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Republicans Poised to Enact Transformative U.S. Federal Tax Reform

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Congressional Republicans are on the cusp of enacting transformative U.S. federal tax reform and getting a bill on President Trump's desk for signature, likely by the end of this week. U.S. tax reform of the type described below can have significant U.S. tax consequences for businesses and individuals in the United States and Canada and throughout the world. Specifically, such tax reform can impact, inter alia, (i) cross-border M&A, (ii) Canadian and other foreign investments into the United States (real property or otherwise), (iii) investments by U.S. businesses and U.S. parented multinationals both within and outside the United States, (iv) U.S. estate, gift and income tax planning for high-net-worth individuals and families either within the United States or outside the United States to the extent that they hold U.S.-situs property and (v) how U.S. and non-U.S. businesses will compensate their U.S. employees. It is worth noting that the proposed U.S. tax reform contains no general grandfathering of current structures. As such, taxpayers should consider how their current structures may be affected by the provisions outlined below, which will, as drafted, generally apply to income earned and payments made after December 31, 2017.

On November 16, 2017, House Republicans passed a tax reform bill, titled the "Tax Cuts and Jobs Act" (House Bill); and on December 2, 2017, Senate Republicans passed their version (Senate Bill) of the tax reform bill which followed some but not all of the provisions of the House Bill. Senate Republicans and House Republicans, looking to come through on a major legislative victory for their base, released on December 15 a joint conference committee report (Final Report) reconciling the House Bill and the Senate Bill. Given the legislative momentum and a belief that there is sufficient support from both House and Senate Republicans to pass a vote of both chambers during the week of December 18, 2017, Republicans are all but assured of getting a bill in front of the President for signature, which would allow the President to keep his promise of delivering a Christmas present to the American people in the form of tax reform.

Although we are still distilling the information contained in the 1,000-plus pages of the Final Report released in the late afternoon of December 15, and comparing the provisions of the Final Report to its counterparts in the House Bill and the Senate Bill, this note highlights certain important aspects of the Final Report, focusing on international matters and likely business concerns.

Key Provisions Affecting Individuals

These provisions generally expire for tax years beginning after December 31, 2025.

Income Tax Rates. The Final Report ***lowers the top rate to 37%***, leaves capital gains rates and qualifying dividend rates (each 20%) intact and, unlike the House Bill, does not reduce the number of brackets.

No Repeal of the Alternative Minimum Tax. In a departure from the House Bill, the Final Report retains the alternative minimum tax, but ***increases the phase-out exemptions to $1 million*** for married taxpayers filing jointly ($500,000 for single taxpayers).

Home Mortgage and State and Local Tax Deductions. The Final Report ***limits home mortgage interest deductions to interest paid on loans of up to $750,000*** (down from $1 million under current law and the Senate Bill, but up from the $500,000 proposed in the House Bill). It also eliminates deductions for state and local taxes unless paid or accrued in carrying on a trade or business while allowing individuals to continue to ***deduct up to $10,000 of state and local income, property or sales taxes***.

Qualified Equity Grants. For stock attributable to options exercised or restricted stock units (RSUs) settled after December 31, 2017 (including with respect to such options or RSUs granted prior to January 1, 2018), if a proper election is timely made, the Final Report limits deferral of gain on "qualified stock" to five years from the date such gain would otherwise be includible in income. Qualified stock is stock of a corporation if (i) no stock of such corporation is readily traded on an established securities market during any preceding calendar year; and (ii) such corporation has a written plan under which, in such calendar year, not less than 80% of all employees that are U.S. service providers are granted stock options or RSUs. In the absence of this election, employees (subject to certain exceptions and limitations) would generally be subject to tax on exercise with respect to stock options or upon settlement (i.e., conversion into shares or cash) with respect to RSUs (or, in either case, if later, the first year for which such stock becomes vested).

Estate Tax. The Final Report follows the Senate Bill by doubling the estate, generation-skipping and gift tax exemption (from $5 million for individuals and $10 million for married couples to $10 million and $20 million, respectively, in each case adjusted for inflation). Unlike the House Bill, the Final Report does not provide for a repeal of the estate tax or generation-skipping tax. (Non-residents would not benefit from these changes unless a treaty applies.)

Key Provisions Affecting Businesses

Corporate Tax Rates. The Final Report proposes to immediately and permanently ***reduce the federal corporate income tax rate from 35% to 21%***. Some entities can be expected to convert to corporate status if the provision is enacted. The rate reduction may encourage the retention of earnings in corporate form, meaning that the federal penalty taxes on excess profit accumulation may have a more significant role in the future.

