

Tax Cuts and Jobs Act – Final Legislation

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The U.S. Senate and the House of Representatives have just passed the “Tax Cuts and Jobs Act” (the “Act”). President Trump is expected to sign the bill into law later this week. Once enacted, the Act will be the most transformative U.S. tax legislation since the enactment of The Tax Reform Act of 1986, a generation ago. The Act will have a profound impact upon most U.S. businesses and high-income individuals.

In the domestic area, the Act creates a new pass-through tax regime which will give rise to legitimate planning as well as gaming opportunities. The unprecedented reduction in the corporate tax rate coupled with the new pass-through tax regime will compel most owners of private companies to closely reexamine their ownership and operational structures to determine whether they remain tax-efficient under the new legislation. The substantial limitations imposed with respect to the state and local tax deduction will lead many individuals residing in high-tax states to explore different ways in which they can ameliorate their new “tax hit.” Finally, the new 100-percent expensing deduction for certain business assets and the limitations imposed with respect to business interest deductions could change the way many M&A transactions and financings are structured.

The changes in the international tax area are radical. These changes will force U.S. multinationals to completely reevaluate their domestic and international business strategies and operations. The Act drastically changes U.S. international tax rules, by, among other things, (i) providing for a so-called “territorial,” rather than a worldwide, tax system, subject to the limitations and exceptions described below, and (ii) imposing a mandatory deemed repatriation tax on a U.S. shareholder’s pro-rata share of its foreign subsidiaries’ historical earnings and profits (“E&P”) at a reduced rate, which should result in the potential repatriation of \$2.5 trillion in earnings held offshore by U.S. multinationals.

This Client Advisory discusses selected provisions of the Act that should be of particular interest to businesses and high-income individuals.

DETAILED ANALYSIS

Domestic Tax Provisions

1. Reduction in Corporate Tax Rate

- The Act reduces the corporate tax rate to 21 percent on a permanent basis, effective for taxable years beginning after December 31, 2017.

Observations

- Corporations are incentivized to accelerate deductions into 2017, to realize tax savings at the higher 35 percent corporate tax rate in 2017.
- In light of the drastic reduction in the corporate tax rate, many owners of closely-held companies that are classified as partnerships or sole proprietorships for tax purposes will consider whether to operate the business as a C corporation, especially if the owners are ineligible to qualify for the pass-through tax deduction, discussed below.
- In many cases, the owner of a closely-held company will be reluctant to operate as a C corporation, because, although it is generally easy to convert a partnership or a sole proprietorship to a C corporation, converting a C corporation to a partnership or a sole proprietorship is difficult because it triggers a tax based upon the underlying business's unrealized appreciation.
- If the operating entity is classified as a partnership for tax purposes, then individual members may be given the option to invest directly or through an intervening "blocker" C corporation.
- In light of the significant disparity between individual and corporate tax rates, an individual may consider utilizing a C corporation as an investment vehicle or as a personal service corporation.
- In certain cases, the tax benefits arising as a result of the utilization of a C corporation may be disallowed pursuant to judicial, statutory or regulatory anti-abuse rules, including the following: the judicial economic substance and assignment of income doctrines; § 531 (the accumulated earnings tax)^[1]; § 542 (the personal holding company tax); § 269A (relating to personal service corporations); and anti-abuse regulations promulgated pursuant to the Act.

2. State and Local Tax Deduction

- The Act caps the state and local itemized tax deduction at \$10,000.
- The Act expressly provides that an individual may not claim an itemized deduction in 2017 with respect to a *pre-payment* of state and local income tax for a future year.
- State and local taxes paid or accrued in carrying on a trade or business or in connection with an investment activity continue to be deductible (subject to other potential limitations).

Observations

- Query, will state and local taxing jurisdictions restructure their taxes to convert them to "trade or business" taxes (for example, franchise taxes or payroll taxes), in an attempt to qualify for the federal tax deduction?
- Although the Act limits the deductibility of state and local taxes by an individual, state and local taxes paid or accrued by a C corporation are generally deductible. Query whether it would be tax-efficient for a non-corporate taxpayer to incorporate in order to deduct state and local taxes. Note the various judicial, statutory and regulatory anti-abuse rules cited above that could apply in such a case.

3. Pass-through Provisions

- For periods beginning in 2018 and ending after 2025, an individual may generally deduct 20 percent of so-called “qualified business income,” defined below, from a partnership, an S corporation, or a sole proprietorship, as well as 20 percent of aggregate qualified REIT dividends and qualified publicly-traded partnership income.
- A “qualified trade or business” is defined as any trade or business other than a “specified service trade or business,” defined below, and other than the trade or business of being an employee.
- The maximum amount of the deduction generally cannot exceed the greater of (i) 50 percent of the W-2 wages paid with respect to the qualified trade or business or (ii) the sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified depreciable property used in the trade or business.
- A “specified service trade or business” generally does not qualify for the 20 percent deduction subject to one exception described below. A “specified service trade or business” means any trade or business involving the performance of services in the field of law, health, accounting, consulting, financial services, brokerage services, including investing and investment management, trading or dealing in securities, partnership interests or commodities, and 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.
- The “specified service trade or business” and wage limitations discussed above are not applicable with respect to an individual whose taxable income for the year does not exceed \$315,000 (in the case of a joint return) or \$157,500 (in the absence of a joint return). A phase-in of the limitation applies if the taxpayer’s taxable income exceeds \$315,000 but does not exceed \$415,000 (in the case of a joint return) or exceeds \$157,500 but does not exceed \$207,500 (in the absence of a joint return).
- “Qualified business income” does not include specified investment-related income such as (i) short-term or long-term capital gain, (ii) dividend income, (iii) interest income, other than interest allocable to a trade or business, and (iv) the excess of gain over loss from commodities transactions, other than those entered into in connection with a trade or business.
- “Qualified business income” also 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.

