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Legal Alert: Reconciling the Differences, the Senate Tax Cuts and Jobs Act

November 16, 2017

On November 9, 2017, the Senate Finance Committee released a Description of the Chairman's Mark of the "Tax Cuts and Jobs Act" and on November 14, 2017, the Senate Finance Committee released a Description of the Chairman's Modification to the Chairman's Mark of the "Tax Cuts and Jobs Act," both prepared by the Joint Committee on Taxation (the Senate Plan). The Senate Plan, like the parallel Tax Cuts and Jobs Act passed by the House of Representatives (the House Plan), is far reaching and contemplates significant changes to how the US taxes individuals, domestic businesses and multinational enterprises. See the prior Eversheds Sutherland alert on the House Plan. The Senate Plan generally adopts the reductions in taxes identified in the Unified Framework released by the so-called "Big Six" on September 27, 2017, and like the House Plan includes a number of revenue raising provisions intended to pay for a portion of the cost of the tax reductions. See the prior Eversheds Sutherland alert on the Unified Framework. In many cases, the revenue raising proposals in the Senate Plan modify or eliminate long-standing tax incentives.

Eversheds Sutherland Observation: Republicans aim to pass a tax bill by the end of the year. The House Plan was passed on a party-line vote by the House Ways and Means Committee and was passed today by the full House. The Senate Plan shares many similarities with the House Plan. However, as discussed in greater detail below, there are meaningful differences in the substance of the two proposals. Additionally, Republicans have chosen to advance the Senate Plan under the budget reconciliation process, which permits certain legislation to be passed in the Senate without the possibility of a filibuster (meaning it can be passed with 50 rather than 60 votes). Under the Senate's Byrd rule, legislation passed this way can only make changes outside the 10-year budget window (i.e., be permanent, as opposed to sunsetting) if the legislation is not projected to increase the federal deficit outside of the 10-year budget window. It is not yet clear what total impact the Byrd rule will have on the Senate Plan, but many of the modifications made on November 14 appear to have been driven by budgetary considerations. Given the extensive changes contemplated by the Senate Plan (and the parallel House Plan), individuals and businesses will need to carefully follow and consider the potential impact of proposed tax reform.

This alert summarizes the principal proposals in the Senate Plan and notes the most significant differences from the House Plan. See the Eversheds Sutherland Tax Reform Law blog for more information, including the description of the Senate Plan and the Senate Finance Committee's section-by-section summary of the Senate Plan. The blog includes additional in-depth analysis of the provisions described below, including alerts on the accounting methods, insurance, energy and international provisions of the Senate Plan. The blog also includes in-depth analysis of the House Plan.

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Proposed Taxation of Individuals:

- Retains seven brackets, but sets reduced rates for those brackets at 10%, 12%, 22%, 24%, 32%, 35% and 38.5%. These reduced rates expire for taxable years beginning after December 31, 2025.
  - ***Eversheds Sutherland Observation:*** The House Plan would consolidate the current seven brackets into four and retain the top rate of 39.6%. Under the House Plan, taxpayers in the 39.6% bracket would lose the benefit of the 12% bracket, effectively subjecting a portion of their income to tax at a marginal rate of 45.6%.
- Nearly doubles the standard deduction to $24,000 for married taxpayers filing jointly (and $12,000 for other individuals), while eliminating personal exemptions.
- Eliminates most itemized deductions.
  - The mortgage interest deduction on up to $1 million of acquisition indebtedness would be retained, though the deduction for interest on home equity indebtedness would be repealed.
  - Eliminates the deduction for property taxes as well as state and local income taxes.
    - ***Eversheds Sutherland Observation:*** The House Plan would permit up to $10,000 per year in property taxes to be deducted. House Ways and Means Committee Chairman Kevin Brady has suggested the House will not agree to the full elimination of the deduction for property taxes.
  - Unlike the House Plan, the Senate Plan retains the deduction for medical expenses.
  - Retains the charitable contribution deduction.
- Eliminates the alternative minimum tax (AMT). The repeal of the individual AMT expires for taxable years beginning after December 31, 2025.
- Retains the estate, gift and generation-skipping taxes, but doubles the exemption amount.
- Repeals the penalty for failure to maintain coverage under the Affordable Care Act (commonly referred to as the individual mandate).
  - According to the Joint Committee on Taxation, eliminating the individual mandate will raise approximately $318 billion over 10 years.

