November 14, 2017

Update on the Tax Cuts and Jobs Act

On November 7, 2017, we published a client memorandum (our "Initial Tax Reform Memo") summarizing key provisions of the "Tax Cuts and Jobs Act," which the House Ways and Means Committee released on November 2, 2017, and which was modified by certain amendments Chairman Brady proposed on November 3, 2017, and November 6, 2017 (together, the "House Bill"). Chairman Brady proposed an additional amendment on November 9, 2017 (the "Amendment to the House Bill"), which made significant changes.

On November 9, 2017, the Senate Finance Committee released a Description of the Chairman's Mark of the Tax Cuts and Job Act, which sets forth the Senate's initial tax reform proposal (the "Senate Proposal"). While the Senate Proposal generally maintains the same framework for tax reform as the House Bill, there are meaningful differences between the two proposals. Given the extent of the changes being considered and the nature of the differences between the House Bill and Senate Proposal, it is hard to predict with any certainty which proposals in the House Bill or Senate Proposal, if any, may ultimately become law.

We summarize below the key changes introduced by the Amendment to the House Bill as well as describe certain key provisions of the Senate Proposal.[1]

Amendment to the House Bill

The Amendment to the House Bill made a number of meaningful changes including:

- Introducing an additional 9% preferential rate with respect to the first $75,000 of "qualified business income" for married taxpayers with total business income less than $150,000 (or $37,500 and $75,000 for individual taxpayers), which would be phased in over five taxable years;

- Preserving the existing "limited partner" exception from self-employment tax, which would have been repealed under the House Bill;

- Reducing the 70% dividends received deduction ("DRD") to 50% and the 80% DRD to 65% (with the effect of taxing such dividends at 10% and 7%, respectively, consistent with existing law);

- Increasing the effective tax rates on deemed repatriated earnings from 12% to 14% on earnings held in cash and cash equivalents and 5% to 7% on all other earnings;

[1] Unless otherwise noted, the changes discussed would be effective for taxable years beginning after 2017.

- Modifying aspects of the new excise tax on certain payments from domestic corporations to related foreign corporations by eliminating the cost plus component of the deemed expense deduction and allowing a foreign tax credit equal to 80% of foreign taxes paid (measured by reference to existing law on foreign tax credits rather than a formula based on financial accounting information);

- Preserving the current law treatment of nonqualified deferred compensation, which the House Bill would have dramatically changed; and

- Expanding the repeal of the "Johnson Amendment" (which currently prohibits tax-exempt organizations from participating or intervening in political campaigns on behalf of, or in opposition to, candidates for public office) to all Section 501(c)(3) organizations for the 2019 through 2023 taxable years (with the repeal applying only to churches thereafter).

Senate Proposal

Tax Reform for Individuals

Tax Rates

Unlike the House Bill, which would consolidate the individual income tax brackets into four brackets while retaining the 39.6% rate for income over $1 million, the Senate Proposal would use seven brackets with slightly modified income thresholds: 10%, 12%, 22.5%, 25%, 32.5%, 35% and 38.5%, with the 38.5% rate applying to income over $1,000,000 for married taxpayers filing jointly.

Deductions and Exemptions

Similar to the House Bill, the Senate Proposal would (i) almost double the standard deduction (the House Bill would actually double the deduction), (ii) repeal personal exemptions, (iii) repeal the overall limitation on itemized deductions (commonly known as the Pease limitation), (iv) increase the limit on the deduction for charitable contributions to 60% of a taxpayer's adjusted gross income, (v) repeal the alternative minimum tax (the "AMT") and (vi) repeal the itemized deduction for all state and local income taxes not incurred in a trade or business. Note that this is more restrictive than the House Bill, which would allow an itemized deduction of up to $10,000 for state and local property taxes. The Senate Proposal also clarifies (as did a letter from Chairman Brady) that the trade or business exception would not apply to income taxes payable at the individual level. The Senate Proposal would also fully repeal all the itemized deductions for expenses previously subject to the 2% floor limitation (*i.e.*, expenses incurred for the production or collection of income and all unreimbursed expenses attributable to the trade or business of being an employee).

