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Legal Alert: How a Framework Becomes a Law: House Republicans Release Tax Reform Bill

November 7, 2017

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On November 2, 2017, Republicans on the House Ways and Means Committee released their much anticipated tax reform bill, titled the Tax Cuts and Jobs Act (as modified by Chairman Brady on November 3 and November 6, the House Plan). The House Plan is far reaching and contemplates significant changes to how the US would tax individuals, domestic businesses and multinational businesses. The House Plan generally adopts the reductions in taxes identified in the Unified Framework released by the so-called "Big Six" on September 27, 2017, but also includes a number of revenue raisers intended to pay for a portion of the cost of the tax reductions. In many cases, the revenue raisers modify or eliminate long-standing tax incentives. See the prior Eversheds Sutherland alert on the Unified Framework.

Eversheds Sutherland Observation: Republicans aim to pass a tax bill by the end of this year. The introduction of the House Plan is a significant step towards that goal. However, it is not final legislation. In the two business days since the introduction, substantial amendments to the House Plan have been introduced, and it is likely to undergo further revision before it is voted on by the full House. In addition, it is expected that the Senate Finance Committee will release its own tax reform bill this week. While the Unified Framework was intended to guide both of the tax-writing committees, the Senate bill likely will differ from the House Plan in some meaningful ways, and these differences will need to be reconciled before legislation can be enacted. Given the extensive changes contemplated by the House Plan, individuals and businesses will need to carefully follow and consider the potential impact of proposed tax reform.

The House Plan is a far-reaching tax reform proposal that incorporates changes to the ways that individuals and domestic and multinational businesses are taxed. The principal proposals are summarized in this alert. See the Eversheds Sutherland Tax Reform Law blog for more information, including the text of the House Plan, the House Ways and Means Committee Summary and the Joint Committee on Taxation Explanation. The blog includes additional in-depth analysis of the provisions discussed below, including a separate alert on the employee benefits and compensation provisions and anticipated alerts on the energy, insurance, accounting methods, and US international provisions of the House Plan, as well as the state and local tax implications.

Proposed Taxation of Individuals:

- Consolidates the current seven tax brackets for individuals into four: 12%, 25%, 35% and 39.6%.
  - While the top tax bracket would remain at 39.6%, it would only apply to adjusted taxable income of more than $1 million for married taxpayers

filing jointly (and $500,000 for other individuals).

- Nearly doubles the standard deduction to $24,400 for married taxpayers filing jointly (and $12,700 for other individuals), while eliminating personal exemptions.

- Eliminates most itemized deductions, including the deductions for state and local income or sales taxes and medical expenses.

  - The mortgage interest deduction would be retained; however, for indebtedness incurred after November 2, 2017, the limitation on the aggregate amount of qualifying indebtedness would be reduced from $1,000,000 to $500,000.

  - Retains the deduction for property taxes, although capped at $10,000 per year.

  - Retains the charitable contributions deduction.

- Eliminates the alternative minimum tax (AMT).

- Doubles the estate tax exemption starting in 2018 and eliminates the estate and generation-skipping transfer tax starting in 2024.

  - Retains the current step-up in tax basis to fair market value for assets owned at death.

<u>Proposed Taxation of Domestic Businesses</u>:

- Reduces the corporate tax rate from 35% to 20%.

  - Personal services corporations would be subject to a 25% corporate tax rate.

- 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.

- Limits use of NOLs.

  - NOLs generally would not be permitted to be carried back (present law allows a two-year carryback); however, NOLs could be carried forward indefinitely and would be increased by an interest factor intended to preserve their value.