Proposed Taxation of Domestic Businesses:

- Reduces the corporate tax rate from 35% to 20%, effective for taxable years beginning after December 31, 2018. In contrast to the reduced individual rates, the reduced corporate rate is permanent and does not sunset.
  - ***Eversheds Sutherland Observation:*** The House Plan would reduce the corporate tax rate to 20% commencing in 2018. The one-year delay of the rate reduction in the Senate Plan, coupled with the fact that many other provisions in the Senate Plan are effective for taxable years beginning in 2018, may produce anomalous results (or planning opportunities) that taxpayers should closely consider.
  - Personal services corporations would be subject to the same 20% corporate tax rate.
  - The current 80% and 70% dividends received deductions (DRDs) would be reduced to 65% and 50%, respectively. The reductions are intended to align the DRDs with the reduction in the corporate tax rate described above so that the effective rate of tax on dividends received remains the same as under current law.
- Eliminates the corporate AMT, although amendments would be made to limit the use of carryforward net operating losses (NOLs) to 90% of the taxpayer's taxable income in a manner similar to the current corporate AMT through taxable years beginning before December 31, 2023.
  - For taxable years beginning after December 31, 2023, taxpayers would only be permitted to offset 80% of their taxable income (determined without regard to the deduction). However, if cumulative aggregate on-budget federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds certain thresholds, this 80% limitation would be repealed for taxable years beginning after December 31, 2025.
- Generally eliminates the ability to carry back NOLs (present law allows a two-year carryback); however, NOLs could be carried forward indefinitely (present law permits NOLs to be carried forward 20 years).
- Limits the ability to deduct net business interest expense to 30% of adjusted taxable income.
  - Adjusted taxable income generally is taxable income determined without regard to any business interest income, the 17.4% deduction for certain pass-through income (discussed below) or any deduction for NOLs. Unlike the parallel provision in the House Plan, depreciation and amortization are not reversed in determining adjusted taxable income, meaning depreciation and amortization reduce the amount of allowable interest expense. This is

particularly significant in light of increased expensing provisions under the proposed legislation.

- In the case of a US consolidated group, this limitation applies at the consolidated return filing level. In the case of a partnership, this limitation applies at the partnership level.
- This provision does not apply to certain regulated utilities or real property trades or business.
- Any disallowed deduction may be carried forward indefinitely, which is a departure from the House Plan that permits disallowed deductions to be carried forward only for five years.
- As discussed below, US corporations that are members of a worldwide affiliated group are potentially subject to an additional limitation on their ability to deduct interest expense and, to the extent both rules apply, whichever rule allows the lower amount of interest expense to be deducted controls.

• Permits full expensing for five years.

- Taxpayers would be permitted to fully and immediately deduct 100% of the cost of qualified property (i.e., other than real estate) acquired or placed into service after September 27, 2017, and before January 1, 2023.

• Allows like-kind exchange treatment only with respect to real property (i.e., an exchange of intangibles or tangible personal property would no longer be eligible for such treatment).

• Permits individuals to deduct 17.4% of domestic qualified business income from pass-through entities, reducing the amount of such income that would be subject to tax at the taxpayer's applicable rates.

- Qualified business income generally means the net amount of income, gain, deduction, and losses with respect to the taxpayer's qualified businesses (generally, trades and businesses other than services in the fields of health, law, engineering, architecture, accounting and other services businesses).
- The amount of the 17.4% deduction is generally limited to 50% of the taxpayer's allocable or pro rata share of W-2 wages of the partnership, S corporation or sole proprietorship.
- The benefit of the 17.4% deduction is phased out for taxpayers whose taxable income exceeds $500,000 for married individuals filing jointly or $250,000 for other individuals.

  - This reduced rate differs significantly from the parallel provision in the House Plan, which creates a maximum 25% (or 9% for certain taxpayers) tax rate for qualified business income.

- For taxable years beginning after December 31, 2025, requires research or experimental expenditures to be capitalized and amortized ratably – in the case of research conducted in the US, over a five-year period, and in the case of research conducted outside the US, over a 15-year period.

  - However, if cumulative aggregate on-budget federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds certain thresholds, this proposal would be repealed effective for taxable years beginning after December 31, 2025 (i.e., this proposal would never take effect given its effective date).

<u>Proposed Taxation of Compensation and Benefits</u>:

- Neither the Senate Plan nor the House Plan now includes a provision changing deferred compensation. Each proposal originally included such a provision, and in each case, the provisions were removed.