Unlike the House Bill, which would impose new limits on the mortgage interest deduction more generally, the Senate Proposal would only repeal the deduction with respect to home equity loans and would leave the limit on deductible mortgage debt at $1 million (*i.e.*, the deduction would still be available for second home mortgages). Finally, among other things, the Senate Proposal would not eliminate the deduction for medical expenses or alimony payments as contemplated by the House Bill.

Basis for Sales of Securities

The Senate Proposal would modify current law with respect to taxpayers owning different "lots" or "blocks" of securities by generally requiring taxpayers to determine the cost of any securities sold on a first-in, first-out basis, rather than permitting identification of specific lots sold.

Estate and Gift Taxes

Like the House Bill, the Senate Proposal would double the exemptions for federal estate, gift and generation-skipping transfer ("GST") taxes. Effective January 1, 2018, those exemptions would be $11.2 million ($10 million, adjusted for inflation since 2011). Except for the expanded exemptions, the federal estate, gift and GST tax rules would remain the same as under current law. Unlike the House Bill, there would be no future repeal of the estate and GST taxes and no future reduction of the gift tax rate (both of which would occur in 2024 under the House Bill).

Partnerships and Other Pass-Through Entities

Pass-Through Rate

The Senate Proposal would permit individual taxpayers to deduct 17.4% of "domestic qualified business income" received from partnerships and other pass-through entities, which would result in a top rate on "domestic qualified business income" of approximately 31.8% assuming a top marginal rate of 38.5%. This is meaningfully different than the approach taken in the House Bill.

For purposes of the Senate Proposal, "qualified business income" would generally include items of income, gain, deduction and loss with respect to a taxpayer's businesses but would not include certain types of income that resemble W-2 wages or reasonable compensation. There would be no distinction for active or passive business income under the Senate Proposal.[2] Similar to the House Bill, the proposed 17.4% deduction would not be available to certain types of professional service businesses such as law, accounting, financial services firms and other businesses where the principal asset of such trade or

2 The House Bill would provide that 100% of passive business income and 30% of active business income (subject to certain elections for capital intensive businesses) would be eligible for the preferential pass-through rate.

business is the reputation or skill of one or more of its employees, but the deduction would apply to dividends from REITs.

Sale of Partnership Interests by Non-U.S. Partners

The Senate Proposal would override the holding of a recent U.S. Tax Court case[3] by providing that a non-U.S. partner's sale of an interest in a partnership engaged in a U.S. trade or business would result in income effectively connected with a U.S. trade or business ("ECI") to the extent such partner would have realized ECI upon a hypothetical sale of assets by the partnership as of the date of the sale or exchange of the partnership interest. To implement this new rule, the Senate Proposal would require transferees of partnership interests to withhold 10% of the amount realized on the sale or exchange of such an interest unless the transferor partner provides certification of its domestic status if applicable. The partnership would be required to deduct and withhold from distributions to the transferee partner if the transferee fails to withhold the correct amount from the transferor.

Other Observations

The current version of the Senate Proposal would not change the current tax treatment of carried interest (though certain proposed amendments that the Senate Finance Committee may consider in markup will focus on carried interest) and would preserve the "limited partner" exception from self-employment tax.

Corporate Tax Reform

Like the House Bill, the Senate Proposal would lower the corporate tax rate to 20% and repeal the corporate AMT, although the 20% rate would not go into effect until 2019. In addition, like the House Bill as amended, the Senate Proposal would also reduce the current DRD rate from 70% to 50%, and the 80% DRD that applies to subsidiaries in which the corporate shareholder owns 20% or more (but less than 100%), would be reduced to 65%. This reduction would take effect in 2019 along with the reduced 20% corporate rate.

Immediate Expensing

The Senate Proposal is generally consistent with the House Bill, except that used property would not be eligible for immediate expensing.

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3 *Grecian Magnesite Mining Co.* v. *Commissioner*, 149 T.C. No. 3 (July 13, 2017).