Pass-Through Business Tax Rates. For taxable years beginning after December 31, 2017, and before January 1, 2026, individuals who do business through pass-through entities (e.g., S corporations, sole proprietorships, partnerships, limited liability companies treated as partnerships for tax purposes) would qualify for a new ***20% deduction***. The deduction generally would be limited to 50% of the taxpayer's share of wages paid by the pass-through entity (or, if greater, ***25% of such wages plus 2.5% of the unadjusted basis of all qualified property***) and would not be available for taxpayers engaged in specified service businesses (e.g., lawyers and accountants); however, these limitations will generally not apply to taxpayers with taxable income not exceeding ***$157,500 ($315,000 for married taxpayers filing jointly***). Moreover, the Final Report provides that trusts and estates are eligible for this new deduction. This provision would permit a top marginal tax rate of 29.6% with respect to qualifying income.

Accelerated Cost Recovery. The Final Report would provide for 100% immediate expensing of certain property placed in service after September 27, 2017, but prior to January 1, 2023. Beginning with property placed in service on or after January 1, 2023, the Final Report would begin phasing out the portion of the property that can be immediately expensed. The Final Report would eliminate the requirement that the original use of the property commence with the taxpayer (i.e., acquisitions of used property may be eligible for immediate expensing so long as the taxpayer claiming the deduction did not previously use such property).

Interest Deductibility Limitations. The Final Report would replace the current "earnings stripping" rules with a limit of 30% of EBITDA (down from 50%) for taxable years beginning prior to January 1, 2022. For taxable years beginning after December 31, 2021, the interest deductibility limitation would be based on 30% of EBIT. The new rules would exempt businesses with average gross receipts of $25 million or less and specified trades or businesses, including 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). Disallowed interest would be carried forward indefinitely. ***The Final Report eliminates an interest deductibility limitation of the House Bill and Senate Bill that would have applied 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 have been subject to limitations on their interest deductions to an amount based on the proportion of the U.S. borrower's EBITDA compared with worldwide group EBITDA.

Modification of Net Operating Loss Deduction. ***For net operating losses arising in taxable years beginning after December 31, 2017, the Final Report would limit the deduction of a net operating loss to 80% 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 (but not back) indefinitely (as compared with 2 years back and 20 years forward under current law).

Limit on Like-Kind Exchanges. The Final Report removes the possibility of deferring tax on simultaneous and deferred asset swaps for properties other than real estate not held primarily for sale.

Carried Interests. Under current law, a service provider that receives a partnership interest in connection with the performance of services for the partnership (i.e., a carried interest) is generally entitled to long-term capital gain treatment (and a reduced rate of 20%, plus the 3.8% net investment income tax) on the disposition of the partnership interest if the service provider held the partnership interest for greater than one year if the character of the underlying profits of the partnership is long-term capital gain. The Final Report creates a three-year holding period requirement (as opposed to the current one-year holding period requirement) that must be satisfied in order for carried interest holders to receive long-term capital gain treatment.

Narrowing of Contribution to Capital Limitation in House Bill. Under a provision of the current law, contributions to capital of a corporation are generally excluded from the gross income of that corporation. The House Bill proposed to eliminate this provision for contributions to capital where the fair market value of the contribution exceeded the fair market value of the equity received. ***The Final Report did not follow the House Bill's proposal, but instead provides that a contribution to capital will not be excluded from gross income if (i) the contribution is in aid of construction as a customer or potential customer or (ii) the contribution is by a governmental entity or civic group (unless such contribution is made as a shareholder)***.

Private Activity Bonds. The House Bill surprised many tax practitioners by repealing the tax-exemption for interest on private activity bonds, a common mechanism for financing large-scale infrastructure projects with private funds. The Final Report follows the Senate Bill by leaving in place the tax exemption for private activity bonds. The Final Report does, however, include provisions from the House Bill that would eliminate the exclusion for interest on advance refunding bonds and prevent the issuance of tax-credit and direct-pay bonds.

Renewable Energy Credit. The House Bill contained certain provisions that would have adversely affected the availability of, and benefits attributable to, certain renewable energy credits, including (i) a reduction of the production tax credit to 1.5 cents per kilowatt hour and an elimination of the adjustment for inflation; and (ii) a requirement that projects that begin construction maintain a continuous program of construction beginning with commencement and ending when the property is placed in service, which requirement may have been different from that provided by existing IRS guidance and may have had retroactive effect. The Final Report does not include the provisions of the House Bill.

