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Tax Cuts and Jobs Act

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The U.S. Senate passed the "Tax Cuts and Jobs Act" on December 2nd. The House of Representatives passed its version of this tax legislation on November 16th. The House and Senate are in the process of reconciling the differences between the two bills.

If enacted, which appears likely, the Act would be the most transformative U.S. tax legislation since the enactment of the 1986 Tax Act a generation ago, and the new Act would have a profound impact upon most U.S. businesses and high-income individuals. Set forth below is a brief description of selected provisions in the House and Senate bills.

TAKEAWAYS

Both the House and Senate bills would:

- Reduce the corporate tax rate to 20 percent;
- Eliminate the state and local income tax itemized deduction and cap the property tax deduction at $10,000;
- Reduce the tax rate applicable to certain business income derived through pass-through entities;
- Impose significant limitations on the deductibility of business interest;
- Allow a business taxpayer to fully and immediately expense 100 percent of the cost of most tangible personal property acquisitions;
- Eliminate net operating loss ("NOL") carrybacks for NOLs arising in taxable years beginning after December 31, 2017, and limit a taxpayer's deduction for NOLs to 90 percent of the taxpayer's taxable income (determined without regard to the NOL), among other changes; and
- Drastically alter the U.S. international tax system by, among other things, (i) providing for a so-called "territorial," rather than a worldwide, tax regime, subject to the limitations and exceptions discussed below; and (ii) imposing a mandatory deemed repatriation tax on a U.S. shareholder's pro-rata share of its foreign subsidiary's historical earnings and profits ("E&P") at a reduced tax rate, which should result in the potential repatriation of approximately $2.5 trillion in earnings held offshore by U.S. multinationals.

DETAILED ANALYSIS

1. Corporate Rate

Although both the House and Senate bills would reduce the corporate tax rate to 20 percent, under the House bill, the reduced tax rate would be effective January 1, 2018, while under the Senate bill, the reduced tax rate would not be effective until January 1, 2019. While both bills provide for a 20 percent rate, over the weekend President Trump suggested that a 22 percent corporate rate may ultimately be enacted.

2. Pass-Through Provisions

House Bill

- A portion of the net income derived by an owner or shareholder of a pass-through entity (such as a partnership, a limited liability company or an S corporation) may be treated as “qualified business income,” subject to a maximum 25 percent tax rate, rather than the current 39.6 percent maximum individual tax rate.
- In the case of a service business, such as law, accounting, consulting, financial services, or performing arts, it would generally be very difficult to qualify for the reduced 25 percent tax rate, but a limited tax rate reduction may be available if it could be demonstrated that the business is highly capital-intensive in nature.
- In the case of a non-service business, it is necessary to determine whether the income is “active” or “passive” business income. Code Section 469 passive activity loss tests are utilized in determining whether income is deemed “active” or “passive” in nature.
- In the case of “passive” income, 100 percent of the income qualifies for the preferential 25 percent tax rate.
- In the case of “active” income, 30 percent of the income generally qualifies for the preferential 25 percent tax rate. However, in the case of a capital-intensive business, a taxpayer may make an election to have more than 30 percent of the income qualify for the preferential 25 percent tax rate.

Note

Under this new provision, it would generally be advantageous if an activity were classified as “passive” under Code Section 469 -- because all “passive” income is eligible for the reduced 25 percent tax rate. This is paradoxical because taxpayers typically attempt to avoid “passive” activity classification under Code Section 469 in order to avoid limitations on utilization of tax losses.

Senate Bill

- Under the Senate provision, an individual taxpayer may generally deduct 23 percent of “qualified business income” from a pass-through entity, provided, however, that the maximum amount of the deduction cannot exceed the individual’s pro rata share of 50 percent of the entity’s W-2 wages.
- The deduction does not apply to specified service businesses (e.g., law, health, engineering, architecture, accounting and consulting) except in the case of a taxpayer whose income does not exceed a specified threshold amount.
- “Qualified business income” does not include reasonable compensation paid by an S corporation or any amount that is a guaranteed payment for services rendered to or on behalf of a partnership.

- “Qualified business income” also does not include investment income, such as short-term capital gain, interest or dividend income.

3. Cost Recovery – Expensing

Under both the House and Senate bills, business taxpayers would be allowed to fully and immediately expense 100 percent of the cost of most tangible personal property acquired and placed in service after September 27, 2017 and before January 1, 2023.