Interest Deductions

Under the Senate Proposal, like in the House Bill, business interest expense would always be available to offset business interest income and any net business interest expense would be disallowed to the extent the interest expense exceeds 30% of the business' "adjusted taxable income." Under the Senate Proposal depreciation and amortization would be deducted from "adjusted taxable income," and therefore the expected limitation under the Senate Proposal for any particular taxpayer would be expected to be lower than under the House Bill. The Senate Proposal is more generous than the House Bill with respect to carryforwards; under the Senate Proposal, excess amounts can be carried forward indefinitely, whereas the House Bill would limit carryforwards to five years. Like the House Bill, the interest deductibility limitation would also apply at the level of a partnership. The Senate Proposal would provide helpful technical rules related to the tiering up of the interest limitation.

The Senate Proposal would also impose an additional limitation on interest deductions of certain multinational groups, which is similar to the House Bill, but the details of the two proposals vary significantly. Under the Senate Proposal, deductions attributable to interest paid by U.S. corporations that are part of a "worldwide affiliated group" (one or more chains of corporations (including foreign corporations) connected through stock ownership (50% for these purposes) with a common parent) would be reduced by the product of (i) net interest expense and (ii) the "debt-to-equity differential percentage" of the worldwide affiliated group. The debt-equity differential percentage, in turn, is the ratio of (i) the "excess domestic indebtedness" to (ii) the total indebtedness (of the domestic members of the worldwide affiliated group). The excess domestic indebtedness would be equal to the amount by which total indebtedness of the domestic members of the group exceeds 110% of what such debt would be if the U.S. group's debt to equity ratio was proportionate to the debt to equity ratio of the worldwide affiliate group as a whole (ignoring intragroup debt and equity for this purpose). As under the House Bill, this limitation applies in addition to the general 30% limitation described above, and again the carryforward is more generous (indefinite as opposed to five years under the House Bill).

Changes to NOLs

As would be the case under the House Bill, under the Senate Proposal, NOL carryforwards would only be available to offset 90% of the taxpayer's income in any taxable year (similar to the rules for NOL carryforwards under the current AMT). The Senate Proposal generally conforms with the House Bill by permitting taxpayers to carry forward indefinitely unused NOLs generated in taxable years after December 31, 2017, and subject to limited exceptions, would eliminate NOL carrybacks. Unlike the House Bill, the Senate Proposal would not provide for an interest factor for NOLs that are carried forward.

Other Changes

The Senate Proposal would limit like-kind exchanges to those involving real property and reduce the circumstances where a taxpayer can deduct entertainment expenses, which is consistent with the House Bill. The Senate Proposal would eliminate certain credits, but not necessarily the same credits or to the same extent as in the House Bill. For example, the Senate Proposal would reduce but not eliminate the "orphan drug" credit and would not currently eliminate or modify any energy credits. The Senate Proposal proposes significant changes to the taxation of insurance companies (although the specific proposals are different from the House Bill). The Senate Proposal would also shorten the recovery period for nonresidential and rental properties to 25 years (from 39 years and 27.5 years, respectively) for taxpayers other than real property businesses electing out of the new proposed limitations on interest deductibility.

Finally, the Senate Proposal would make various changes to tax accounting rules, including (i) requiring a taxpayer to recognize income no later than the taxable year in which such income is taken into account as income on an applicable financial statement, (ii) permitting a taxpayer to defer income attributable to certain advance payments in certain circumstances if such income is also deferred for the taxpayer's financial statement purposes and (iii) providing that general revenue recognition principles would take precedence over original issue discount rules in determining the timing of income associated with payments on debt instruments such as late-payment fees, cash-advance fees, or interchange fees.

International Tax Considerations

The Senate Proposal also would move the U.S. tax system closer to a territorial system while introducing new provisions to combat base erosion. As discussed below, however, the details of the international tax proposals in the Senate Proposal differ from the House Bill in a number of important ways.

