Client Alert

December 21, 2017

U.S. Tax Reform Bill Passes Both Houses; Awaits President's Signature

On December 20, 2017, both the House and the Senate passed H.R. 1 (the "Bill"),[1] which President Trump is expected to sign by January 3, 2018.[2] The Bill dramatically alters the U.S. approach to domestic and international taxation. It represents the results of a conference agreement between the House and Senate reconciling the version passed by the House on November 16, 2017, and the version passed by the Senate on December 2. For most provisions, the final legislation follows the approach of either the House or Senate version of the Bill, but in some places the Bill adds something new.

The following is a brief summary of the key provisions in the Bill in the individual, business, and international spaces.

Individual Tax[3]

- The number of tax brackets remains the same at seven, but the rates applicable to each bracket are: 10%, 12%, 22%, 24%, 32%, 35%, and 37% (as opposed to 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% under current law).
- The standard deduction is increased to $24,000 (married filing jointly), $18,000 (head-of-household), and $12,000 (single). These amounts represent an increase over current law, which provides for a standard deduction of $12,700 (married filing jointly), $9,350 (head-of-household) and $6,350 (single).
- Gives non-corporate taxpayers a deduction from gross income equal to 20% of domestic "qualified business income" ("QBI") from a partnership, S corporation, sole proprietorship, estate, or trust. The deduction therefore reduces the maximum tax rate on such income to 29.6%.[4] The deduction is also available for ordinary dividends from a real estate investment trust ("REIT") and qualified income earned through a publicly traded partnership (e.g., a master limited partnership or "MLP").[5] For income earned from a partnership, S corporation, sole proprietorship, estate, or trust the deduction equals 20% of the QBI amounts for each qualified trade or business carried on by the taxpayer. The 20% of QBI deduction is limited to the greater of (i) 50% of the taxpayer's share of W-2 wages paid with respect to the qualified

1 The Bill is entitled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." It was originally known as the "Tax Cuts and Jobs Act," but that title was dropped on a point of order in the Senate.
2 The text of the Bill, the Conference Report for the Bill, our Client Alerts on the Bill's prior versions, and other tax reform resources are available on our tax reform website, at http://www.mofotaxreform.com.
3 Generally, most individual provisions in the Bill are effective for taxable years beginning after December 31, 2017. The Bill generally provides that provisions applicable to individuals expire on December 31, 2025. After that date, all affected provisions revert back to their form under current law.
4 Taking into account the new 37% maximum individual rate.
5 Dividends paid by a regulated investment company (e.g., a mutual fund or closed end fund) are not eligible for the 20% deduction. Also, there is no provision in the Bill for a regulated investment company to pass through the deduction to its shareholders.

trade or business or (ii) the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property.[6] QBI does not include income from "specified services" trades or businesses including health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, or trading or dealing in securities, partnership interests, or commodities. Architecture and engineering, however, are not treated as specified services and, therefore, are eligible for the deduction. The deduction for the taxable year is the lesser of (i) the sum of the deductible amounts for each qualified trade or business carried on by the taxpayer and 20% of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income or (ii) 20% of the taxpayer's ordinary income less net capital gain.[7] The wage or wage and capital limit and the specified services exclusion do not apply to taxpayers with annual taxable incomes under certain threshold amounts ($315,000 for joint filers and $157,500 for single filers) subject to scale back as taxable income increases (to $415,000 for joint filers and $207,500 for single filers). The deduction is available to itemizers and non-itemizers.

- Disallows excess business losses of a taxpayer other than a corporation. For this purpose, "excess business loss" generally means the excess (if any) of the aggregate deductions attributable to trades or businesses of the taxpayer (determined without regard to the limitation in this provision) over the sum of aggregate gross income or gain attributable to such trades or businesses plus a threshold amount ($250,000 or twice the amount in the case of a joint return). Such losses are carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward in subsequent taxable years as determined under the NOL rules provided in the Bill.

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

- Reduces the amount of home mortgage indebtedness on which interests payments are deductible. Under current law, taxpayers may deduct interest on up to $1,000,000 in acquisition indebtedness. The acquisition indebtedness for which interest deductions are allowed will be reduced to $750,000 for taxable years beginning after December 31, 2017, and beginning before January 1, 2026 ($375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred before December 15, 2017, this limitation is $1,000,000 ($500,000 in the case of married taxpayers filing separately). Additionally, the deduction for interest on home equity indebtedness is suspended.