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 only subject to U.S. tax to the extent it is earned in the United States, the Final Report 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, certain "hybrid dividends" or so-called subpart F income. This exemption would apply only to a domestic corporation that satisfies a 365-day holding period with respect to the stock on which the dividend is being paid. Foreign tax credits attributable to exempt dividends would be disallowed.

Forced Repatriation of Deferred Foreign Earnings

In the case of the last taxable year that begins before January 1, 2018 of an applicable foreign corporation with post-1986 accumulated deferred foreign earnings, the Final Report requires U.S. persons (individuals and corporations) owning 10% or more of a controlled foreign corporation and specified foreign corporations to include in income the previously deferred earnings of the foreign corporation (under the subpart F regime). ***Such deferred earnings would be taxed over eight years (if elected) at a 15.5% rate if such earnings were previously held in the form of cash or other short-term assets or an 8% rate otherwise.*** A foreign tax credit may be available with respect to a portion of the foreign income taxes associated with the forced income inclusion. Note that although U.S. individuals are subject to the forced repatriation provisions of the Final Report, they are not eligible for the "going forward" participation exemption regime for distributions from foreign subsidiaries, which is available only for corporate U.S. shareholders.

Controlled Foreign Corporations and Subpart F Regime. The Final Report would generally retain the subpart F income regime with certain modifications. The key modifications are as follows:

- The definition of "controlled foreign corporation" (CFC) would be expanded by (i) expanding the stock attribution rules for purposes of determining whether a foreign corporation is a CFC by treating a U.S. corporation as owning stock of a foreign corporation held by its foreign shareholders and (ii) expanding the definition of "United States shareholder" to include U.S. persons that own stock representing 10% of the value of a foreign corporation (as opposed to just 10% of the voting power as under current law).
- The current requirement that a corporation be a CFC for at least 30 consecutive days for a United States shareholder to be required to include its share of subpart F income would be eliminated.

In addition, certain taxpayer-friendly modifications that were included in the House Bill and the Senate Bill were not included in the Final Report, including (i) the proposed repeal of the provisions that currently tax U.S. corporate shareholders on the untaxed earnings of CFCs 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 or obligations of U.S. affiliates), which seems odd in light of the Final Report's switch to a territorial tax system; and (ii) the proposal to make the CFC-look-through exception permanent.

Current Year Inclusion of "Global Intangible Low-Taxed Income"

The Final Report departed from the House Bill and took an approach more similar to the Senate Bill by adopting a current year inclusion by a U.S. shareholder of a CFC of the U.S. shareholder's global intangible low-taxed income (GILTI). GILTI generally refers to the excess of a shareholder's net CFC-tested income over the shareholder's net deemed tangible income return (generally based on 10% of the CFC's aggregate adjusted basis in its depreciable tangible property).

For corporate U.S. shareholders, the Final Report permits a deduction equal to 50% of the GILTI otherwise includible in income. For tax years beginning after 2025, the GILTI deduction is reduced to 37.5%. In addition, quite apart from the CFC-related GILTI deduction, the Final Report permits a deduction for U.S. corporations equal to 37.5% of certain "foreign-derived intangible income." For tax years beginning after 2025, the foreign-derived intangible income deduction is reduced to 21.875%. The foreign-derived intangible income deduction essentially permits a U.S. corporation to take a deduction against a portion of the income it receives from foreign persons for sales of property or the performance of services for use outside the United States. The net effect of this provision and the proposed corporate tax rate reduction to 21% is to create a "patent-box" type of concession under which U.S. corporations that export goods or services or that license outside the United States will be subject to a reduced tax rate of 13.125% (increased to 16.406% for tax years beginning after 2025) on income attributable to their export activities.

Base Erosion Minimum Tax. The Final Report again departed from the House Bill, which included a 20% excise tax on certain U.S. source payments, and instead adopted the "base erosion minimum tax" provision of the Senate Bill (with some adjustments). The base erosion minimum tax provision would be imposed on "base erosion payments" paid or accrued by a taxpayer to a foreign related person. Basically, certain U.S. companies making deductible, depreciable or amortizable payments to foreign affiliates would have to pay the excess of (i) 10% of its modified taxable income (determined without regard to such payments) over (ii) such corporation's regular tax liability. This provision would apply to corporations subject to U.S. net income tax with average annual gross receipts of at least $500 million if those corporations' base erosion payments are at least equal to 3% of their total deductions for the year. In most instances, this provision of the Final Report will not apply to cross-border purchases of inventory includible in cost of goods sold (certain cross-border inventory purchases from "surrogate foreign corporations" will be treated as base erosion payments).