Partial Participation Exemption/Territorial System

The Senate Proposal would establish a partial participation exemption system that broadly aligns with the proposal outlined in the House Bill, but with a few notable differences including doubling the required holding period to be eligible for the exemption as compared to the House Bill. The Senate Proposal adds a limitation that is not included in the House Bill that would exclude from the participation exemption any "hybrid dividend" received by a U.S. shareholder from a controlled foreign corporation (a "CFC"). A hybrid dividend is an amount received from a CFC that would otherwise be eligible for the exemption, but for which such CFC received a deduction or other tax benefit from taxes imposed by a foreign country.

Deemed Repatriation of Deferred Earnings

Consistent with the House Bill, the Senate Proposal would require a mandatory deemed repatriation of deferred foreign earnings and a corresponding U.S. tax thereon, however, certain details of the plan vary. Among other things, the Senate Proposal would provide (i) a 10% rate on liquid assets and a 5% rate on illiquid assets, (ii) an election that a U.S. shareholder could make to pay the tax liability in respect of the deemed repatriation over a period of up to eight years (with smaller payments in the first five years as compared to the House Bill), and (iii) a six-year statute of limitations with respect to the deemed repatriation tax.

The Senate Proposal also introduces a recapture rule that results in a 35% tax rate with respect to deemed repatriated earnings if a U.S. shareholder becomes an expatriated entity within the meaning of Section 7874(a)(2) within the 10-year period following enactment of the rule.

Tax on "Global Intangible Low-Taxed Income"

The Senate Proposal would add a tax on "global intangible low-tax income" ("GILTI") that is similar to the House Bill proposed tax on "foreign high return amounts" but at a higher effective rate of tax. The Senate Proposal generally results in a minimum 12.5% tax rate on GILTI (compared to 10% under the House Bill). As under the House Bill, a U.S. shareholder that includes income under this provision would receive a foreign tax credit which would be limited to 80% of the foreign taxes paid by the CFC on this income, which means that residual U.S. tax would be fully eliminated only if foreign taxes are paid at a rate of at least 15.625% (as compared to 12.5% under the House Bill).

The Senate Proposal also includes a transition rule that could enable the transfer of intangible property that is held by CFCs on the date of enactment of the proposal back into the U.S. (thereby avoiding application of the rules), by limiting in certain circumstances, the fair market value of intangible property that is distributed by a CFC to its U.S. corporate shareholder to such property's adjusted basis.

Other Base Erosion Rules in Senate Proposal Not Contained in House Bill

In an attempt to further disincentivize U.S. corporations from conducting "inversion" transactions, the Senate Proposal would not permit an individual shareholder to receive preferential qualified dividend treatment on dividends received from "surrogate foreign corporations" in "60% inversions." There is no grandfathering provision in the Senate Proposal, so the less favorable treatment would apply to dividends received from companies that have already inverted. The Senate Proposal would also make certain changes that are intended to restrict the ability of U.S. taxpayers to transfer intangible property overseas tax-free.

The Senate Proposal would also make other changes in this area, including eliminating deductions otherwise allowable with respect to "hybrid transactions" in which interest or royalties are paid or accrued by a U.S. entity to a related party that are not treated as income or are deductible in the recipient's resident country such as repurchase agreements (or "repos"), which are often used in U.S.-Canadian cross-border transactions.

Finally, while the Senate Proposal does not include the House Bill's 20% base erosion excise tax on certain payments from U.S. corporations to related foreign corporations, it would introduce a version of an alternative minimum tax in this context—the base erosion minimum tax amount for certain large U.S. corporations (other than RICs, REITs and S Corporations). The base erosion minimum tax amount would be the excess of 10% of the corporation's taxable income, determined without regard to any benefits from deductible payments made to related parties, over the corporation's regular tax liability net of certain tax credits.

