

Client Alert

December 5, 2017

Senate Advances Tax Reform Bill

On December 2, 2017, the Senate passed its version of tax reform legislation (the "Senate Bill"), advancing it to the next stage.

While the House of Representatives passed its version of tax reform (the "House Bill") on November 16, 2017, significant differences exist between the House Bill and the Senate Bill. Like the House Bill, the Senate Bill proposes dramatic changes to existing U.S. income tax law. The differences between the House and Senate bills will need to be worked out in conference.

The following is a brief summary of key provisions of the Senate Bill and a description of how the Senate Bill differs from the provisions that were passed in the House:

Individual Tax¹

- Maintains the number of tax brackets at seven, although the rates and thresholds for some brackets would be decreased. The House Bill, on the other hand, reduces the number of tax brackets from seven to four. While the House Bill maintains the top marginal rate of 39.6%, the Senate Bill would slightly decrease the top rate to 38.5%.
- Like the House Bill, roughly doubles the standard deduction to \$24,000 but eliminates personal exemptions.
- Allows a deduction from gross income to noncorporate taxpayers equal to 23% of the taxpayer's "qualified business income" from domestic sources ("QBI") from a partnership, S corporation or sole proprietorship. The deduction is the lesser of 23% of the taxpayer's QBI or 50 percent of the taxpayer's share of W-2 wages paid by the qualified business that is properly allocable to the QBI. Deduction is not available for specified service businesses (including health, law, engineering, architecture, accounting, athletics and financial services), except for taxpayers with taxable income up to \$500,000 (for taxpayers filing jointly), subject to a full phase out at \$600,000. Deduction allowance is different than the House Bill, which would create a new preferential 25% tax rate for income from a "business activity." This favorable tax treatment also applies to income earned through "qualified publicly traded partnerships."
- Dividends from a real estate investment trust ("REIT") that are currently treated as ordinary income would be includable in qualified business income and therefore count towards the deduction. Under the House approach, the preferential rate for business activity would apply to the REIT ordinary income dividends.

¹ The Senate Bill provides that tax reform provisions applicable to individuals would expire on December 31, 2025. After that date, all affected provisions would revert back to their form under current law.

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- Like the House Bill, repeals the itemized deduction for state and local income taxes and limits deductions for state and local property taxes to \$10,000. Earlier versions of the Senate Bill would have entirely repealed the deduction for all state and local taxes.
- Similar to the House Bill, repeals the so-called "Pease limitation," which generally limits itemized deductions for high-income taxpayers.
- Unlike the House Bill, maintains the current law on the deductibility of interest on home mortgage acquisition indebtedness (the House Bill would lower the amount of acquisition indebtedness with respect to which interest is deductible from \$1 million to \$500,000). Under both the Senate and House Bills, the deduction for interest paid on home equity indebtedness would be eliminated, and the requirements for excluding gains from the sale of a principal residence would be tightened.
- Repeals deductions for any expenses that would currently be subject to the "miscellaneous itemized deduction" 2% floor, including deductions for expenses paid or incurred for the production or collection of income and unreimbursed expenses attributable to the trade or business of being an employee.
- Limits gambling deductions to the extent of gambling winnings. Under current law, gambling losses are limited to gambling winnings, but other expenses connected to gambling (when conducted as a trade or business) are not so limited. The House Bill contains a similar provision.
- Similar to the House Bill, increases the limitation on charitable contributions to 60% of adjusted gross income (up from 50% under current law).
- Increases the exemption from estate and gift taxes from \$5,000,000 to \$10,000,000.
- Preserves the alternative minimum tax ("AMT") but raises the income thresholds to which it applies. Earlier versions of the Senate Bill would have eliminated the AMT, as provided for in the House Bill.

Business Tax

- Similar to the House Bill, the Senate Bill permanently reduces the general corporate tax rate to a flat 20%. However, unlike the House Bill, this 20% rate will not be effective until 2019 (a one-year delay versus the House Bill). Unlike the House Bill, the Senate retains the corporate AMT in its current form.
- While both bills preserve the research and development tax credit, some companies are concerned that the research and development tax credit is undermined by the Senate Bill's preservation of the corporate AMT (as discussed above).²
- The House Bill reduced the current 70% dividends received deduction (the "DRD") to 50% and reduced the current 80% DRD to 65%, effective in 2017. The Senate Bill does the same, but as with the corporate tax rate cuts, such changes would not be effective until 2018.