Anti-Hybrid Rules. The Final Report also contains a provision that would disallow a deduction for related-party interest or royalties under a hybrid transaction (i.e., a transaction under which a payment is treated as interest or royalties for U.S. tax purposes, but is not treated as such under the tax law of the jurisdiction of the recipient) or involving a hybrid entity (i.e., an entity whose treatment as a pass-through entity or corporation for U.S. tax purposes differs from its treatment for foreign tax purposes) if (i) there is no corresponding income inclusion to the related party under local tax law or (ii) the related party is allowed a deduction with respect to the payment under local tax law. The provision grants regulatory authority to the extent necessary to carry out the purposes of this provision with respect to branches and domestic entities. As drafted, this provision seems to target certain cross-border financing structures, including those commonly used in the Canada-U.S. context, such as "repo" transactions, and would potentially deny deductions for interest paid in connection with such a structure. Moreover, the Final Report does not contain any grandfathering rule with respect to this anti-hybrid provision and therefore could have an impact on covered payments made after 2017 with respect to cross-border financing structures that are already in place.

Sale of Certain Partnership Interests Characterized as Effectively Connected Income. The Final Report would reverse a tax court decision that an interest in a partnership sold by a foreign party constitutes a separate capital property and does not entail a sale of the underlying assets of the partnership. Under the Final Report, gain or loss from the sale or exchange by a non-U.S. person of an interest in a partnership engaged in a U.S. trade or business would be treated as effectively connected income subject to U.S. tax if a sale by the partnership of all of its assets would give rise to effectively connected income. The Final Report further provides that the transferee of the partnership would be required to withhold 10% of the amount realized. Although the tax would apply with respect to transactions taking place on or after November 27, 2017, the withholding application would apply only with respect to transactions taking place after December 31, 2017.

Year-End Tax-Planning Considerations

Although year-end is rapidly approaching, and assuming (as we expect) the Final Report is signed into law, there will not be much time to implement tax strategies based on the new tax laws. Some possible considerations are as follows:

- To the extent possible, consider deferring gain or transactions that would result in the recognition of gain (particularly for corporate taxpayers) until 2018, when tax rates would be lower, or accelerating deductions into 2017 before tax rates go down.
- Consider whether a change in taxable year to either accelerate or defer application of the new tax laws could be beneficial.
- Defer taxable gifts until 2018 when the gift tax exemption would be doubled as compared with current law.
- In 2018, consider incorporating flow-through businesses and non-corporate holdings of interests in CFCs into domestic holding corporations in order to access lower corporate tax rates and the participation exemption deduction; however, beware of the risk of future changes in law to address such structures, as well as the personal holding company and accumulated earnings tax rules.
- Note that there is a continued benefit to holding offshore operations through CFCs if the local country tax rate is below 21% (for U.S. corporate shareholders).

Conclusion

With the release of the Final Report by the joint conference committee consisting of Senate and House Republicans, congressional Republicans are but a couple of votes and a presidential signature away from enacting what would be transformative U.S. federal income tax reform. Given historical congressional gridlock on tax matters, until the Final Report is passed by both the House and the Senate and signed by the President, anything can happen. Nevertheless, the current thinking is that the Final Report is likely to be enacted with little, if any, substantive changes, before Christmas.

Congressional Republicans and the President are both looking for a legislative victory that they can report to their respective bases before the end of the year, particularly as the 2018 mid-term elections are fast approaching. Congressional Republicans will therefore certainly be pushing to get a final bill in front of the President for signature, as he has stated his intention to provide a holiday gift to the American people in the form of tax cuts.

If a final bill is enacted, taxpayers and practitioners, including those that invest, do business or practise in the U.S.-Canada cross-border space, will need to carefully consider and compare their cross-border tax structures to identify and exploit tax opportunities and prevent or minimize any adverse tax consequences that may result from this U.S. tax reform.

This perspective reflects the state of the tax reform legislation as of Tuesday, December 19 at 9:00 am.

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