Fifteen Provisions to Watch in the Tax Reform Proposals

November 17, 2017

On November 14, 2017, Senate Finance Committee Chairman, Orrin Hatch (R-Utah), released his modified tax reform plan ("Senate Bill"),[1] which adopts some of the House Bill proposals (as amended) ("House Bill"),[2] but also includes some important differences as highlighted below. Discussions are ongoing and the notable provisions summarized below may change and/or be replaced by new provisions. We will update you as significant developments unfold.

1. Corporate Tax Rate

House Bill: Reduce the maximum corporate tax rate to 20% from 35% effective 2018.

Senate Bill: Same, except that the reduction would be deferred until 2019.

2. Partnership and S Corporation Tax Rate

House Bill: Qualified business income of owners/shareholders of a partnership or S corporation would be subject to a maximum tax rate of 25% rather than the current 39.6% maximum individual tax rate.

- For service businesses such as law, accounting, consulting and financial services, qualified business income is limited to the "capital percentage" of each owner's net income derived from active business activities. Owners/shareholders in non-service businesses may elect to treat qualified business income (which includes any net income derived from a passive business activity) as equal to 30% of its net business income from active business activities.

[1] *See* Description of the Chairman's Mark of the "Tax Cuts and Jobs Act", dated as of November 9, 2017, and Description of the Chairman's Modification to the Chairman's Mark of the "Tax Cuts and Jobs Act", dated as of November 14, 2017. This summary does not reflect a review of the proposed statutory text of the Senate Bill, which has not yet been released at the time of drafting.

[2] H.R. 1, Tax Cuts and Jobs Act.

Senate Bill: An individual taxpayer generally may deduct 17.4% of domestic qualified business income from a partnership, S corporation, or sole proprietorship, capped at 50% of the taxpayer's allocable or pro rata share of W-2 wages paid by the partnership, S corporation or sole proprietorship.

- The deduction generally does not apply to specified service businesses, except in the case of a taxpayer whose taxable income does not exceed $500,000 for married individuals filing jointly or $250,000 for single individuals.

3. Carried Interest

House Bill: 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.

Senate Bill: No current proposal.

4. 30% Limitation on Interest Deductions

House Bill: Interest deductions for all business entities would be limited to 30% of the business's adjusted taxable income (as defined, similar to EBITDA). Any disallowed interest expense may be carried forward for up to five tax years.

Senate Bill: Similar to the House Bill, except that "adjusted taxable income" under the Senate Bill excludes depreciation and amortization. Any disallowed interest expense may be carried forward indefinitely.

5. Deductions of Domestic Corporations in International Groups Separately Limited

House Bill: The interest deductions of a U.S. corporation that is a member of an international financial reporting group would be limited if the corporation's net interest expense exceeds 110% of its share of the group's net interest expense (allocated in proportion to each member's EBITDA). Any disallowed interest expense may be carried forward for up to five tax years.

Senate Bill: The interest deductions of a U.S. corporation that is a member of a worldwide affiliated group is reduced by the corporation's net interest expense multiplied by the debt-to-equity differential percentage of the group (generally, comparing the amount by which the total U.S. group indebtedness exceeds 110% of the debt the U.S. group would hold if the group had proportionate debt-to-equity ratios). Any disallowed interest expense may be carried forward indefinitely.

6. Dividends Received Deduction

House Bill: 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.

Senate Bill: Similar proposal, except that the change would be effective in 2019.

7. Shift to Quasi-Territorial International Tax System

House Bill: 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. Foreign tax credits may be available to offset a portion of this tax and a taxpayer may elect to pay the tax liability over 8 equal annual installments. Future distributions of E&P subject to the one-time tax would not be subject to a second tax upon receipt.
- A 14% rate would apply to E&P attributable to cash and 7% rate to the remaining amount of E&P.

Senate Bill: Similar proposal except that a 10% rate would apply to E&P attributable to cash and a 5% rate to the remaining amount of E&P, and taxpayers may elect to pay the tax liability over 8 annual installments (first five installments each equal to 8% of the liability and sixth, seventh and eighth installments equal to 15%, 20% and 25%).

8. Excise Tax on Related Party Payments / Minimum Tax on Base Erosion Payments

House Bill: A 20% excise tax would be imposed on payments (other than interest) from U.S. corporations to related foreign corporations that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset, unless the related foreign corporation elects to treat the payments as income effectively connected with the conduct of a U.S. trade or business.

Senate Bill: 10% (increased to 12.5% beginning in 2026) base erosion minimum tax would be imposed on corporations (other than a RIC, REIT or S corporation) calculated on a modified tax base that excludes certain items, such as deductions for payments made to a related foreign party. The base erosion minimum tax would only apply to corporations with average annual gross receipts of at least $500 million, at least 4% of whose deductions are derived from payments made to a related foreign party.

9. Foreign High Returns / Global Intangible Low-Taxed Income

House Bill: A U.S. parent of foreign subsidiaries would be subject to current U.S. tax on 50% of the U.S. parent's "foreign high returns", which are the excess of the U.S. parent's foreign subsidiaries' aggregate net income over a routine return (7% plus the Federal short-term rate) on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, reduced by interest expense.

Senate Bill: A U.S. parent would be subject to current U.S. tax on the global intangible low-taxed income earned by its foreign subsidiaries ("GILTI"), which is the amount by which the net income of a foreign subsidiary exceeds a 10% rate of return on certain of its business assets.

- A U.S. parent may deduct 37.5% (reduced to 21.875% beginning in 2026) of the lesser of (i) the amount of its foreign-derived intangible income plus GILTI, or (ii) its taxable income, determined without regard to the proposal.

- Certain inbound distributions of intangible property to a U.S. parent would be tax-free.

10. Limitation of Treaty Benefits for Deductible Payments

House Bill: Payments of interest, dividends, rents and annuities that are deductible in the U.S. and made by an entity that is controlled by a foreign parent to an affiliate in a tax treaty jurisdiction will be subject to 30% withholding tax without reduction for any treaty benefits, unless the withholding tax would be reduced if the payment were made directly to the foreign parent. This provision was omitted in Chairman Brady's markup of the Bill.

Senate Bill: None.

11. U.S. Tax on Sale of Certain Partnership Interests

House Bill: None.

Senate Bill: 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 in 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.

12. Capital Expensing

House Bill: Generally, businesses would be able to immediately "write off" or expense 100% of the cost of qualified property acquired and placed in service between September 28, 2017 and January 1, 2023.

Senate Bill: The Senate includes a similar proposal, except that "qualified property" may include real property.

13. Net Operating Losses

House Bill: The use of net operating losses would be limited to 90% of taxable income with changes to the carryback and carryforward rules.

Senate Bill: The Senate Bill includes a similar proposal, except that the use of net operating losses would be further limited to 80% of taxable income beginning in 2023 (but would return to 100% in 2026 if revenue targets are met).

14. Like-Kind Exchanges

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

Senate Bill: The Senate Bill includes a similar proposal.

15. Insurance Companies

Both the House and Senate proposals include extensive changes to the taxation of insurance companies.

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