- Doubles the child tax credit from $1,000 to $2,000 per qualifying child and provides for a $500 nonrefundable credit for qualifying dependents other than qualifying children.

6 Qualified property means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year and that is used in the production of QBI. The unadjusted basis is essentially original cost, but an asset is not counted beyond the earlier of (i) ten years after acquisition or (ii) the end of its useful life for depreciation purposes.

7 There is also a deduction for certain cooperative dividends. Thus, certain agricultural and horticultural cooperatives are entitled to a 20% deduction after accounting for dividends to members and subject to the wage and wage and capital limits described above.

- Limits the itemized deduction for state and local taxes to up to $10,000 for the aggregate of (i) state and local property taxes and (ii) state and local income taxes (or sales taxes in lieu of income taxes). The Bill prohibits individuals from prepaying state and local income taxes for taxable years after December 31, 2017, and receiving a deduction for such prepayments in 2017.

- 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 for any expenses that would currently be subject to the "miscellaneous itemized deduction" 2% floor, including deductions for expenses paid or incurred for the production or collection of income and unreimbursed expenses attributable to the trade or business of being an employee.

- Preserves the itemized deduction for unreimbursed medical expenses, but only to the extent such expenses exceed 7.5% of adjusted taxable income for taxable years beginning after December 31, 2016, and ending before January 1, 2019.

- For taxable years beginning after December 31, 2018, repeals deductions for alimony and separate maintenance payments to the payor and excludes such amounts from income for the payee.

- Repeals deduction for moving expenses.

- Increases the exemption from estate and gift taxes from $5 million to $10 million.

- Preserves the individual alternative minimum tax ("AMT") but increases both the exemption amount and the exemption amount phase-out thresholds.

- Eliminates the "individual mandate" under the Affordable Care Act for health coverage status of months beginning after December 31, 2018.

Business Tax

- Permanently reduces the general corporate tax rate from a maximum graduated rate of 35% to a flat 21% for taxable years beginning after December 31, 2017.[8] The Bill also eliminates the corporate alternative minimum tax.

- Reduces the current 70% dividends received deduction (the "DRD") to 50% and reduces the current 80% DRD to 65%, for taxable years beginning after December 31, 2017.

8 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.

- Preserves the research and development tax credit.

- 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 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 deductions 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). For taxable years beginning after December 31, 2017, and before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion. Under the Bill, interest deductions by businesses whose 3-year average annual gross receipts for the immediately preceding year did not exceed a $25,000,000 average gross receipts ceiling are exempt from the limitation. This provision also would not generally apply to real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trades or businesses. These changes are effective beginning in 2018 with no grandfather provision for existing debt.

- The Bill generally modifies the rules for carrying back net operating losses ("NOLs") for corporations by eliminating the existing general two-year carryback and permitting an unlimited NOL carryforward period (rather than the current maximum of 20 years). However, the Bill provides a two-year carryback in the case of certain losses incurred in the trade or business of farming and a two-year carryback and 20-year carryforward for NOLs of a property and casualty insurance company (generally defined under the Code as an insurance company other than a life insurance company). In addition, the unused NOL carryforwards would be adjusted. Under the Bill, not more than 80% of the taxpayer's current year's taxable income can be offset by otherwise available NOL carryovers. The provision is effective for losses arising in taxable years beginning after December 31, 2017.

- The Bill includes a provision that could potentially be a back-door mark-to-market provision for certain taxpayers. The Bill generally requires an accrual method taxpayer to recognize income no later than the taxable year in which such income is taken into account as income on an "applicable financial statement" of the taxpayer (defined to include a GAAP statement or 10-K, among other statements) or other financial statement as the Secretary may specify. The Bill includes exceptions for (a) any item of gross income in connection with a mortgage servicing contract and (b) certain items of gross income for which the taxpayer uses a special method of accounting. The Conference Report also makes it clear that the provision does not force realization where there would not be realization under general tax principles. However, it is unclear whether this proviso includes market discount on market discount bonds. This amendment would be effective for taxable years beginning after December 31, 2017.

