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House Republicans Release Draft Tax Proposal; Committee Markup Begins

On November 2, 2017, the House Ways and Means Committee unveiled the Tax Cuts and Jobs Act (the "Bill"). The Bill could dramatically alter the U.S. approach to domestic and international taxation. Although the possibility of tax reform has been the subject of much discussion since the election of President Donald Trump, many past proposals have been light on details. The Bill represents the first potential legislative language. House Ways & Means Committee Chairman Kevin Brady (R-Texas) released an amendment to the Bill on November 6, 2017 (the "Amendment").[1] The committee is marking up the Bill this week with a vote expected Thursday. Republican leaders in the House hope for a full vote the week of November 13th.[2]

The Bill proposes dramatic changes to existing U.S. tax rules. For individuals, the Bill reduces the amount of home mortgage indebtedness on which interest payments are deductible and repeals the itemized deduction for state and local income taxes. For businesses, the Bill permanently reduces the corporate income tax rate to 20% and allows taxpayers to fully and immediately expense 100% of the cost of certain qualified property. For multinational groups, the Bill moves the United States toward a territorial system coupled with anti-base erosion measures intended to shore-up the U.S. tax base. The Bill also proposes a one-time transition tax on currently deferred foreign earnings.

The following is a brief summary of the key provisions in the Bill:

Individual Tax

- Reduces the number of tax brackets from seven to four: 12%, 25%, 35%, and 39.6%. Significantly lowers the taxable income threshold of the 35% bracket and significantly raises the application of the 39.6% bracket; the benefit of the 12% bracket is lost as a taxpayer's income exceeds $1,200,000 (married filing jointly) or $1,000,000 (single). (The effect of these shifts (without regard to other changes that tend to increase taxable income) is to cause married taxpayers at the top of current 35% bracket ($480,050 of taxable income) to experience the lowest percentage reduction in effective tax rate under the proposed rate revisions (a 0.82% reduction). The percentage reduction thereafter climbs to a maximum percentage reduction of 2.78% at $1,000,000 of taxable income.) The maximum dollar amount of reduction in tax liability is $27,844, reached at $1,000,000 of taxable income (without regard to the new 25% preferential rate discussed below).
- Doubles standard deduction to $24,000 but eliminates personal exemptions. (The effect of the elimination of the personal exemption more than offsets the increased standard deduction for taxpayers claiming

[1] Chairman Brady also released a mark-up with some technical changes on Friday, November 3, 2017.
[2] On the Senate side, the Senate Finance version will be released later this week.

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more than two exemptions, but under some circumstances for low-income taxpayers, the net reduction for such taxpayers may be offset by an increase in credits for dependents.)

- Creates a new preferential 25% rate for income from a "business activity." All of business income from passive activities qualifies for the 25% maximum rate, while the amount of business income from activities in which the taxpayer materially participates depends on a taxpayer's "capital percentage" for the relevant activity (that is, the portion of the income not considered to be attributable to services provided by the taxpayer). The default capital percentage is 30%, but taxpayers may elect instead to determine their percentage using a formula in the statute. Relies heavily on existing passive/active business activity rules (Section[3] 469) to determine which income qualifies for the 25% maximum rate and which is subject to ordinary individual income tax rates. The 25% maximum rate does not apply to income from "specified service activities," which include "any activity involving the performance of services described in Section 1202(e)(3)(A), including investing, trading, or dealing in securities (as defined in Section 475(c)(2)), partnership interests, or commodities (as defined in Section 475(e)(2))." The 25% maximum rate also does not apply to "investment-related items," which include capital gain, dividend and dividend-equivalent income, interest income not allocable to a trade or business, and certain other categories of passive income.

- Applies the maximum 25% business activity rate to real estate investment trust ("REIT") dividends that are currently treated as ordinary income.

- Determines self-employment income from flow-through businesses by reference to a "labor percentage." The labor percentage is the inverse of the capital percentage computed for that business (discussed above). The exclusion for distributive shares of partnership income allocated to limited partners would be repealed.