² See Richard Rubin, "Passage of Senate Tax Bill Puts R&D Tax Credit in Doubt," available at: <https://www.wsj.com/articles/passage-of-senate-tax-bill-puts-r-d-tax-credit-in-doubt-1512328243>.

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- Similar to the House Bill, the Senate Bill would generally increase the first year additional depreciation percentage to 100% for property placed in service after September 27, 2017, and before January 1, 2023. Unlike the House Bill, however, the Senate Bill does not apply this provision to used property.
- Under current law, use of the cash method is limited to corporations whose three-year average annual gross receipts did not exceed \$5,000,000 for any prior year. The House Bill generally increases this threshold to \$25,000,000. Instead, the Senate Bill would generally increase this threshold to \$15,000,000.
- Unlike the House Bill, the Senate Bill includes a provision that could potentially be a back-door mark-to-market provision for certain taxpayers. Section 13221 of the Senate Bill generally requires an accrual method taxpayer to recognize income no later than the taxable year in which such income is taken into account as income on an "applicable financial statement" of the taxpayer (defined to include a GAAP statement or 10-K, among other statements) or other financial statement as the Secretary may specify. The Senate Bill's new rule includes exceptions for (a) any item of gross income in connection with a mortgage servicing contract and (b) certain items of gross income for which the taxpayer uses a special method of accounting. This amendment would be effective for taxable years beginning after December 31, 2017.
- The Senate Bill requires that the cost of any "specified security" (as defined in existing Code section 6045(g)(3)(B)) sold, exchanged or otherwise disposed of after January 1, 2018 be determined on a first-in first-out basis, except to the extent the average basis method (as described in the Code) is allowed. The definition of "specified security" includes any share of stock of a corporation (including stock of a RIC), any note, bond, debenture, or other evidence of indebtedness; and certain other securities as to which the Treasury Secretary determines adjustment basis Form 1099-B reporting is appropriate. The House Bill did not include a similar provision.
- Similar to the House Bill, the Senate Bill restricts business interest expense deductions by providing that no business, regardless of form, may deduct interest expense in excess of 30% of such business's adjusted taxable income (that is, taxable income allocable to the trade or business without regard to the interest deduction, loss carryovers, and certain other items). Under the House Bill, interest deductions by businesses whose 3-year average annual gross receipts for the immediately preceding year did not exceed \$25,000,000 would not be subject to this limitation; the Senate Bill expanded the scope of the disallowance by lowering the exception to a \$15,000,000 average gross receipts ceiling. Similar to the House Bill, this provision also would not apply to real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trades or businesses. This portion of both bills would be effective beginning in 2018 with no grandfather provision for existing debt.
- Similar to the House Bill, the Senate Bill generally modifies the rules for carrying back net operating losses ("NOLs") for corporations by eliminating the existing general two-year carryback and permitting an unlimited NOL carryforward period (rather than the current maximum of 20 years). In addition, the unused NOL carryforwards would be adjusted. Under both bills, not more than 90% of the taxpayer's current year's taxable income can be offset by otherwise available NOL carryovers. In a departure from the

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House Bill, the Senate Bill would limit the NOL deduction to 80% of taxable income in years beginning after December 31, 2023.

- The House Bill limits like-kind exchange non-recognition treatment to the exchange of real property only. The Senate Bill would also generally limit like-kind exchange non-recognition treatment to exchanges of real property but would further exclude any exchanges of real property held primarily for sale.
- Provisions specifically related to tax credits for the renewable energy industry that were included in the House Bill (such as a reduction in the amount of the “production tax credit” and a provision relating to the commencement of construction), and that were widely perceived as adverse to the renewable energy industry and to wind energy in particular, have not been included in the Senate Bill. However, the calculation of the additional tax on base-eroding payments (described below) has the potential to reduce the value of production tax credits (PTCs) and investment tax credits (ITCs) derived by certain multinational taxpayers investing in eligible projects.
- Similar to the House Bill, the Senate Bill limits the deductions for FDIC assessments for insured depository institutions that have consolidated assets of more than \$10,000,000.
- The House Bill would generally require contributions to the capital of any entity to be included in such entity's gross income unless exchanged for stock or equity of such entity. The Senate Bill does not have a similar provision.
- The Senate Bill imposes a three-year holding period requirement for partnership interests received in connection with the performance of services to be eligible for long-term capital gain. The House Bill contains a similar provision.