Changes to CFC Rules and PFIC Rules

The Senate Proposal generally follows the House Bill with respect to rules related to CFCs (including eliminating the limitation on attribution from U.S. persons to non-U.S. persons), but unlike the House Bill, the Senate Proposal would expand the definition of a "United States shareholder" to include U.S. taxpayers who own 10% or more of the total value (as opposed to solely the vote) of shares of all classes of stock of such foreign corporation. In the Senate Proposal, both of these changes would be retroactive and apply for the last taxable year of the applicable foreign corporation beginning before January 1, 2018. This change may impact taxpayers who invest currently in foreign corporations where vote and value have been separated in order to avoid application of the CFC rules. Like the House Bill, the Senate Proposal would also propose an exception to the general rule requiring subpart F income to be recognized upon a CFC's investment in U.S. property for domestic corporations that are U.S. shareholders in the CFC, either directly or through a domestic partnership. In addition, like the House Bill, the Senate Proposal would amend the insurance business exception to the PFIC classification to be a more objective test based in part on calculations of the entity's insurance liabilities, rather than the business activities of the entity.

Section 883 (Cruise Income) Changes

The Senate Proposal would introduce a new category of income defined as "passenger cruise gross income," with detailed rules to determine whether that income should be considered ECI, and would remove that income for exemption from U.S. taxation under Section 883. This would result generally in effectively connected passenger cruise income becoming subject to U.S. tax on a net basis for the first time in nearly a century.

Tax-Exempt Organization Considerations

The Senate Proposal contains a number of new provisions that make the UBTI rules more burdensome on tax exempts generally, including requiring tax-exempt organizations to compute their UBTI on a separate trade or business basis rather than an aggregate basis across all unrelated trades or businesses and including in UBTI income generated from licensing a name or logo of a tax-exempt organization. Unlike the House Bill, the Senate Proposal would not subject so-called "super tax-exempt investors," such as State pension plans to tax on their UBTI.

The Senate Proposal would not repeal the "Johnson Amendment" as contemplated by the House Bill.

Significant Executive Compensation-Related Amendments

The Senate Proposal appears to revive the radical changes to the taxation of deferred compensation and stock options as originally proposed in the House Bill; even though on the same day (as noted above) the Amendment to the House Bill scrapped the analogous provisions of the House Bill (reverting to current law).

The Senate Proposal would also make a few changes affecting 401(k) plans and other tax-favored retirement plans, such as, eliminating the opportunity for participants over age 50 to add extra "catch-up contribution" amounts to their 401(k) deposits if the participant received $500,000 or more in wages in the preceding year.

For many employers, proper classification of some workers as either an independent contractor vs. an employee is difficult, and misclassification mistakes can be costly. The Senate Proposal offers some relief by providing a multi-pronged safe harbor test that, if met, will confirm classification as an independent contractor for all purposes of the Internal Revenue Code (including employment taxes). Interestingly, the safe harbor would impose a new tax-withholding obligation on payments to independent contractors – today, no withholding is required – but the withholding would be limited to 5% of the compensation up to $20,000. Although a welcome start in this area, the Senate Proposal would only apply to the federal tax laws, and would not change the checkered patchwork of federal labor policy under the NLRA and state labor and employment laws that also regulate classification as an independent contractor or employee, including minimum wages and overtime. This proposal clearly reflects the importance of the fast-moving "gig" economy that prizes the flexibility offered by the independent contractor classification.

Among matters affecting tax-exempt organizations, the Senate Proposal would follow the House Bill by imposing a new 20% penalty tax on exempt organizations for paying executive compensation in excess of stated limits. In addition, further taxes could be imposed on the organization for unreasonable compensation under revised "intermediate sanctions" rules.

Other than as set forth above, the Senate Proposal is substantively similar to the House Bill with respect to compensation-related matters. Importantly, this includes the expansion of Section 162(m), as described in our Initial Tax Reform Memo, such that the $1 million deduction limitation on proxy officer compensation (including the CFO) would no longer exclude performance-based compensation and would apply to certain debt issuers and companies publicly traded through ADRs, as well as certain large private corporations.

We expect that the Senate Proposal will continue to evolve as the Senate Finance Committee does its markup of the Senate Proposal this week. We will continue to monitor developments throughout the tax reform process and provide updates as they become available.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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