- Repeals the so-called "Pease limitation," which generally limits itemized deductions for high-income taxpayers.

- Reduces the amount of home mortgage indebtedness on which interest payments are deductible. Under current law, taxpayers may deduct interest on up to $1,000,000 in acquisition indebtedness.[4] Under the Bill, with respect to debt incurred after November 2, 2017, this would be reduced to $500,000. The $1,000,000 limit would be retained for debt incurred on or before November 2, 2017 (including refinancing of such grandfathered debt), and debt incurred under a binding contract exception. The deduction for interest paid on home equity indebtedness would be eliminated.

- Limits the exclusion of gains from sale of a principal residence by (i) requiring that the taxpayer have used the residence for 5 of the previous 8 years (instead of 2 of the previous 5 years under current law), (ii) limiting the ability to use the exclusion to once every 5 years (instead of once every 2 years under current

[3] References to "Sections" throughout this Client Alert are to the currently effective version of the Internal Revenue Code of 1986, as amended, unless otherwise specified.
[4] In addition to "acquisition indebtedness," current law also permits taxpayers to deduct interest on up to $100,000 of "home equity indebtedness."

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law), and (iii) phasing out the exclusion for taxpayers with a 3-year average adjusted gross income exceeding $500,000 (for joint filers), determined without regard to inclusion of gains attributable to the phase-out.

- Repeals the itemized deduction for state and local income taxes. Limits state and local property tax deduction to $10,000.
- Limits gambling deductions to the extent of gambling winnings. Under current law, gambling losses are limited to gambling winnings, but other expenses connected to gambling (when conducted as a trade or business) are not so limited.
- Increases the limitation on charitable contributions to 60% of adjusted gross income (up from 50% under current law).
- Repeals deductions from gross income for alimony payments, moving expenses, and itemized deductions for tax preparation expenses and medical expenses and expenses attributable to the trade or business of being an employee.
- Eliminates the ability of taxpayers to recharacterize IRA contributions as Roth IRA contributions (and vice-versa).
- Increases the exemption from estate, gift, and generation-skipping transfer tax from $5,000,000 to $10,000,000, and beginning 2023, repeals the estate and generation-skipping transfer taxes.
- Repeals the alternative minimum tax ("AMT") beginning in 2018. Taxpayers may claim a refund for AMT credit carryforwards beginning in 2019.

Business Tax

- Permanently reduces the general corporate tax rate from a maximum graduated rate of 35% to a flat 20%.[5] Similarly, reduces the tax rate for qualified personal service corporations[6] from a flat 35% to a flat 25%.
- Allows taxpayers to fully and immediately expense 100% of the cost of certain qualified property (e.g., certain tangible personal property, certain computer software, water utility property, etc.). Repeals the current requirement that the original use of the property must begin with the taxpayer taking the depreciation deduction. Instead, under the Bill, a taxpayer is generally eligible for the depreciation deduction if it is such taxpayer's first use of the property.
- Permits the use of the cash method of accounting for tax purposes by entities taxed as corporations (and partnerships with a corporate partner) whose 3-year average annual gross receipts (determined as of the

[5] Currently the rate is 15% for taxable income up to $50,000; 25% for taxable income between $50,000 and $75,000; 34% for taxable income between $75,000 and $10,000,000; and 35% for taxable income above $10,000,000.
[6] Section 448(d)(2) generally defines a "personal service corporation" as a corporation that performs services (i.e. health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting). Currently Section 11(b)(2) provides that qualified personal service corporations are subject to a flat rate of 35%.

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end of the immediately preceding taxable year) did not exceed $25,000,000. Under current law, use of the cash method is limited to corporations whose 3-year average annual gross-receipts did not exceed $5,000,000 for any prior year.

