Tax Update

Seventeen Provisions to Watch in the Senate Tax Reform Bill

December 12, 2017

On December 2, 2017, the Senate passed a tax reform bill[1] that differs in some key aspects from the tax reform bill the House approved on November 16, 2017. A House and Senate conference committee will begin work to resolve the differences between the House and Senate bills. Once the conference committee has reached an agreement, both the House and Senate must vote to pass a final bill in identical form before President Trump can sign the tax reform bill into law. Key provisions of the Senate bill are summarized below. We will update you as significant developments unfold.

1. Corporate Tax Rate

Reduces the maximum corporate tax rate to 20% from 35% effective 2019, but retains the corporate alternative minimum tax.

2. Partnership and S Corporation Taxation

An individual taxpayer generally may deduct 23% 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

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.

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

4. 30% Limitation on Interest Deductions

Interest deductions for all business entities would be limited to 30% of the business's adjusted taxable income (as defined, similar to EBIT). Any disallowed interest expense may be carried forward indefinitely.

5. Deductions of U.S. Corporations in International Groups Separately Limited

The interest deductions of a U.S. corporation that is a member of a worldwide affiliated group are 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 a percentage (which would phase in from 130% for 2018, 125% for 2019, 120% for 2020, 115% for 2021 and 110% for tax years beginning in 2022) 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

Effective In 2019, 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.

7. 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 (14.5% rate would apply to E&P attributable to cash and 7.5% 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 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%). Future distributions of E&P subject to the one-time tax would not be subject to a second tax upon receipt.

8. Minimum Tax on Base Erosion Payments by U.S. Corporations

A 10% (increased to 12.5% beginning in 2026) base erosion minimum tax would be imposed on U.S. 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. Special rules apply to banks and security dealers.

9. Deduction for Foreign-Derived Intangible Income of U.S. Corporations

A U.S. corporation would be subject to a 12.5% effective tax rate between 2018 and 2025 after permitted deductions (15.625% effective tax rate beginning in 2026), rather than the new 20% 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).

10. Global Intangible Low-Taxed Income of Foreign Subsidiaries

A U.S. corporation would be subject to a 10% U.S. tax (increased to 12.5% beginning in 2026) on the global intangible low-taxed income earned by its foreign subsidiaries, which is the amount of income of a foreign subsidiary that exceeds an implied 10% rate of return on certain of its tangible business assets.

11. Inbound Distributions of Intangible Property by Foreign Subsidiaries

Certain inbound distributions of intangible property by a foreign subsidiary to a U.S. parent would be tax-deferred.

12. U.S. Tax on Sale of Certain 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.

13. 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).

14. Net Operating Losses

The use of net operating losses would be limited to 90% of taxable income with changes to the carryback and carryforward rules, and the use of net operating losses would be further limited to 80% of taxable income beginning in 2023.

15. Like-kind Exchanges

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

16. FIFO Accounting for Securities Sales

Investors other than regulated investment companies generally would be required to use "first-in, first-out" accounting for sales, charitable contributions, and other dispositions of securities instead of being permitted to specify the lot being sold under current law.

17. Insurance Companies

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

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