- Limits the ability to deduct interest expense.
  - Existing rules limiting the deduction for related party interest expense would be replaced with new rules that limit deductible net interest to 30% of the business's adjusted taxable income (taxable income computed without regard to interest income and expense, NOLs, depreciation, amortization and depletion). For the purpose of calculating net interest, business interest income is offset against business interest expense. Any disallowed interest expense could be carried forward for five years. This provision would not apply to certain regulated public utilities or real property trades or businesses.
  - ***Eversheds Sutherland Observation.*** The Joint Committee explanation of the proposed provision indicates that a US consolidated group will be treated as a single taxpayer for purposes of determining net interest expense and applying the limitations.
  - ***Eversheds Sutherland Observation.*** This is an expansion of the existing interest expense limitation rules, which only covered related party interest expense. In addition, domestic corporations that are part of multinational groups also have to consider the application of an additional interest expense limitation, which generally limits domestic net interest expense to 110% of the domestic business's proportionate share of group interest expense determined based on domestic earnings before interest, taxes, depreciation and amortization (EBITDA) relative to the worldwide EBITDA of the multinational group, as discussed below.
- Permits full expensing for five years.
  - Taxpayers would be permitted to fully and immediately deduct 100% of the cost of qualified property (generally property other than real estate) acquired and placed in service after September 27, 2017, and before January 1, 2023 (with an additional year for certain qualified property with a longer production period).
- 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).
- Creates a maximum 25% tax rate for certain qualified business income of individuals from partnerships, S corporations or sole proprietorships.
  - Qualified business income generally would include all net business income from passive business activities, plus the capital percentage of net business income from active business activities, reduced by certain net business losses for the current year and by carryover business losses. The classification of an activity as either passive or active for this

purpose would be determined under the passive activity loss rules of section 469.

- For any active business activity, a taxpayer generally would be deemed to have a capital percentage of 30%, unless the taxpayer were to elect to use its applicable percentage for such activity, which, for any taxable year, would be calculated by dividing (1) the taxpayer's deemed return on capital from the activity for such year (based, very generally, on the taxpayer's adjusted basis in the activity at the end of the year, multiplied by the short-term applicable federal rate plus 7%), by (2) the taxpayer's net business income from the activity for such year.

  - The special maximum 25% rate generally would <u>not</u> apply to specified service activities, which would include service activities in the fields of medicine, law, engineering, architecture, and other trade or business activities where the primary asset is the reputation or skill of the service providers, such as investing, trading or dealing in securities, partnership interests or commodities. For these activities, the taxpayer's capital percentage generally would be deemed to be zero. However, with respect to any capital-intensive specified service activity, which generally would include any specified service activity for which the taxpayer's applicable percentage (as discussed above) is at least 10%, the taxpayer would be permitted to elect to utilize a capital percentage equal to the taxpayer's applicable percentage for such activity.

- Imposes the unrelated business income tax on certain state and local entities (such as public pension plans) that are otherwise exempt from US federal income tax as government-sponsored entities.

<u>Modifications to Energy Incentives</u>:

- The House Plan would significantly change energy incentives.

  - The amount of the production tax credit under section 45 would be reduced for certain new wind facilities and the requirements for beginning construction may be changed.

  - While the House Plan reinstates the section 48 investment tax credit for certain non-solar projects that were not included in the 2015 PATH Act extensions, it does not reinstate the biodiesel or alternative fuels tax credits.

  - The nuclear production tax credit was amended 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.

Changes to the Taxation of Insurance Companies:

- The House Plan contains a number of provisions that have material tax implications for insurance companies, in addition to the generally applicable changes. These provisions include:
  - A significant modification to the methodology for computing life reserves that incorporates reserve discounting;
  - An increase to loss reserve discounting for property and casualty companies;
  - The repeal of the small life insurance company deduction;
  - The repeal of the life insurer special adjustment period for changes in reserve computation, and, concomitant, application of the general change in accounting method provisions;
  - The repeal of the special NOL carryback/carryforward periods for life insurers and, concomitant, application of the general NOL carryback/carryforward periods;
  - The repeal (with a transition rule) of the special rules applicable to life insurers for pre-1984 policyholder surplus accounts;
  - The repeal of section 847 (originally enacted in connection with the 1986 Code to provide statutory accounting relief for surplus strain that resulted from loss reserve discounting for tax purposes);
  - Modifications to the rules related to the receipt of exempt income by insurance companies;
  - Increasing the amount of policy acquisition expenses that must be capitalized; and
  - Modifying the exception for insurance companies to the passive foreign investment company (PFIC) rules.
- In addition, the 20% excise tax discussed below may have a disproportionate impact on insurance companies.

Proposed Taxation of Multinational Businesses:

- **Shift toward a territorial system.**
  - Implements a participation exemption system that generally provides for a 100% dividends received deduction (DRD) for dividends paid out of

foreign-source earnings of a foreign corporation (other than a PFIC) to a United States shareholder (generally a domestic 10% owner) that is a corporation. The trade-off for the dividend exemption is that no foreign tax credits would be allowed for any taxes paid or accrued with respect to any dividend entitled to the DRD.

- A corresponding change is proposed to eliminate the required inclusions with respect to controlled foreign corporation (CFC) investments in "United States property," as defined in section 956(c), by United States shareholders that are corporations or partnerships with corporate partners.