- Limits like-kind exchange non-recognition treatment to an exchange of real property that is not held primarily for sale.
- 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 over $10 billion.
- Repeals the technical termination rule of Section 708(b)(1)(B) of the Code. Under current law, a technical termination occurs where more than 50% of a partnership's profits and capital interests are transferred over a 12-month period. One of the more important consequences of a technical termination was that the "new" partnership must reset the depreciable lives of its assets.
- Restricts the potential tax benefit of carried interest by limiting the availability of long-term capital gain rates. Under this restriction, a person must use a three-year holding period for partnership assets to determine whether gains from certain partnership interests qualify for long-term capital gain treatment. Amounts that are disqualified under this rule are instead treated as short-term capital gain, which is subject to rates that equal ordinary income rates. The restriction applies to partnership interests that are received in connection with performing services for a business that consists in whole or in part of (1) raising or returning capital and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition) or (3) developing specified assets. "Specified assets" include securities, commodities, real estate held for rental or investment, cash or cash equivalents, and derivatives that reference any of the foregoing. The House Committee on Ways and Means Report on the House's initial bill states that interests in privately held partnerships are "specified assets" for this purpose. The restriction 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. Although this provision targets carried interest arrangements, the three-year holding period is consistent with (or less than) the average holding period of many private investment funds. Nevertheless, it may trigger conflicts of interest where a fund has an opportunity to dispose of an investment more than one year (the normal holding period for LTCG) but less than three years after acquisition.

International Tax

Territorial Taxation of U.S. Corporations

- The Bill moves in general toward a territorial system of taxation of U.S. corporations, primarily by allowing U.S. C corporations to deduct 100% of the foreign source portion of dividends received from most foreign corporations where the U.S. corporation owns at least a 10% interest (the "participation exemption"). Dividends paid by PFICs that are not also CFCs are not eligible, nor are "hybrid dividends" -- payments where the payor has derived a foreign tax benefit, such as an interest deduction.[9] Foreign taxes (including withholding taxes) paid or accrued with respect to any dividend that qualifies for the participation exemption (an "exempt dividend") or any hybrid dividend may not be credited or deducted.

- The participation exemption will be effective for dividends paid after December 31, 2017. In general, a 365-day holding period requirement applies.

One-Time Repatriation Tax

- The Bill imposes a one-time transition tax on all deferred post-1986 foreign earnings to facilitate the transition to a territorial regime. Specifically, each U.S. shareholder owning at least 10% of a foreign corporation (other than PFICs that are not CFCs and other non-CFCs having no U.S. corporate shareholders) must 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 (the "income inclusion").

- The income inclusion amount is determined as of November 2, 2017 or December 31, 2017 (whichever produces a greater amount). The provision applies for the foreign corporation's last taxable year beginning before 2018, and for the taxable year of the U.S. shareholder in which or with which that taxable year of the foreign corporation ends. Some netting against earnings deficits of 10%-owned foreign corporations is permitted.

- Income inclusion applies to <u>all</u> 10% or more U.S. shareholders, not only those U.S. corporate shareholders that will be entitled to the participation exemption.

- The Bill effectively imposes a reduced tax rate of 15.5% for offshore business earnings held as cash and cash equivalents and 8% for noncash assets. The income inclusion tax is payable over up to 8 years at the taxpayer's election. Foreign tax credit carryforwards are fully available, and foreign tax credits triggered by the deemed repatriation are partially available, to offset the U.S. tax.[10]

- Any U.S. shareholder that becomes an expatriated entity ("inverts") within 10 years after the enactment date of the Bill will be retroactively denied the benefit of the reduced rates of tax with respect to the income inclusion, and will be unable to use foreign tax credits to offset the additional tax due.

Base Erosion Anti-Abuse Tax ("BEAT")

- The Bill imposes a new tax in the nature of an "anti-base erosion" minimum tax. Specifically, taxpayers that are C corporations and have average annual gross receipts of at least $500,000,000 may be subject to a tax equal to the excess of 10% of their modified taxable income (i.e., increased to include otherwise-deductible amounts relating to certain dealings with related foreign parties), over their regular tax liability (reduced by certain allowable credits). Base erosion tax benefits that may be picked up by this provision include deductions for payments made by the taxpayer to a related foreign person for interest, royalties,

9 "PFIC" refers to "passive foreign investment company," and "CFC" refers to "controlled foreign corporation."
10 The Bill provides that a REIT's income inclusion by reason of having a foreign taxable REIT subsidiary is not taken into account for purposes of the REIT's gross income tests, and the REIT may elect to include the income over 8 years.

and certain services (except to the extent such payments were subject to U.S. tax), as well as cost recovery deductions on certain property acquired from a related foreign person. Special rules apply to certain hybrid payments, reinsurance arrangements, payments pursuant to derivatives, and payments following an expatriation transaction, among other things. An initial reduced tax rate of 5% applies for tax years beginning in 2018, and the tax rate is scheduled to increase after 2025. Taxpayers that are banks or registered securities dealers are subject to a higher tax.