- Restricts business interest expense deduction by providing that no business, regardless of form, may deduct interest expense in excess of 30% of such business's adjusted taxable income (that is, taxable income allocable to the trade or business without regard to the interest deduction, loss carryovers, and certain other items). Interest deductions by businesses whose 3-year average annual gross receipts for the immediately preceding year did not exceed $25,000,000 would not be subject to this limitation. The provision also would not apply to real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trades or businesses.
- Modifies the rules for carrying back net operating losses ("NOLs") for corporations by eliminating the existing general 2-year carryback and permitting an unlimited NOL carryforward period (rather than the current maximum of 20 years). In addition, the unused NOL carryforwards will be increased by an interest factor for the period that they remain unused. Similar to the existing alternative minimum tax rules, not more than 90% of the taxpayer's current year's taxable income can be offset by otherwise available NOL carryovers.
- Limits like-kind exchange non-recognition treatment to exchange of real property only. Under current law, qualifying personal property may also qualify for preferred like-kind exchange treatment if certain conditions are satisfied.
- Under current law, insured depository institutions may deduct FDIC assessments as a trade or business expense. The Bill phases out these deductions for financial institutions that have consolidated assets between $10,000,000 and $40,000,000.
- Restricts the potential tax benefit of carried interest by limiting the availability of long-term capital gain rates. In general, under new Section 1061, a taxpayer that performs substantial services for an investment business and receives a partnership interest in exchange must use a 3-year holding period to determine long-term capital gain with respect to that partnership interest. Amounts that are disqualified because of the 3-year rule are treated as short-term capital gain. The 3-year rule does not apply where a partnership interest generates a capital loss, rather than capital gain, for a tax year. It also does not apply to partnership interests held directly or indirectly by a corporation or certain capital interests in partnerships.[7]

International Tax

Territorial Taxation of U.S. Corporations

- Generally moves toward territorial taxation of U.S. corporations, primarily by allowing U.S. corporations to deduct the foreign source portion of any dividends received from a foreign corporation (other than from a

[7] If enacted, new Section 1061 could raise potential conflicts between investment managers (such as private equity and venture capital sponsors) on one hand and their investors on the other.

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passive foreign investment company ("PFIC") that is not a controlled foreign corporation ("CFC")) in which the U.S. corporate stockholder owns at least a 10% interest (an "exempt dividend").

- Prohibits foreign tax credits and deductions for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend and ignores deductions for expenses properly allocable to an exempt dividend (or stock that gives rise to exempt dividends) for purposes of determining the U.S. corporate shareholder's foreign-source income.
- Makes other conforming changes to integrate this "participation exemption" into the existing tax rules. For example, the current Subpart F rules relating to CFC investments in U.S. property (Section 956) would no longer apply in the case of a U.S. corporate shareholder. In addition, on the disposition of shares in a 10% owned foreign corporation, basis adjustments would prevent a taxpayer from realizing a loss that corresponded to exempt dividends previously received from that corporation.
- The participation exemption would be effective for dividends paid after December 31, 2017. Certain holding period requirements apply.

One-Time Repatriation Tax

- Imposes a one-time transition tax on all deferred post-1986 foreign earnings, to facilitate the transition to a territorial regime.
- Requires each U.S. shareholder owning at least 10% of most foreign corporations (other than PFICs that are not CFCs and other non-CFCs having no 10% U.S. corporate shareholder) to include as Subpart F income the shareholder's proportionate share of the foreign corporation's net post-1986 earnings not previously subjected to U.S. tax.
- Inclusion is determined as of November 2, 2017, or December 31, 2017 (whichever results in a greater amount), and applies for the foreign corporation's last taxable year beginning before 2018.
- Income inclusion applies to *all* 10% or more U.S. shareholders, not only U.S. shareholders that are corporations that will be entitled to the participation exemption.
- Tax rate for offshore business earnings held as cash and cash equivalents is 12%; noncash assets are taxed at 5%. Tax would be payable over up to 8 years at the taxpayer's election. Foreign tax credit carryforwards would be fully available, and foreign tax credits triggered by the deemed repatriation would be partially available, to offset the U.S. tax.[8]