- The proposal also includes certain provisions targeting potential abuses, including reducing the basis in stock of foreign corporations to reflect distributions in calculating any losses, and requiring the recapture of net losses of a foreign branch that is transferred to a foreign corporation.

– The proposal would impose a one-time transition tax on previously untaxed foreign earnings and profits (E&P) of a CFC or other foreign corporation with respect to which one or more domestic corporations is a United States shareholder at an effective tax rate of 12% for E&P retained in the form of cash and cash equivalents and at an effective tax rate of 5% for other E&P. The tax is imposed by increasing the subpart F income of such corporations.

- 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 (i.e., 85.7% of the foreign tax credits attributable to cash and cash equivalents and 65.7% of the foreign tax credits attributable to other E&P 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.

- United States shareholders would be permitted to elect to pay their net tax liability in equal 12.5% installments over eight years.

- **Retains, but modifies, the subpart F provisions.**

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

- Making the related party look-through rule permanent would permit a lower-tier CFC to make distributions to higher-tier CFCs without resulting in a subpart F inclusion. First-tier CFCs could then distribute dividends to US corporate shareholders that may be eligible for the 100% DRD.

- Expands the ownership attribution rules of section 958(b) to include “downward attribution” from a foreign person to a related US person.
  - This provision may cause certain foreign corporations previously not treated as CFCs to be treated as CFCs going forward.
- 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.
- The proposal also creates a new provision analogous to subpart F income, the “foreign high return amount,” which generally imposes a worldwide minimum tax on the earnings of CFCs.
  - Imposes a 10% tax on a portion of the combined earnings of CFCs in which a taxpayer is a US shareholder, referred to as the “foreign high return amount.”
  - A foreign tax credit is allowed for 80% of the foreign taxes paid related to such income, 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 reference to a percentage of the combined depreciable tangible asset basis of the assets held by the controlled foreign corporations, intended to reflect an ordinary return on such assets.

- **Adopts measures to prevent base erosion.**
  - 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 interest expense based on the leverage of the domestic group relative to the multinational enterprise.
    - The limitation applies if the US group’s share of the global group’s net interest expense exceeds 110% of the US group’s share of the global group’s EBITDA.
  - Imposes a 20% excise tax on the gross amount of payments by US corporations to related foreign corporations if the average aggregate annual amount of such payments for the group exceeds $100 million.
    - This excise tax does not apply if the recipient of the payment elects to treat the payment as effectively connected income that is subject

to current US tax. A foreign corporation that makes the election is only allowed to deduct deemed expenses, in an amount that results in the portion of the payment subject to US tax corresponding to the non-US profit margin for the relevant product line, as determined based on the group's consolidated financial statements. A foreign corporation that makes the election is permitted a credit for foreign taxes deemed paid with respect to the income, equal to half of the average effective tax rate of the foreign members of the worldwide group.

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

- Makes limited changes to the rules applicable to tax-qualified plans.
  - Expands hardship distribution opportunities in 401(k) plans.
  - Reduces the earliest normal retirement date in defined benefit plans to age 59.5.
  - Provides nondiscrimination testing relief for frozen or closed defined benefit plans.
- Eliminates most deferred compensation.
  - Compensation would be taxed when earned unless receipt is subject to a substantial risk of forfeiture (effectively imposes long-standing not-for-profit rules on for-profit entities).
  - Deferred compensation includes stock options and stock appreciation rights, which will be taxed when vested.
  - Existing deferred compensation as of December 31, 2017, would be subject to these new rules effective beginning in 2026, meaning that existing deferred compensation would all become taxable in 2025 unless subject to a substantial risk of forfeiture.
- Expands the section 162(m) $1 million limit on deductible compensation.
  - Applies to any employer with registered securities or that files period reports, meaning that public debt will subject the issuer to these limits.
  - Eliminates the exception for performance-based compensation.
  - The covered employee definition is expanded to again include the principal financial officer. Once an individual is a covered employee, the individual remains a covered employee as long as the individual is

employed by the employer.

- Subjects tax-exempt employers to a new 20% excise tax on payments to their five highest-paid employees in excess of $1 million and certain separation payments if the payments are more than three times average annual compensation.

- Makes certain fringe benefits taxable, including tuition assistance, moving expenses and adoption assistance. Eliminates the employer deduction for certain fringe benefits that are personal in nature, e.g., on-premises gyms.

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