Special Tax Rules for Intangibles Income

Congress has repeatedly heaped scorn on taxpayers who reincorporate offshore or move significant business assets or operations offshore. In an apparent effort to help stem the tide of intangible property transfers from the United States, the Bill adopts the following two-prong "carrot and stick" approach that seems intended to reduce perceived current-law incentives to relocate the ownership of income-producing intangible property outside the United States.

Tax on Global Intangible Low-Taxed Income ("GILTI")

- A “United States shareholder” of a CFC will be required to include in income currently its share of GILTI, which is of the shareholder’s pro rata share of (x) the excess of the CFC’s net income over (y) a deemed routine return on specified tangible property of the CFC that is used in a trade or business (the average of the aggregate adjusted basis in such property times 10%). In the case of a United States shareholder that owns interests in multiple CFCs, these concepts are generally applied on a net or aggregate basis.
- United States shareholders that are C corporations will ordinarily be taxed on their GILTI at an effective 10.5% rate for tax years beginning prior to December 31, 2025, and 13.125% for tax years beginning after December 31, 2025. (Other United States shareholders will be taxed at their normal tax rates.) Income effectively connected with a U.S. trade or business, Subpart F income and certain other specified types of income are excluded from net income subject to this provision, and relevant foreign tax credits are allowed on a limited basis.

Reduced Tax Rate for Foreign Derived Intangibles Income ("FDII")

- For tax years beginning after December 31, 2017, a domestic corporation will be able to deduct 37.5% of its "FDII," that is, income that is both (x) deemed to be derived from intangible property (income that exceeds a routine (10%) return on certain tangible property) and (y) foreign-derived (income derived in connection with either property that is sold to a foreign person for a foreign use or services provided to a foreign person or with respect to foreign property). Certain transactions with domestic intermediaries or related foreign parties generally are excluded from FDII. For tax years beginning after December 31, 2025, the deduction will be decreased to 21.875% of income that is deemed to be from intangible property and foreign-derived. These deductions generally result in tax rates for this category of income earned by a domestic corporation that is not a RIC or a REIT (13.125% prior to 2026, and 16.406% in subsequent years) that generally compare favorably with the mainline jurisdictions that have attracted U.S. companies looking to Invert or transfer IP offshore.

Other International Rule Changes

- The Bill legislatively overrules the decision in the recent *Grecian Magnesite*[11] case by providing that all or a portion of a non-U.S. person's gain on a disposition of a partnership interest may be treated as income effectively connected with a U.S. trade or business, based on a look-through to the assets of the partnership. Similar to the FIRPTA rules, the transferee of a partnership interest may be required to withhold U.S. tax at a rate of 10% of the amount realized on the transfer.

- The Bill expands the reach of the Subpart F rules by determining "United States shareholder" status based on either a vote or value test (previously the rule had focused solely on voting power), adopting broader share attribution rules, and eliminating the current law limitation that Subpart F income inclusion will not apply unless CFC status has existed for at least 30 consecutive days during the tax year. Narrowly focused changes also are made to certain Subpart F income provisions.

- In addition, the reduced "qualified dividend income" rates will no longer be available for dividends paid by a former domestic corporation that successfully expatriates after the date of enactment of the Bill.

- Income from the sale of inventory property produced within the United States but sold outside the United States will generally be sourced to the United States (previously it was sometimes possible to treat a portion of the income as foreign source).

- The Bill also repeals the active trade or business exception in Section 367 for the transfer by a U.S. person of property to a foreign corporation, and codifies the Obama-era regulations that repealed taxpayer-favorable regulations permitting tax-free transfers to foreign corporations of foreign goodwill and going concern value.

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The Bill will have a wide-ranging impact on all types of taxpayers. This Client Alert is only meant to serve as a general summary of the contents of the Bill, which 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.

11 *Grecian Magnesite Mining*, 149 T.C. No. 3 (July 13, 2017).

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