Anti-Base Erosion Measures

- *Tax on high foreign returns*. Expands the existing Subpart F regime to require "United States shareholders" of a CFC to include in income 50% of the CFC's net income that exceeds a routine return (generally, the applicable federal short-term rate plus seven percentage points, times the

[8] Although REITs are not the subject of this provision of the Bill, there is no enumerated exception for REITs that have foreign taxable REIT subsidiaries. Currently, it is unclear how this provision would apply in the REIT context.

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CFC's adjusted basis in its tangible property used in a trade or business). Income effectively connected with a U.S. trade or business, Subpart F income and certain other specified items of income are excluded from net income subject to this provision, and relevant foreign tax credits are allowed on a limited basis. This provision would make structures in which high-return intellectual property is held in a low-taxed foreign corporation more expensive.[9]

- *Excise tax on related party payments*. Imposes an excise tax of 20% on certain payments by a U.S. corporation to a related foreign corporation, unless the foreign corporation elects to treat the payment as effectively connected with a U.S. trade or business (or permanent establishment). The excise tax would apply to most payments that are, with respect to the U.S. corporation, allowable as a deduction or includible in costs of goods sold, inventory or the basis of a depreciable or amortizable asset, but would not apply to payments of interest, for certain securities and commodities, or for certain services charged at cost. This provision would apply only to a U.S. corporation that is a member of an international financial reporting group (which requires, among other things, that U.S. group members have made average annual aggregate payments to foreign members exceeding $100,000,000 over a test period) with respect to payments to a foreign corporation that is a member of the same group.[10]

- *Limitation on U.S. interest deduction*. Where a U.S. corporation is a member of an international financial reporting group (which, for these purposes, is a group of entities that includes at least one foreign corporation engaged in a U.S. trade or business or that includes at least one domestic corporation and one foreign corporation, prepares consolidated financials, and has average annual gross receipts over $100,000,000), limits the U.S. corporation's deduction for net interest expense to the extent that the U.S. corporation's share of the group's net interest expense exceeds 110% of the U.S. corporation's share of the group's EBITDA. Disallowed interest expense may be carried forward for 5 years. Comparable rules apply to partnerships and to foreign corporations engaged in a U.S. trade or business.

- *Limitation on treaty withholding tax reduction*. The Bill would have eliminated the potential for treaty-based reduction of U.S. withholding tax on payments that are deductible in the United States (such as royalties) and that are made by any person that is a member of a group of entities controlled by a foreign parent to any person that is a member of the same group, unless the foreign parent would have been entitled to a reduced rate under an applicable treaty if the payment were made directly to the foreign parent. This provision was dropped from the Chairman's mark, which was released on November 3, 2017.

The wide-ranging and, in some respects, unexpected nature of the proposed tax changes make it difficult to predict the overall impact of the changes, even in the event the changes were enacted into law as currently

[9] The Bill also would make narrowly focused changes to the Subpart F rules to bring more taxpayers within their scope and to modify the scope of passive income subject to these rules; and would generally source to the United States income from the sale of inventory property produced within the United States but sold outside the United States.
[10] As a practical matter, this unexpected and controversial provision could require foreign payee corporations that have no taxable presence in the United States to elect to file U.S. tax returns and pay U.S. net income tax (and potentially branch profits tax). An election applies for all subsequent years unless the IRS consents to revocation.

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reflected in the Bill. In particular, Chairman Brady has already indicated that the base erosion measures are up for discussion. Therefore, many aspects of the proposal described above could change materially before any bill is enacted. We will continue to monitor the latest developments in this area.

The Bill also includes numerous other proposed changes that are beyond the scope of this Client Alert. In particular, proposed changes to the tax rules governing employee compensation will be covered in a separate Client Alert.

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