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House Republicans Moving Forward on U.S. Tax Reform

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After many promises and surprising secrecy, House Republicans took a significant step toward enacting transformative federal tax legislation on November 2, 2017. The House Republicans released a bill titled the "Tax Cuts and Jobs Act" (Act), which adopts many of the principles set forth in the nine-page framework for overhauling the U.S. system of taxation released on September 27, 2017, and is meant to be consistent with a budget reconciliation procedure. Under reconciliation, proposed legislation requires a simple majority of Senate votes, reducing the chance it will be held up on the Senate floor. Although the Act, authored by House Ways and Means Chairman Kevin Brady, will likely go through many changes prior to becoming law, this release marks the launch of what may be a whirlwind attempt to enact tax reform by the end of 2017.

This bulletin highlights important aspects of the proposed Act, with an emphasis on international matters and likely business concerns. Although we expect significant lobbying efforts to incorporate transition relief, at present there is no general grandfathering of current structures under the Act. Taxpayers should consider how their current structures may be affected by the provisions in the Act, which will, as drafted, generally apply to income earned and payments made after December 31, 2017.

Key Provisions Affecting Individuals

Income Tax Rates. The Act would reduce the number of income tax brackets from seven to four, but would leave the highest rate untouched and capital gains rates intact.

Repeal of the Alternative Minimum Tax. The alternative minimum tax (AMT) would be repealed.

Estate Tax. The Act would double the estate, generation-skipping and gift tax exemptions (from $5.6 million for individuals and $11.2 million for married couples to $11.2 million and $22.4 million, respectively). The estate and generation-skipping taxes (but not the gift tax) would then be phased out, beginning in 2024. Even after the elimination of the estate tax, heirs will be able to inherit property with a tax basis step-up at the decedent's death. (Non-residents would not benefit from the increased exemptions except to the extent that a treaty applies. Canadian residents, for example, would benefit from the increased estate tax exemption in accordance with the terms and limitations of the US-Canada treaty.)

Key Provisions Affecting Businesses

Corporate Tax Rates. The Act proposes to immediately reduce the federal corporate income tax rate from 35% to 20%. (Despite earlier speculation, the rate reduction would not be phased in over time. Some entities can be expected to convert to corporate status if the provision is enacted, meaning that the federal penalty taxes on excess profit accumulation may have a more significant role in the future.)

Pass-Through Business Tax Rates. Individuals who do business through pass-through entities (e.g., S corporations, partnerships, limited liability companies treated as partnerships for tax purposes) would qualify for a new 25% maximum federal income tax rate, but the reduced rate generally would not be available with respect to income that is in the nature of wages or salary. As a result, the reduced rate may not be available to professional service providers, such as lawyers and accountants.

Accelerated Cost Recovery. The Act would provide for immediate expensing of certain short-lived property placed in service prior to January 1, 2023.

Interest Deductibility Limitations. The Act would replace the current "earnings stripping" rules with a limit of 30% of EBITDA (down from 50%), but the new rules would exempt businesses with average gross receipts of $25 million or less and real property trades or businesses. Unlike under current law, the interest deductibility limitation would apply to interest whether or not it is being paid to a related party lender. In addition, the proposed limitations would apply to partnership interest expense and be determined at each partnership level (presumably without duplication of limitations or allowances). Further limitations would apply to certain large corporate groups with an audited financial statement and receipts or intercompany payments of at least $100 million. U.S. corporate taxpayers in those groups would also be subject to limitations on their interest deductions to an amount based on the proportion of the U.S. borrower's EBITDA, compared to worldwide group EBITDA. Disallowed interest would be carried forward to the succeeding five taxable years.

Modification of Net Operating Loss Deduction. The Act would limit the deduction of a net operating loss to 90% of the taxpayer's taxable income (determined without regard to the net operating loss). In addition, net operating losses would be able to be carried forward indefinitely (compared with 20 years under current law) and increased by an interest factor to preserve their value.

Limit on Like-Kind Exchanges. The Act would remove the possibility of deferring tax on simultaneous and deferred asset swaps for properties other than real estate.

New Trap for the Unwary. The Act would provide that capital contributions to a regarded entity (whether corporate or a pass-through) would give rise to income to the issuer unless additional equity is issued.

Key International Provisions

Partial Territorial Tax System

Participation Exemption

Under the current U.S. system of worldwide taxation, the United States taxes the income earned by U.S. corporations and their foreign subsidiaries wherever such income is earned, either at the time it is earned or when it is later distributed. In order to shift the United States toward a territorial system of taxation in which income is generally subject to U.S. tax only to the extent that it is earned in the United States, the Act would exempt from U.S. tax 100% of any foreign source dividends paid by a foreign corporation to a U.S. corporate shareholder that holds at least 10% of the stock of such foreign corporation, but would not exempt unincorporated branches or so-called subpart F income. The Act would generally retain the subpart F income regime with certain modifications. One such modification would expand the definition of "controlled foreign corporation," thereby requiring more foreign corporations to report their subpart F income to their U.S. shareholders. The Act would treat certain "high returns" of foreign subsidiaries of a U.S. parent corporation that are not immediately invested in tangible assets in a manner similar to subpart F income, in that the U.S. parent corporation would be taxed on the foreign high returns on an annual basis whether or not the earnings were held offshore or repatriated into the United States. The Act would, however, repeal the provisions that currently tax U.S. corporate shareholders on the untaxed earnings of controlled foreign corporations to the extent that those earnings are reinvested in United States property (e.g., U.S. real estate, tangible property located in the United States and obligations of U.S. affiliates).

Forced Repatriation of Deferred Foreign Earnings

The Act would require U.S. persons (individuals and corporations) owning 10% or more of a foreign subsidiary to include in income the previously deferred earnings of the subsidiary as of December 31, 2017 (or, if higher, November 2, 2017). Deferred earnings would be taxed over eight years (if elected) at a 12% rate if such earnings were previously held in the form of cash or other short-term assets, or a 5% rate otherwise.

Excise Tax on Certain U.S.-Source Payments to Related Foreign Corporations. Subject to exceptions, the Act would also impose a 20% tax on certain deductible payments (other than interest) made by a U.S. corporation to a related foreign corporation unless the foreign corporation elects to treat such payments as taxable on a net basis in the United States. Although the Act is silent on whether tax treaties would apply to exempt payments from the excise tax, it should be considered whether this provision could override the benefits otherwise available under an applicable tax treaty.

Limitation on Treaty Benefits. Finally, on the basis of prior legislative proposals, the Act would deny treaty benefits that reduce the rate of U.S. withholding tax on U.S. source payments of interest, dividends, rents and certain other amounts, if the payment of such income is deductible to the U.S. payor and is made to a connected non-resident where the payment would not have qualified for treaty relief if it had been made directly to an ultimate foreign common parent corporation. (The Internal Revenue Service is given discretion to select the common parent – in some cases to avoid abuse.)

Conclusion

The release of the Act by the House Representatives is a significant step toward possible enactment of U.S. federal income tax reform. Given congressional grid lock on tax matters for many years, even this initial step is noteworthy. Of course, Congress still has much to do before any legislation is enacted, and many questions must still be answered, such as whether the Senate's proposals (expected around Thanksgiving) will be similar or identical to the Act, and whether Congress will be able to reconcile any differences in a timely manner. President Trump, who is looking for a legislative win, will certainly be pushing to sign a final bill as he has stated his intention to provide a holiday gift to the American people in the form of tax cuts.

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