Note
The new expensing provision may give rise to more corporate M & A transactions being structured as *asset* acquisitions or *deemed asset* acquisitions, as opposed to *stock* acquisitions. The new expensing provision may also contribute to an increase in tax-motivated M&A transactions.

4. 30 Percent Limitation on Deductibility of Net Business Interest

House Bill

- Except to the extent described below, every business would be subject to a disallowance of a deduction for net interest expense in excess of 30 percent of the business’s “adjusted taxable income,” defined below.
- “Adjusted taxable income” is a business’s taxable income computed without regard to interest expense and income, NOLs, and depreciation, amortization and depletion.
- Any interest amounts subject to disallowance are carried forward to the succeeding five taxable years.
- In the case of a partnership, the 30 percent interest limitation is applied at the partnership level, rather than at the partner level.
- A business with average annual gross receipts of $25 million or less is not subject to this limitation.
- A real property trade or business is exempt from this limitation but it would also be ineligible to fully expense the cost of personal property acquisitions.

Senate Bill

- The Senate bill is more draconian than the House bill because under the Senate bill, in computing “adjusted taxable income,” there is no add-back of depreciation and amortization.
- A real property trade or business must make an affirmative election to be exempt from the 30 percent interest limitation, in which case, it would be ineligible to expense personal property acquisitions or depreciate real property over the shorter 25-year period, as discussed below.
- Query: Could a taxpayer avoid the reduction in interest expense by financing a capital acquisition through a leveraged lease financing, rather than through a conventional debt financing?

5. NOLs

House Bill

- A taxpayer would be allowed to deduct an NOL carryover or carryback only to the extent of 90 percent of the taxpayer's taxable income (determined without regard to the NOL).
- NOL carrybacks would generally be disallowed, but under an exception, an NOL incurred in 2017 could be carried back as long as the NOL is not attributable to the increased expensing allowed pursuant to the new legislation.
- NOLs could be carried forward for an indefinite period, whereas under current law, NOLs can only be carried forward for 20 years.
- NOLs arising in tax years beginning after 2017 that are carried forward can be increased by an interest factor to preserve their fair market value.

Senate Bill

The Senate bill is substantially similar to the House bill, subject to the following caveats:

- The Senate bill provision limiting the NOL deduction applies to NOLs arising in taxable years beginning after December 31, 2017; and
- The Senate bill provision allowing indefinite carryforwards and modifying carrybacks applies to NOLs arising in taxable years beginning after December 31, 2017.

6. Limitation on Deduction of Interest by Corporations Which are Members of an "International Financial Reporting Group"

House Bill

- The deductible net interest expense of a U.S. corporation that is a member of an "international financial reporting group," defined below, is 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 EBITDA.
- An "international financial reporting group" is a group of entities that includes at least one domestic corporation and one foreign corporation, prepares consolidated financial statements, and has annual gross receipts in excess of $100 million.
- Any disallowed interest expense may be carried forward for up to five years.

Senate Bill

- The Senate bill would limit the amount of interest deductible by a U.S. member of an international group if the debt-equity ratio in the U.S. exceeds a specified percentage of the worldwide affiliated group's debt-equity ratio.
- Any disallowed interest expense may be carried forward indefinitely.

7. Like-Kind Exchanges

Under both House and Senate bills, like-kind exchanges would generally be limited to real property.

8. Depreciation Recovery Period for Real Property

- While the Senate bill would shorten the depreciation recovery period with respect to nonresidential real and residential rental property to 25 years, effective for property placed in service after December 31, 2017, there is no comparable provision in the House bill.
- A real property trade or business that depreciates real property over a 25-year period would be subject to the rules described above limiting deductibility of interest. A real property trade of business can avoid the rules limiting the deductibility of interest by electing to depreciate nonresidential real property over a 40-year period and residential real property over a 30-year period.

9. Carried Interest

Under both the House and Senate bills, a partnership interest received in connection with performance of services would generally have to be held for a minimum of three years (increased from the present one-year holding period requirement) in order to qualify for long-term capital gain treatment.