- Both the Senate Plan and the House Plan include an expanded section 162(m) deduction disallowance for compensation in excess of $1 million. The proposals eliminate the exception for performance-based compensation and expand the group of executives to which the deduction limitation applies. The Senate Plan includes a transition rule under which certain compensation that is fully vested by December 31, 2016 will not count against the $1 million limit.

- Both the Senate Plan and the House Plan would impose a new 20% excise tax payable by tax-exempt employers on compensation in excess of $1 million and separation pay in excess of three times average annual compensation, in each case for the five highest-paid employees.

- The Senate Plan would aggregate 457(b) plans with 401(k) and 403(b) plans in determining whether an individual reaches the deferral limit ($18,500 for 2018), while the House Plan would lower the earliest normal retirement age for defined benefit plans to age 59-1/2.

Eversheds Sutherland Observation: The big news in the compensation and benefits area is (i) that 401(k) deferrals have not been "Rothified" as was being proposed in the earlier stages of the tax reform process this fall, and (ii) the removal of the changes to deferred compensation in both the House Plan and Senate Plan.

<u>Proposed Taxation of the Insurance Industry</u>:

- The House Plan approved by the Ways and Means Committee on November

9, 2017, excluded a number of provisions applicable to insurance companies that had originally been included and added an 8% surtax on life insurance companies. The Senate Plan's insurance company provisions, including the modification to the insurance company exception to the passive foreign investment company (PFIC) rules, are similar to those in the House Plan approved by the Ways and Means Committee.

- The Senate Plan, however, does not include the 8% surtax but includes (i) a deferred acquisition costs provision that was eliminated from the Ways and Means Markup and (ii) new reporting provisions on stranger-owned life insurance.

- Senator Tim Scott of South Carolina has introduced an amendment to the Senate Plan with respect to life insurance companies (Scott Amendment), which has not yet been incorporated into the Senate Plan. The Scott Amendment would make more changes to the taxation of life insurance companies, which are described in detail in the November 14, 2017, Eversheds Sutherland alert. The November 2, 2017, Eversheds Sutherland alert details the House Plan insurance company provisions.

Proposed Taxation of the Energy Industry:

- The House Plan proposed a reduction in the amount of the production tax credit under section 45 for certain new wind facilities and included possible changes to the requirements for beginning of construction requirement. In addition, the House Plan proposed to reinstate the section 48 investment tax credit for certain non-solar projects that were not included in the 2015 PATH Act extensions and to amend the nuclear production tax credit to allow facilities placed in service after 2020 to qualify for the tax credit and for certain taxpayers to transfer their credits to other persons involved in the project.

- The Senate Plan does not include similar proposed changes. The November 16, 2017, Eversheds Sutherland alert addresses the impacts of the House Plan and Senate Plan on the energy sector.

Proposed Taxation of Multinational Businesses:

- Participation exemption.

  - Like the House Plan, implements a participation exemption system that generally provides for a 100% DRD for the foreign-source portion of dividends received from a foreign corporation by a United States shareholder (generally a 10% owner) that is a corporation. No foreign tax credits would be allowed for any taxes paid or accrued with respect to any dividend that qualifies for the DRD.

    - The Senate Plan does not permit the DRD in respect of dividends received by a United States shareholder from a controlled foreign corporation (CFC) if the dividends are deductible by the CFC in computing its taxes (i.e., hybrid dividends).

  - ***Eversheds Sutherland Observation:*** The significance of the DRD for many multinational taxpayers may be limited by the transition tax imposed on existing earnings and profits (E&P), which will result in previously taxed income that could be distributed without additional US tax, and the proposed tax on global intangible low-taxed income (GILTI), described below.

- As corollary provisions, the Senate Plan would:

  - Reduce the basis in stock of foreign corporations to reflect distributions eligible for the DRD in calculating losses;

  - Permit the DRD in respect of deemed dividend distributions under section 1248 on sales of CFC stock; and

  - Require the recapture of net losses of a foreign branch that is transferred to a foreign corporation — an expansion of existing recapture rules with respect to losses of foreign branches.

- The proposal would impose a one-time transition tax on a United States shareholder with respect to its investments in CFCs and certain other foreign corporations. The tax is generally imposed on the net aggregate amount of the United States shareholder's pro rata shares of the previously untaxed foreign E&P of such CFCs and other foreign corporations. The tax is imposed at an effective rate of 10% to the extent the amount of net E&P does not exceed the amount of the aggregate cash and cash equivalents held by the tested corporations, and 5% for any amounts in excess thereof.

  - The tax is imposed by increasing the subpart F income of CFCs or foreign corporations with positive E&P pools for their last taxable year beginning before January 1, 2018.

