

Tax Update

Eleven Business Provisions to Watch in the House Tax Reform Bill

November 6, 2017

On November 2, 2017, Republicans in the House of Representatives released their long-anticipated tax reform bill (the "Bill") which includes significant changes to the current U.S. federal income tax regime for businesses and individuals. While other members of the House of Representatives will comment on this Bill and significant changes are expected, the provisions noted below warrant close attention.

1. Corporate Tax Rate

- The maximum corporate tax rate would be reduced to 20% from 35%.

2. Partnership and S Corporation Tax Rate

- 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.
- Qualified business income includes any net income derived from a passive business activity, and, at the election of the owners/shareholders in non-service businesses, may equal 30% of its net business income from active business activities. Alternatively, and in the case of service businesses such as law, accounting, consulting and financial services, qualified business income equals the "capital percentage" of each owner's net income derived from active business activities.

3. Interest Deductions

- Interest deductions for all business entities would be limited to 30 percent of the business's adjusted taxable income, and interest deductions by domestic corporations which are members of an international financial reporting group would be limited to the extent the U.S. corporation's share of the group's global net interest expense exceeds 110 percent of the U.S. corporation's share of the group's global earnings before interest, taxes, depreciation, and amortization (EBITDA).

- The amount of disallowed interest deductions is the greater of the amount from either provision. Any disallowed interest expense would be carried forward for up to five tax years.

4. 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 percent of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10 percent 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 this tax. Future distributions of E&P subject to the one-time tax would not be subject to a second tax upon receipt.
 - A 12 percent rate would apply to E&P relating to cash or cash-equivalent assets and a 5 percent rate would apply to the remaining amount of E&P.
 - Taxpayers may elect to pay the tax liability over a period of up to 8 years, in equal annual installments of 12.5% of the total tax due.

5. Excise Tax on Related Party Payments

- A 20 percent excise tax would be imposed on certain payments (other than interest) from domestic corporations to related foreign corporations made by a U.S. corporation to a related foreign corporation 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 elected to treat the payments as income effectively connected with the conduct of a U.S. trade or business.

6. Current Year Inclusion on "Foreign High Returns"

- A U.S. parent of one or more foreign subsidiaries would be subject to current U.S. tax on 50 percent of the U.S. parent's "foreign high returns".
- "Foreign high returns" would be measured as the excess of the U.S. parent's foreign subsidiaries' aggregate net income over a routine return (7 percent plus the Federal short-term rate) on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense.

7. Limitation of Treaty Benefits for Deductible Payments

- If a payment of "FDAP" income (generally, interest, dividends, rents and annuities) is deductible in the U.S. and the payment is made by an entity that is controlled by

a foreign parent to another entity in a tax treaty jurisdiction that is controlled by the same foreign parent, then the statutory 30 percent withholding tax on the income would not be reduced by any treaty unless the withholding tax would be reduced by a treaty if the payment were made directly to the foreign parent.

- In Chairman Brady's markup of the Bill, this provision was omitted.

8. Expensing

- Generally, businesses would be able to immediately "write off" or expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023.

9. Net Operating Losses

- The use of net operating losses would be limited to 90 percent of taxable income with changes to the carryback and carryforward rules.

10. Like-Kind Exchanges

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

11. Insurance Companies

- The Bill includes a number of extensive changes to the taxation of insurance companies.

We will keep you informed of future iterations and clarifications of this tax reform proposal.

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