Observation

- A “specified service trade of business” may hold certain assets, which, if held by a separate entity, could qualify for the pass-through tax deduction. If so, the disqualified “specified service trade or business” may consider spinning off the qualifying business into a separate pass-through entity, which would be owned by the same members that own the disqualified service business. Query, would the regulations and the IRS ultimately permit a taxpayer to engage in such a tax-motivated restructuring? At a minimum, following the spin-off, the two companies would have to be operated as separate entities.

4. Cost Recovery - 100-Percent Expensing

- Business taxpayers are generally 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 21, 2023.
- Used personal property may qualify for the 100-percent expensing allowance, subject to certain limitations.

Observations

- A corporation may be incentivized to accelerate personal property acquisitions into 2017, so that it could claim the 100-percent expense allowance at the 35 percent corporate tax rate in 2017, rather than at the 21 percent corporate tax rate that will apply in future years.
- This new expensing provision may result in more corporate M&A transactions being structured as *asset* acquisitions or *deemed asset* acquisitions, as opposed to stock acquisitions. This new provision may also contribute to a significant increase in tax-motivated M&A transactions.

5. 30-Percent Limitation on Deductibility of Net Business Interest

- Subject to the exceptions 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.
- For taxable periods beginning after December 31, 2017 and before January 1, 2022, "adjusted taxable income" is defined as the taxable income of the business computed without regard to interest expense and income, net operating losses ("NOLs"), and depreciation, amortization, and depletion.
- In computing "adjusted taxable income" for taxable periods beginning on or after January 1, 2022, there is no adjustment with respect to the deduction allowable for depreciation, amortization, or depletion. Accordingly, the disallowance provision will become more draconian in nature on or after January 1, 2022.
- Any interest amounts subject to disallowance are carried forward indefinitely to the succeeding 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 must make an affirmative election in order to be exempt from the 30-percent interest limitation, in which case, it would be (i) ineligible to expense personal property acquisitions and (ii) obligated to depreciate real property under the alternative depreciation system ("ADS"), over a period of 40 years with respect to nonresidential real property, and over a period of 30 years with respect to residential real property.
- 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?

6. NOLs

- The Act limits the NOL deduction to 80 percent of taxable income (determined without regard to the deduction) for losses arising in taxable years beginning after December 31, 2017.
- NOL carrybacks are generally disallowed with respect to an NOL arising in taxable years beginning after December 31, 2017.
- NOLs arising in taxable years beginning after December 31, 2017 can be carried forward for an indefinite period, whereas prior to the enactment of the Act, NOLs could only be carried forward for a period of 20 years.

7. Like-Kind Exchanges

- Like-kind exchanges are now generally limited to real property that is not held primarily for sale, subject to a transition rule.

8. Corporate Alternative Minimum Tax (“AMT”)

- The Act repeals the corporate AMT.

9. Loss Limitation Applicable to Individuals

- The Act limits the ability of an individual to utilize so-called “excess business losses” to shelter passive and portfolio income.
- An “excess business loss” is defined as the excess of (i) the aggregate deductions of the taxpayer for the taxable year which are attributable to trades or businesses of the taxpayer over (ii) the sum of the aggregate gross income of such taxpayer for the taxable year which is attributable to such trades or businesses, plus \$500,000 (in the case of a joint return) or \$250,000 (in the absence of a joint return).
- In the case of a partnership or an S corporation, the limitation is applied at the partner or shareholder level.

10. Modification of Limitation on Excessive Employee Remuneration (§ 162(m))

- Section 162(m) limits the deductibility of certain compensation expenses in the case of a publicly traded corporate employer. The deduction for compensation with respect to a so-called “covered employee” of a publicly-held corporation is generally limited to no more than \$1 million per year, subject to certain exclusions.
- Prior to the enactment of the Act, the following types of compensation were not taken into account under § 162(m): (i) remuneration payable on a commission basis, and (ii) remuneration payable solely on account of the attainment of one or more performance goals if certain outside

director and shareholder approval requirements are met (“performance-based compensation”).