10. Home Mortgage Interest Deduction

House Bill

- Under current law, a taxpayer may claim an itemized deduction for mortgage interest paid with respect to a principal residence and one other residence. A taxpayer may deduct interest on up to $1 million in acquisition indebtedness and up to $100,000 in home equity indebtedness. For debt incurred after November 2, 2017, the House bill would reduce the $1 million limitation to $500,000. Interest would only be deductible on a taxpayer’s principal residence and interest on home equity indebtedness incurred after November 2, 2017 would not be deductible.

Senate Bill

- While the Senate bill does not propose to change the $1 million base amount, it would eliminate the mortgage interest deduction with respect to a new home equity line of credit.

11. Shift to a Partial-Territorial Tax Regime; Participation Exemption for Dividends from Foreign Subsidiaries

Under both the House and Senate bills:

- Each 10 percent U.S. shareholder of a foreign corporation would be required to include in gross income its share of the foreign corporation’s E&P, to the extent the E&P has not previously been subject to U.S. tax.
- Each 10 percent U.S. shareholder would be taxable at a 14 percent tax rate (14.5 percent under

the Senate bill) to the extent the E&P is attributable to cash or cash equivalents, and at a 7 percent tax rate (7.5 percent in the Senate bill) with respect to the remaining E&P. (U.S. multinational are estimated to have approximately $2.5 trillion in earnings "parked offshore," which will largely be repatriated to the U.S. as a result of this mandatory repatriation tax.)

- The foreign tax credit may be available to offset the U.S. tax.
- At the election of the U.S. shareholder, the tax liability could be payable over a period of up to eight years.
- In the case of any dividend received from a "specified 10-percent owned foreign corporation," by a domestic corporation which is a 10 percent U.S. shareholder with respect to such foreign corporation, a 100 percent dividend received deduction (a "DRD") would be available with respect to the foreign source portion of the dividend.
- Dividend distributions from a "passive foreign investment company" that does not constitute a controlled foreign corporation would not qualify for the 100 percent DRD.
- Under the Senate bill, the 100 percent DRD would not be available for any dividend received by a U.S. shareholder from a controlled foreign corporation if the dividend is a so-called "hybrid dividend." A "hybrid dividend" is any amount received from a controlled foreign corporation for which the foreign corporation receives a deduction from taxes imposed by the foreign country.

12. Foreign High Returns / Global Intangible Low Taxed Income

House Bill

- A U.S. parent of a foreign subsidiary would be subject to current U.S. tax on 50 percent of the U.S. parent's "foreign high return" earned by the foreign subsidiary. "Foreign high returns" would be measured as the excess of the foreign subsidiary's net income reduced by a percentage (7 percent plus the federal short-term rate) of the foreign subsidiary's adjusted bases in depreciable tangible property, adjusted downward for interest expense.

Senate Bill

- A U.S. shareholder of a controlled foreign corporation would be required to include in gross income for a taxable year its so-called "global intangible low-taxed income" ("GILTI") in a manner generally similar to inclusions of Subpart F income. GILTI is generally the amount by which the net income of a foreign subsidiary exceeds a 10 percent return on certain of its business assets.

13. House Excise Tax on Certain Payments from a Corporation to a Related Foreign Corporation; and Senate Base Erosion Anti-Abuse Tax

House Bill

- Payments (other than interest) made by a U.S. corporation to a related foreign corporation that are deductible, includible in the cost of goods sold, or includible in the basis of a depreciable or

amortizable asset would generally be subject to a 20 percent excise tax, unless the related foreign corporation elects to treat the payments as income "effectively connected" with the conduct of a U.S. trade or business (and thus subject to U.S. tax).

- No excise tax would be payable, however, for intercompany services which a U.S. company elects to pay for at cost, with no markup.
- The 20 percent excise tax would be applicable only with respect to an international financial reporting group with payments from U.S. corporations to their foreign affiliates totaling at least $100 million annually. This provision would only apply after 2018.

Senate Bill

- If a corporation has average annual gross receipts of at least $500 million and at least 4 percent of its deductions are attributable to payments made to a related foreign party, then the U.S. corporation would be subject to a 10 percent base erosion minimum tax, which would be imposed on a modified tax base that excludes payments made to the related foreign party.

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If you have any comments or questions regarding this Client Advisory, please contact Jack Miles at jmiles@kelleydrye.com or (212) 808-7574, or any of the following members of the Kelley Drye & Warren LLP Tax Department:

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