide affiliated group means the amount by which the total indebtedness of the U.S. members of the group exceeds 110% of the total indebtedness those members would hold if their total indebtedness to total equity ratio were proportionate to the ratio of the total indebtedness to total equity of the worldwide group. Intragroup debt and equity interests are disregarded for purposes of this calculation. This provision would serve both as a limit on the ability of a related foreign parent corporation to strip earnings out of a U.S. subsidiary through debt capitalization and as a de facto "world-wide apportionment rule" for the allocation of interest expense incurred by a U.S. multinational between U.S. earnings and exempt foreign-source dividend income.
- **Definition of "U.S. Shareholder" of a Controlled Foreign Corporation.** The Senate proposal broadens the definition of "U.S. shareholder" to include a person who owns 10% or more of a foreign company's stock by value (in addition to those who own 10% or more by vote, which is the test under current law) for the purposes of determining whether a foreign corporation is a "controlled foreign corporation" and for purposes of the various changes described above. This change would take effect for taxable years beginning before January 1, 2018.

- **No Preferential Rates for Dividends From Inverted Companies.** Shareholders would not be eligible for the lower rates that apply to certain "qualified" dividends if those dividends were received from a corporation that had engaged in an inversion transaction (i.e., where U.S. shareholders hold an inversion percentage in the 60-80% range).
- **Source of Income From Sales of Inventory.** As in the House proposal, 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.
- **Outbound Transfers of Intangible Property.** The Senate proposal confirms IRS authority on recent guidance regarding the treatment of outbound transfers of certain intangibles. The proposal supports the position put forth in Treasury regulations proposed in September 2015, which provide that upon an outbound transfer of foreign goodwill or going concern value, a U.S. transferor would be subject to either current gain recognition or to a special rule that requires inclusion of deemed royalties following such transfer, even if the value of the transferred property was created exclusively through offshore activities. The Senate proposal would also confirm the IRS's authority to specify the method to be used to determine the value of the intangible property transferred.
- **Denial of Deduction for Interest and Royalty Payments Involving Hybrid Entities.** The Senate proposal would deny a deduction with respect to certain payments of interest or royalties between related parties where the recipient is not required to include the payment in income under the tax law of its country of residence, is allowed a deduction with respect to such amount, or is a "hybrid entity" (i.e., is treated as a passthrough entity for U.S. tax purposes but not for foreign tax purposes, or vice versa).

Individual Taxation:

- **Individual Tax Rates.** The seven current marginal tax rates for individuals would be modified, with a top rate of 38.5% for income in excess of $500,000 for individuals and $1 million for married couples, but there would be no "catch-up" provision to phase-out the benefit of the 10% rate on the lowest tranche of income for the highest earners. The House proposal includes only four brackets, maintaining the current top marginal rate of 39.6%.
- **Doubled Standard Deduction and Eliminated Personal Exemptions.** As in the House proposal, 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 would be eliminated.
- **Changes to Itemized Deductions.** As in the House proposal, the limitation on the total amount of itemized deductions for high-income taxpayers would be repealed (although this would be less significant with the proposed limitations on the state and local tax deductions). All "miscellaneous itemized deductions" that currently may only be claimed if their aggregate amount exceeds 2% of the taxpayer's adjusted gross income would be eliminated (e.g., deductible investment expenses from passthrough entities).
- **State and Local Tax Deduction.** The Senate proposal would not allow individuals to deduct any state and local income, sales, or property taxes, unless such taxes were paid or accrued in carrying on a trade or business. The House proposal also would deny deductions for an individual's state and local income and sales taxes, but would allow individuals to deduct state and local property taxes up to $10,000.
- **Charitable Deduction.** The Senate proposal, like the House proposal, would preserve the charitable deduction with several minor changes.
- **Mortgage Interest Deduction.** The Senate proposal would preserve the mortgage interest deduction in its current form (for mortgages up to $1 million), but would repeal the deduction for interest on home equity indebtedness. The House proposal limits the mortgage interest deduction

to mortgages of up to $500,000, and only permits the deduction with respect to the taxpayer's personal residence.

- **Further Limits on Exclusion of Gain From Sale of Principal Residence.** Consistent with the House proposal, the exclusion of gain from the sale of a principal residence would be allowable only if the taxpayer lived in the residence for five of the previous eight years. The exclusion would not be phased out as the taxpayer's adjusted gross income rises.
- **Estate, Gift and Generation-Skipping Transfer Taxes.** The Senate proposal would double the estate, gift and generation-skipping transfer tax exemption amount (to $11.2 million per person (or $22.4 million for a married couple) in 2018, adjusted annually for inflation), but would not repeal the estate and generation-skipping transfer taxes, as the House proposal would do. No other changes would be made to the estate and gift tax regime.
- **Application of Self-Employment Tax to Allocations of Passthrough Income.** Consistent with an amendment to the House proposal, the Senate proposal retains the current rules on the application of payroll taxes to amounts received through a passthrough entity.
- **No "Rothification" of Retirement Accounts.** As in the House proposal, the Senate proposal 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.** As in the House proposal, the AMT would be eliminated for individuals.
- **Deduction for Alimony.** The Senate proposal does not eliminate the deduction for alimony payments, as the House proposal would do.
- **Elimination of Certain Employee Exclusions and Deductions.** Consistent with the House proposal, the exclusion for qualified moving expense reimbursement, as well as the qualified bicycle reimbursement, would be eliminated. The deduction for moving expenses would also be eliminated. Notably, however, the exclusion for adoption assistance programs and dependent care programs seems untouched in the Senate proposal.
- **"Carried Interest" Treatment Not Affected.** The Senate proposal would not affect the treatment of income in respect of carried interest. However, an amendment to the House proposal earlier this week included a limitation on the application of preferential rates to gains on investments allocable to a carried interest in respect of investments held for three years or less.

Changes Applicable to Tax-Exempt Organizations:

- **Excise Tax for Compensation in Excess of $1 Million.** As in the House proposal, 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.
- **No Application of UBIT to Public Pension Plans.** The Senate proposal would not cause state and local government pension plans, which are generally exempt from tax, to be subject to the "unrelated business income tax." The House proposal would do so.
- **Investment Income Excise Tax on Private Colleges and Universities.** As in the House proposal, certain large private college and university endowments would be subject to a 1.4% excise tax on net investment income. However, unlike in the House proposal, the excise tax that applies to private foundations would be unchanged.

Amendments to the bill will be filed by members of the Senate Finance Committee this weekend, and the Committee will begin acting on the bill on November 13, 2017. Many of the details of the above proposals should be clarified as the markup progresses. The Committee will aim to complete the markup by the end of next week and to submit the bill to a vote on the Senate floor during the week after Thanksgiving.

THE HOUSE BILL

The House Committee on Ways and Means marked up its own proposed bill this week and passed an amended version of that proposal by a 24-16 party-line vote. The amendments to the initial House proposal included several significant changes, including an increase in the tax rates applicable to deemed-repatriated foreign earnings, an extension of the holding period required to benefit from "carried interest" treatment, and abandonment of the proposed treatment of nonqualified deferred compensation described above. The House Committee on Rules will convene next week to consider the bill as passed by the Ways and Means Committee. After that, the bill would go to the floor of the House for a final vote.

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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