  - The effective tax rate is achieved through a DRD on the deemed subpart F inclusion.

  - Foreign tax credits would only be permitted for the portion of foreign income taxes deemed paid or accrued with respect to the portion of the previously untaxed E&P that is subject to tax. In other words, the portion of foreign tax credits corresponding to the blended DRD for the United States shareholder would be disallowed. No section 78 gross-up would apply, and no deduction would be permitted for any foreign taxes for which a foreign tax credit is disallowed.

  - Under the Senate Plan, taxpayers could elect to preserve NOLs and opt out of utilizing such NOLs to offset the transition tax. Rules will be provided to coordinate the interaction of existing NOLs, overall domestic losses and foreign tax credit carryforwards, although the specifics of these rules have not been provided.

- Like the House Plan, the Senate Plan permits taxpayers to spread payment of the tax on deferred income over eight years. However, while the House Plan provides for the payments in equal installments over eight years, the Senate Plan provides for the payment of 8% of the liability in each of the first five years, 15% in the sixth year, 20% in the seventh year, and 25% in the eighth year.

- The Senate Plan has a new anti-inversion provision which requires a US corporation to pay the full 35% rate on the deferred foreign earnings for which a DRD was allowed under the transition tax if the US corporation inverts within 10 years after enactment. No foreign tax credits would be available to offset the tax.

- Rules related to passive and mobile income.
  - The proposal creates a new tax imposed on a US taxpayer's global intangible low-taxed income (GILTI). In effect, the provisions impose a worldwide minimum tax on a US shareholder's pro rata share of earnings of its CFCs.
    - Imposes a 10% tax on a portion of the combined earnings of CFCs in which a taxpayer is a US shareholder, by taxing such income currently in the US, and providing a 50% deduction.
    - For taxable years beginning after December 31, 2025, the deduction is reduced from 50% to 37.5%. However, if cumulative aggregate on-budget federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds certain thresholds, the reduced deduction would be repealed effective for taxable years beginning after December 31, 2025 (i.e., the 37.5% rate would never take effect given its effective date).

- A foreign tax credit is allowed for 80% of the foreign taxes paid related to such income earned by CFCs with positive net GILTI, and as a result the provision generally would not result in a US tax liability if the average foreign tax rate imposed on such income is at least 12.5%. The income subject to the tax is reduced by 10% of the combined depreciable tangible asset basis of the assets held by the CFCs, intended to reflect an ordinary return on such assets.
  - ***Eversheds Sutherland Observation:*** The GILTI provisions in the Senate Plan are in place of the inclusion for "foreign high returns" in the House Plan.

- The proposal also allows a domestic corporation to deduct 37.5% of its foreign-derived intangible income, which is deemed intangible income calculated in a manner similar to GILTI. Foreign-derived intangible income is generally equal to all income earned in the United States in excess of a deemed ordinary return on tangible assets multiplied by the fraction of income earned in the United States that is attributable to property sold to a non-US person for foreign use or to services provided outside the United States. The result of the deduction is an effective tax rate of 12.5% on foreign-derived intangible income from sales of property or services.

  - For taxable years beginning after December 31, 2025, the deduction for foreign-derived intangible income is reduced from 37.5% to 21.875%. However, if cumulative aggregate on-budget federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds certain thresholds, the reduced deduction would be repealed effective for taxable years beginning after December 31, 2025 (i.e., the 21.875% rate would never take effect given its effective date).

- Permits intellectual property (IP) to be distributed to United States shareholders from CFCs without US tax.

  - ***Eversheds Sutherland Observation:*** The reduced rate for foreign-derived intangible income together with the ability to distribute IP to United States shareholders tax-free may incentivize companies to move IP to the United States, although there may be significant non-US tax costs of doing so.

- Expands the ownership attribution rules of section 958(b) to include “downward attribution” from a foreign person to a related person effective for the last taxable year of foreign corporations beginning before January 1, 2018.

  - ***Eversheds Sutherland Observation:*** This provision may cause certain corporations not previously treated as CFCs to be treated as CFCs going forward, resulting in additional reporting obligations and, in certain circumstances, potentially subpart F inclusions by certain United States shareholders.

- Modifies the definition of United States shareholder to include any US person that owns 10% or more of the total value of shares of all classes of stock of a foreign corporation effective for the last taxable year of foreign corporations beginning before January 1, 2018. Currently, a United States shareholder must have a 10% voting interest in the foreign corporation.