- The Act eliminates the § 162(m) exceptions for commissions and “performance-based compensation.” Thus, such compensation is generally taken into account in determining whether the \$1 million threshold amount is exceeded.
- The Act changes the definition of the term “covered employee” to include the principal executive officer, the principal financial officer and the three most highly-compensated officers for the taxable year (other than the principal executive officer and the principal financial officer) who are required to be reported on the company’s proxy statement for the taxable year.
- If an individual is a “covered employee” with respect to a corporation for a taxable year beginning after December 31, 2017, the individual remains a “covered employee” for all future years.
- Remuneration provided pursuant to a written binding contract which was in effect on November 2, 2017 and which was not modified in any material respect on or after such date qualifies for transition relief.

11. Carried Interest

- A partnership interest received in connection with the performance of services must 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.

12. Home Mortgage Interest Deduction

- In the case of acquisition indebtedness incurred on or after December 15, 2017, the mortgage interest deduction is limited to \$750,000 in mortgage debt. Acquisition indebtedness incurred before December 15, 2017 is grandfathered and continues to be subject to the limitation of \$1 million (\$500,000 in the case of married taxpayers filing separately).
- The Act disallows the interest deduction with respect to home equity debt.
- Under a special refinancing rule, the \$1 million limitation (\$500,000 in the case of married taxpayers filing separately) continues to apply to any debt incurred on or after December 15, 2017 to refinance qualified residence indebtedness incurred before that date to the extent the amount of debt resulting from the refinancing does not exceed the principal amount of the refinanced debt.

13. Cost Basis of Securities Determined Without Regard to Identification

- If a taxpayer acquired stock in a corporation on different dates or at different prices and the shares are not adequately identified, then the shares sold are deemed to be drawn from the earliest acquired shares (pursuant to a so-called “first-in-first-out” rule). If, however, a taxpayer adequately identifies the shares of stock that it sells, the shares of stock treated as sold are the shares actually identified by the taxpayer. Under the Senate bill, a taxpayer’s basis in shares would have been computed under the “first-in-first-out” rule and the adequate identification rule would have been repealed.

- The Act does not include the Senate bill's "first-in-first-out" rule, and accordingly, the adequate identification rule survives intact.

14. Acceleration of Income Inclusion

- The Act generally requires an accrual method taxpayer to include an amount in gross income no later than the taxable year in which such income is reflected as revenue in an "applicable financial statement."

15. Modification to Estate and Gift Tax

- The Act doubles the estate and gift tax exemption for decedents dying and gifts made after December 31, 2017. The basic exclusion amount is thus doubled from \$5 million to \$10 million. The \$10 million amount is indexed for inflation occurring after 2011.

International Tax Provisions

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

- Each 10-percent U.S. shareholder of a foreign corporation is 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 is taxable at a 15.5 percent tax rate to the extent the E&P is attributable to cash or cash equivalents, and at a tax rate of 8 percent with respect to the remaining E&P. (U.S. multinationals 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 is 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 dividends-received deduction (a "DRD") would be available with respect to the foreign source portion of the dividend.
- Dividend distributions received from a passive foreign investment company that does not constitute a controlled foreign corporation do not qualify for the 100-percent DRD.
- The Act retains § 956, which is surprising in light of the fact that a U.S. parent would generally be entitled to a participation exemption with respect to actual dividends from its foreign subsidiary.

17. "Global Intangible Low-Taxed Income"

- A U.S. shareholder of a controlled foreign corporation is 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, subject to a 50-percent deduction as well as a reduced foreign tax credit at a rate of 80 percent. 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.

- As a result of the 50-percent deduction, the effective U.S. tax rate on GILTI is 10.5 percent for years beginning after December 31, 2017, and before January 1, 2026. Because only 80 percent of foreign tax credits are allowed to offset the U.S. tax on GILTI, if the foreign tax rate with respect to GILTI is equal to or in excess of 13.125 percent, then no residual U.S. tax would be owed by the U.S. parent.

18. “Foreign-Derived Intangible Income”

- A U.S. corporation is allowed a deduction in an amount equal to 37.5 percent of its so-called “foreign-derived intangible income” (“FDII”), thus resulting in an effective tax rate of 13.125 percent (for tax years before 2026). A U.S. corporation’s FDII is the portion of its intangible income, determined based upon a formula, that is derived from serving foreign markets.

19. “Base Erosion Anti-Abuse Tax”

- If a corporation has average annual gross receipts of at least \$500 million and at least three percent of its deductions are attributable to payments made to a related foreign party, then the U.S. corporation is subject to a base erosion anti-abuse tax (“BEAT”), which would be imposed on a modified tax base that excludes payments made to the related foreign party.^[2] The base erosion anti-abuse tax rate is five percent the first year, then 10 percent through 2025, and 12.5 percent after 2025.
- Base erosion payments do not include payments for costs of goods sold.

20. Anti-Hybrid Rule

- The Act disallows a deduction for interest or royalty payments made to a related foreign party to the extent that (i) there is no income inclusion to the foreign-related party under the tax law of the foreign country, or (ii) the foreign-related party is allowed a deduction with respect to such amount.

^[1] All section references are to the Internal Revenue Code of 1986, as amended.

^[2] In the case of a bank, the base erosion percentage is two percent or higher.

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If you have any comments or questions regarding this Client Advisory, please contact [Jack Miles](mailto:Jack.Miles@kelleydrye.com) 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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