Tax Update

Fifteen Key Provisions in the Final Tax Reform Bill

December 21, 2017

On December 20, 2017, the Senate and House of Representatives passed H.R. 1, known as the "Tax Cuts and Jobs Act" ("Tax Reform Bill"). President Trump is expected to sign the Tax Reform Bill by early January. The Tax Reform Bill would represent the most significant revision to the tax code in over thirty years. Our summary below highlights several of the most significant changes that will impact taxpayers.

1. Corporate Tax Rate

Reduces the maximum corporate tax rate to 21% from 35% effective 2018, and repeals the corporate alternative minimum tax.

2. Partnership and S Corporation Taxation

An individual taxpayer or trust generally may deduct 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship, capped at the greater of (i) 50% of the taxpayer's allocable or pro rata share of W-2 wages paid by the partnership, S corporation or sole proprietorship or (ii) the sum of 25% of W-2 wages paid plus a capital component equal to 2.5% of the unadjusted tax basis of the business's tangible depreciable property.

- The full deduction generally does not apply to specified service businesses, except in the case of a taxpayer whose taxable income does not exceed $315,000 for married individuals filing jointly or $157,500 for single individuals (with the benefit of the deduction phased out between $315,000 and $415,000 for married individuals and $157,500 and $207,500 for single individuals).

3. Carried Interest

The required holding period for long-term capital gains is increased to three years in respect of certain partnership interests transferred in connection with the performance of services by taxpayers.

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4. 30% Limitation on Interest Deductions

Deductions for net interest expenses for all business entities would be limited to 30% of the business's "adjusted taxable income" (as defined, similar to EBITDA) The computation of "adjusted taxable income" will become less taxpayer favorable in 2022 when "adjusted taxable income" will be reduced by depreciation, amortization and depletion. Any disallowed interest expense may be carried forward indefinitely.

5. Dividends Received Deduction

Effective in 2018, a corporation may only deduct 65% (rather than 80% under current law) of dividends received from U.S. corporations in which the receiving corporation owns more than 20% of the stock, and a corporation may only deduct 50% (rather than 70% under current law) of dividends received from other U.S. corporations.

6. Shift to Quasi-Territorial International Tax System

Generally, the current worldwide tax system would be converted into a quasi-territorial system through the exemption of 100% of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the foreign corporation.

- Each 10% U.S. shareholder of a foreign subsidiary would be subject to a one-time tax on its share of the foreign subsidiary's historical earnings and profits ("E&P") not previously subject to U.S. tax (15.5% rate would apply to E&P attributable to cash and 8% rate to the remaining amount of E&P).

- Foreign tax credits may be available to offset a portion of this tax and a taxpayer may elect to pay the tax liability over eight annual installments (first five installments each equal to 8% of the liability and sixth, seventh and eighth installments equal to 15%, 20% and 25%). Future distributions of E&P subject to the one-time tax would not be subject to a second tax upon receipt.

7. Base Erosion Anti-Abuse Tax

A 5% (increased to 10% in 2019 and to 12.5% in 2026) minimum tax would be imposed on U.S. C corporations calculated on a modified tax base that excludes certain deductions, such as deductions for payments made to a related foreign party. The minimum tax would only apply to corporations with average annual gross receipts of at least $500 million, at least 3% of whose deductions are derived from payments made to a related foreign party. Special rules apply to banks and security dealers.

8. **Reduced Effective Tax Rate for Foreign-Derived Intangible Income of U.S. Corporations**

A U.S. corporation would be subject to a reduced 13.125% effective tax rate between 2018 and 2025 after permitted deductions (16.406% effective tax rate beginning in 2026), rather than the new 21% corporate tax rate, on foreign-derived intangible income (generally, intangible income of a U.S. corporation from foreign sales, including licenses and leases, and foreign services that exceeds an implied 10% rate of return on its tangible business assets).

9. **Global Intangible Low-Taxed Income of Foreign Subsidiaries**

A U.S. corporation would be subject to a 10.5% U.S. tax (increased to 13.125% beginning in 2026) on the global intangible low-taxed income ("GILTI") earned by its foreign subsidiaries, which is the amount of income of a foreign subsidiary that exceeds an implied 10% rate of return on its tangible business assets. Only 80% of foreign taxes paid on GILTI would be allowed as a foreign credit.

10. **U.S. Tax on Sale of Partnership Interests**

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 if the partner would be treated as having effectively connected income from a hypothetical sale of all the partnership assets. The transferee would be required to withhold 10% of the amount realized, unless the transferor certifies that it is not a foreign person. This provision would effectively codify the IRS's current view and override *Grecian Magnesite*, a recent Tax Court decision.

11. **Capital Expensing**

Generally, businesses would be able to immediately "write off" or expense 100% of the cost of qualified property, including certain real property, acquired and placed in service between September 28, 2017 and December 31, 2022, with a phase-down of full-expensing by 20% a year in the case of property placed in service after December 31, 2022 and before January 1, 2027 (i.e., allowing an 80% deduction for property placed in service in 2023, a 60% deduction for property placed in service in 2024, a 40% deduction for property placed in service in 2025, and a 20% deduction for property placed in service in 2026).

12. **Net Operating Losses**

The use of net operating losses ("NOLs") would be limited to 80% of taxable income for losses arising beginning in 2018. Taxpayers generally may carry forward NOLs indefinitely but may not carry back any NOLs.

13. **Like-kind Exchanges**

Like-kind exchanges would generally be limited to only real property.

14. **Deduction on Executive Compensation**

U.S. and certain foreign public companies generally would not be able to deduct compensation paid to "covered employees" of over $1 million as a result of the repeal of the "performance-based compensation" exception.

- "Covered employees" would include the CFO. In addition, any employee who is a "covered employee" beginning in 2017 would remain a "covered employee" for future years. Compensation paid pursuant to a written contract in effect on November 2, 2017 is exempt if the contract is not materially modified.

15. **Insurance Companies**

The Senate proposals include extensive changes to the taxation of insurance companies.

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