  - ***Eversheds Sutherland Observation:*** These changes to section 958(b) and the definition of United States shareholder may result in additional foreign corporations and United States shareholders being subject to the transition tax discussed above.

- Eliminates the so-called "30-Day Rule" pursuant to which a United States shareholder includes any subpart F income in its gross income only if the foreign corporation was a CFC for an uninterrupted period of 30 days or more during its taxable year.

- Makes the related-party look-through rule under section 954(c)(6) permanent.

  - Making the related party-look through rule permanent allows lower-tier CFCs to make distributions to higher-tier CFCs without giving rise to subpart F income. First-tier subsidiaries could then distribute dividends to US corporate shareholders that may be eligible for the 100% DRD described above.

- Amends section 956 to provide an exception from the required inclusions with respect to CFC investments in "United States property," as defined in section 956(c), for domestic corporations that are United States shareholders in a CFC either directly or through a domestic partnership.

  - ***Eversheds Sutherland Observation:*** The Senate Plan appears to retain section 956 in respect of indirect interests in CFCs (other than through a domestic partnership), in contrast to the House Plan which would generally exclude corporate United States shareholders from the scope of section 956.

- <u>Prevention of base erosion</u>.

  - In addition to the general 30% net interest expense limitation discussed above, the proposal would further limit the ability of domestic corporations that are members of multinational groups to deduct net interest expense based on the leverage of the domestic group relative to the multinational enterprise.

    - The interest expense of such US members would be reduced by the product of the total domestic net interest expense multiplied by the debt-to-equity differential percentage of the worldwide affiliated group.

    - The debt-to-equity differential percentage of the worldwide affiliated group means the amount by which the US members' debt exceeds 110% of the total debt those members would have if the US debt to equity ratio were the same as the worldwide affiliated group's debt to equity ratio.

    - Interest disallowed under this provision may be carried forward indefinitely.

- ***Eversheds Sutherland Observation:*** How assets are valued for purposes of determining equity, which is not specified in the Senate Plan, is crucial in determining the impact of this limitation. If tax basis is used, as was the case in the 2014 proposal by former Ways and Means Committee Chairman Dave Camp, many taxpayers could see their US interest expense fully disallowed under this provision.

- If both this limitation and the limitation on interest expense described above apply, then whichever rule allows the lower amount of interest expense to be deducted controls.

– Base erosion minimum tax.

- Generally imposes a 10% minimum tax on a taxpayer's income determined without regard to tax deductions arising from base erosion payments (including the portion of a taxpayer's NOL treated as related to base erosion payments) which cannot be reduced by credits other than the R&D credit.

- For taxable years beginning after December 31, 2023, a 12.5% rate would apply. However, if cumulative aggregate on-budget federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds certain thresholds, the 12.5% rate would be repealed for taxable years beginning after December 31, 2025.

- Base erosion payments are generally amounts paid by a taxpayer to a related foreign person that are deductible to the taxpayer or create depreciable or amortizable asset basis.

- This provision would apply to US corporations (other than regulated investment companies, real estate investment trusts or S corporations), which have average annual gross receipts of at least $500 million for the three preceding taxable years and which have a base erosion percentage (generally, deductible payments for foreign affiliates over total deductions) of 4% or higher for the taxable year.

- ***Eversheds Sutherland Observation:*** The base erosion minimum tax in the Senate Plan differs from the excise tax on payments to foreign affiliates in the House Plan in that the Senate Plan provision is a minimum tax on total income with deductions for certain related-party payments added back, whereas the excise tax applies to all deductible payments to related foreign persons without regard to the net income of the taxpayer.

– The Senate Plan also proposes to codify certain rules that have been the subject of recent litigation and controversy, including:

- Providing that outbound transfers of foreign goodwill or going concern value by a US transfer or would be subject to current tax;

- Permitting the Internal Revenue Service to specify the method used to determine the value of intangible property transferred, effectively reversing the result in *Veritas Software Corp. & Subsidiaries, et al. v. Comm.*, 133 TC 297 (2009); and

- Causing a foreign partner's gain or loss from the sale or exchange of a partnership interest to be treated as effectively connected with a US trade or business to the extent that the transfer or would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange, legislatively overturning the recent decision in *Grecian Magnesite, Industrial & Shipping Co., SA v. Commissioner*, 149 T.C. 3 (2017). See the prior Eversheds Sutherland alert on Grecian Magnesite.

- Denies deductions for interest or royalty paid between related parties where the recipient is not required to include the payment in income, is permitted a deduction with respect to such amount, or the payor is a "hybrid entity."

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