International Tax

Territorial Taxation of U.S. Corporations

- Similar to the House Bill, the Senate Bill generally moves toward territorial taxation of U.S. corporations, primarily by allowing U.S. corporations to deduct the foreign-source portion of any dividends received from a foreign corporation (other than from a passive foreign investment company (“PFIC”) that is not a controlled foreign corporation (“CFC”)) in which the U.S. corporate stockholder owns at least a 10% interest (an “exempt dividend”). The deduction would not be available for “hybrid dividends.”
- Prohibits foreign tax credits and deductions for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend and ignores deductions for expenses properly allocable to an exempt dividend (or stock that gives rise to exempt dividends) for purposes of determining the U.S. corporate shareholder's foreign-source income.
- Makes other conforming changes to integrate this “participation exemption” into the existing tax rules. For example, the current Subpart F rules relating to CFC investments in U.S. property (Section 956) would no longer apply in the case of a U.S. corporate shareholder. In addition, on the disposition of shares in a

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10% owned foreign corporation, basis adjustments would prevent a taxpayer from realizing a loss that corresponded to exempt dividends previously received from that corporation.

- The participation exemption would be effective for dividends paid after December 31, 2017. Certain holding period requirements apply.

One-Time Repatriation Tax

- Similar to the House Bill, the Senate Bill imposes a one-time transition tax on all deferred post-1986 foreign earnings, to facilitate the transition to a territorial regime.
- Requires each U.S. shareholder owning at least 10% of most foreign corporations (other than PFICs that are not CFCs and other non-CFCs having no 10% U.S. corporate shareholder) to include as Subpart F income the shareholder's proportionate share of the foreign corporation's net post-1986 earnings not previously subjected to U.S. tax (the "income inclusion").
- Inclusion is determined as of November 9, 2017, or December 31, 2017 (whichever results in a greater amount), and applies for the foreign corporation's last taxable year beginning before 2018.
- Income inclusion applies to *all* 10% or more U.S. shareholders, not only U.S. shareholders that are corporations that will be entitled to the participation exemption.
- Applies a modified participation exemption to the deemed repatriation in order to effect a reduced tax rate. The deduction is 58.6% with respect to offshore business earnings held as cash and cash equivalents and 78.6% for offshore business earnings held as noncash assets. For domestic corporations with a marginal tax rate of 35%, the deduction results in a reduced tax rate of 14.5% for cash and cash equivalents and 7.5% for noncash assets. Tax would be payable over up to eight years at the taxpayer's election. Foreign tax credit carryforwards would be fully available, and foreign tax credits triggered by the deemed repatriation would be partially available, to offset the U.S. tax.³
- Any U.S. shareholder that becomes an expatriated entity ("inverts") within 10 years of the enactment date of the Senate Bill will be denied any deductions claimed with respect to the deemed repatriation and the reduced tax rates applicable to the income inclusion will be retroactively increased to 35%. The additional tax is assessed in the year in which the shareholder inverts but is calculated by reference to the year of the income inclusion.

Anti-Base Erosion Measures

- *Tax on base-eroding payments.* Taxpayers would be subject to a tax equal to the excess of 10% of taxable income modified to include otherwise-deductible amounts that erode the tax base over regular tax liability. For purposes of the calculation, the "regular tax liability" is reduced by allowable credits other than the research credit, so that the amount of the tax is increased by such allowable credits.

³ The Senate Bill provides that a REIT's income inclusion by reason of having a foreign taxable REIT subsidiary is not taken into account for purposes of the REIT's gross income tests, and the REIT may elect to include the income over 8 years.

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Base-eroding deductions include deductions for certain payments between the taxpayer and related foreign persons, depreciation (or amortization) on depreciable (or amortizable) property acquired from a related foreign person and a certain percentage of net operating losses. Only a taxpayer that, for the taxable year, is a corporation other than a RIC, REIT or S corporation has average annual gross receipts of at least \$500,000,000 and derives at least 4% of its deductions from base-eroding related-party payments is subject to the tax. Taxpayers that are banks or registered securities dealers would be subject to a higher tax. For tax years beginning after December 31, 2025, the tax would be equal to the excess of 12.5% of modified taxable income over regular tax liability (reduced by allowable credits other than the research credit).

- *No deduction for related-party payments in hybrid transactions.* No deduction would be allowed for certain related-party payments made pursuant to hybrid transactions or by or to a hybrid entity. Interest and royalty payments for which there is no corresponding inclusion by the recipient where the recipient is tax resident or for which the recipient may deduct the amount received are subject to this provision. In order for the provision to apply, there must be a mismatch between the law in the United States and the law in the relevant foreign country regarding the character of the payment or the fiscal transparency of either the payor or the recipient.
- *Limitation on U.S. interest deduction.* Similar to the House Bill, where a U.S. corporation is a member of a "worldwide affiliated group" (which is a group that would be an affiliated group under Section 1504, except that the ownership threshold is more than a 50% interest and foreign entities are included), the Senate Bill limits the U.S. corporation's deduction for net interest expense to the extent that the U.S. members' indebtedness exceeds a certain percentage of the amount of indebtedness that would equalize the U.S. members' debt-to-equity ratio and the worldwide affiliated group's debt-to-equity ratio. The percentage used to determine excess indebtedness is phased-in (from 130% for tax years beginning on or after 2018 to 110% for tax years beginning on or after 2022). Disallowed interest expense may be carried forward indefinitely.

Rules Relating to Income from Intangibles

- *Tax on global intangible low-taxed income.* Similar to the House Bill, a "United States shareholder" of a CFC would include in income currently its global intangible low-taxed income ("GILTI"), which is the excess of the shareholder's pro rata share of the CFC's net income over a routine return on specified tangible property used in a trade or business (the average of the aggregate adjusted basis in such property times 10%). GILTI would be effectively taxed at a 10% rate for tax years beginning prior to December 31, 2025, and at a 12.5% rate for tax years beginning after December 31, 2025. Income effectively connected with a U.S. trade or business, Subpart F income and certain other specified items of income are excluded from net income subject to this provision, and relevant foreign tax credits are allowed on a limited basis.⁴

⁴ Similar to the House Bill, the Senate Bill makes narrowly focused changes to the Subpart F rules to bring more taxpayers within their scope and to modify the scope of passive income subject to these rules.

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- *Deduction for foreign-derived intangible income.* For tax years beginning after December 31, 2017, a domestic corporation would be able to deduct 37.5% of its income that is deemed to be both from intangible property (income that exceeds a routine return on certain tangible property) and foreign-derived (income derived in connection with either property that is sold to a foreign person for a foreign use or services provided to a foreign person or with respect to foreign property). Certain transactions with domestic intermediaries or related foreign parties generally are not treated as foreign-derived. For tax years beginning after December 31, 2025, the deduction would be decreased to 21.875% of income that is deemed to be from intangible property and foreign-derived.
- *Distributions of intangible property to United States shareholders.* In certain cases, intangible property distributed by a CFC to a “United States shareholder” would be treated as having a fair market value not exceeding the adjusted basis immediately before the distribution. If the distribution is not treated as a dividend, the adjusted basis of the property immediately after the distribution would be reduced by any increase to the adjusted basis of the stock with respect to which the distribution was made. The provision would apply to distributions made during the taxpayer's first three taxable years beginning after December 31, 2017.

The wide-ranging and, in some respects, unexpected nature of the proposed tax changes make it difficult to predict the overall impact of the changes, even in the event the changes were enacted into law as currently reflected in the Senate Bill. In particular, Chairman Brady has already indicated that the base erosion measures are up for discussion. Therefore, many aspects of the proposal described above could change materially before any legislation is enacted. We will continue to monitor the latest developments in this area.

The Bill also includes numerous other proposed changes that will be discussed in a separate Client Alert, such as proposed changes to the tax rules governing employee compensation.

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