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Legal Update
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The 2017 Proposed Federal Tax Legislation: A First Look.

After months of uncertain progress, tax reform has dramatically accelerated in the past few weeks. On November 2, U.S. House of Representatives Ways and Means Chairman Kevin Brady released the initial draft legislation as well as a section by section description. According to the House timeline, the Ways & Means Committee will consider the legislation next week, and the House is expected to vote during the week of November 13.

While the Senate has not set a specific schedule, Senate Republicans would like to proceed quickly with the goal of getting the legislation to the President for signature by the end of the year.

Consideration of the legislation will be a contentious process. There are several opportunities for the bill to be revised, stalled, or possibly derailed. The bill contains several dramatic changes to corporate taxation, highlighted below. However, Congressional Republicans are highly motivated to succeed on tax reform and many consider success on tax reform as essential to maintaining the Republican majority in the House.

A key component of the coming debate will be the Joint Committee on Taxation's (JCT) analyses of revenue and distributional effects. JCT's initial analysis was released yesterday. This analysis shows that under static scoring the legislation loses $1.49 trillion over the ten-year budget window, which is just under the $1.5 trillion revenue loss permitted under the fast track/budget reconciliation process being used. However, in order to remain eligible for the budget reconciliation process and avoid being subject to a Senate filibuster, the legislation cannot lose revenue outside the ten-year budget window. Thus, the larger the revenue loss, the less tax relief that can be made permanent.

On November 3, the Chairman's mark eliminated from the proposed legisation the provision that would have denied treaty benefits for certain deductible payments made to foreign affiliates.

Tax Changes for Businesses

Corporate Tax Rate Reduction: The income tax rate for corporations would be reduced from 35% to a flat 20% beginning in 2018. Personal service corporations would be subject to a flat 25% rate.

25% Tax Rate on Passthrough "Business Income": Effective for tax years beginning after 2017, owners of passthrough entities (e.g., partnerships and S corporations) would be taxed at a 25% rate with respect to their "business income." The 25% rate would not apply to passthrough income from the performance of services, which would remain taxable to the owners as compensation at the ordinary individual tax rates.

Net income from a passive business activity would be treated entirely as business income eligible for the 25% rate. For active businesses, the rules require an allocation between business income and services income. A safe harbor would allow small businesses to classify 30% of

the passthrough income as business income and 70% as wages income. Alternatively, the owners of capital-intensive businesses may elect to apply a "capital percentage" formula in order to have a larger portion treated as business income subject to the preferential 25% rate.

Immediate Expensing of Capital Expenditures: An immediate deduction would be allowed for 100% of the cost of capital expenditures for property placed in service after September 27, 2017 and before January 1, 2023 (2024 for certain qualified property with a longer production period). Thereafter, recovery of capital expenditures would revert to the MACRS cost recovery system as currently in effect. A taxpayer would be entitled to immediate expensing if it is the taxpayer's first use of the property. This benefit does not apply to property used by a regulated public utility company or used in a real property trade or business.

Limitations on Interest Expense Deduction: The legislation would introduce a new cap on the deductibility of interest expense. The limitation would be effective for tax years beginning after 2017, with no grandfathering for preexisting debt.

Specifically, the legislation would revamp Section 163(j) which caps the deduction for net interest expense. Under the proposal, net interest expense (notably, both to related and unrelated parties) would be disallowed to the extent it exceeds 30% of adjusted taxable income, an amount similar to EBITDA. Any disallowed amounts may be carried forward for five years.

In the case of partnerships and S corporations, the disallowance would be determined at the partnership (rather than partner) level. This rule would not apply to "small businesses" (taxpayers with average annual gross receipts of $25 million or less), certain regulated public utilities and certain real property trades or business.

The proposal creates an additional limitation on interest expense deductions for U.S. corporations that are members of "international financial reporting groups" (*i.e.,* groups with international operations or subsidiaries with average annual consolidated gross receipts in excess of $100 million). Those U.S. corporations may only deduct interest expense up to 110 percent of the corporation's share of the group's global EBITDA. This limitation would operate in conjunction with the limitation in revamped section 163(j) (discussed above), applying only when it disallows greater interest expense deductions than that provision.

Limitation on Deductibility of Net Operating Losses ("NOLs"): Beginning in 2018, taxpayers would only be able to use NOLs to offset up to 90% of their taxable income. The bill would also generally eliminate all carrybacks of NOLs arising in 2018 and thereafter. The amount of NOL carryforwards, in turn, would be increased by an interest factor to account for time value of money. Note that the reduction to the corporate income tax rate would likely result in an impairment in the value of pre-2018 NOLs for financial accounting purposes.

Repeal of Corporate Alternative Minimum Tax ("AMT"): The corporate AMT would be repealed. Taxpayers would be entitled to claim a refund of 50% of their remaining AMT credits for each year from 2019 to 2021, and could claim any remaining credits in 2022.

Repeal of Domestic Production Deduction: The Section 199 domestic production deduction would be repealed for tax years beginning after December 31, 2017.

Insurance Provisions: The legislation makes a number of changes that impact the calculation of loss reserves and proration for life, property and casualty insurers (e.g., ability to account for an adjustment in reserves over a ten year period is repealed and insurers would account for the changes in the year in which they were made).

Like-Kind Exchanges Limited to Real Property: Beginning in 2018, tax-free "like-kind exchanges" would only apply to real

property. A transitional rule would apply for non-real property like-kind exchanges that begin in 2017, but are not completed until 2018.

Changes to Compensation Rules: The proposal would repeal Section 409A and, as a result, compensation deferred under a nonqualified deferred compensation plan would be included in income by the employee upon vesting.

The proposal would also eliminate full deductibility for "performance-based" compensation paid to top executives of public companies. Thus, the deduction for those performance-based payments would become subject to the $1,000,000 cap generally applicable to compensation paid to those top executives.

International Tax Proposals

Transition to a Territorial System: The Participation Exemption: Effective as of calendar year 2018, the U.S. would shift to a territorial system of taxation with respect to the earnings of foreign subsidiary corporations. Similar to the "participation exemption" found in many European countries, dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the stock of the distributing corporation would be effectively exempt from U.S. tax (through a 100% dividend-received deduction).

No direct or indirect foreign tax credits would be allowed with respect to the exempt dividends (unless the subsidiary's income was currently taxable in the U.S. as Subpart F income).

It is possible that this participation exemption may also apply to gains from the sale of stock of foreign subsidiaries to the extent such gain is recharacterized as a dividend under existing U.S. tax rules.

Notwithstanding the above, U.S. corporations would still be subject to tax on any foreign income earned through a branch or disregarded entity.

Consistent with the shift to a territorial system, the legislation would make a number of other changes. For example, the Section 956 "deemed dividend" rules would be repealed for U.S. corporate shareholders so that there is no U.S. tax imposed on earnings of a controlled foreign corporation ("CFC") that are invested in U.S. property (e.g., when a CFC holds a debt obligation of its U.S. shareholder).

Deemed repatriation tax or "toll charge": As part of the transition to a participation exemption regime, a one-time tax would be imposed on the untaxed earnings of foreign subsidiaries. This "deemed repatriation" tax would apply to U.S. corporations that own 10% or more of the stock of a foreign subsidiary.

Specifically, the U.S. shareholder would be required to include in income its *pro rata* share of the foreign subsidiary's post-1986 non-previously taxed earnings. The earnings of the foreign subsidiaries are measured as of November 2, 2017 or December 31, 2017, whichever amount is greater.

This one-time tax would be imposed at reduced rates:

- A 12% rate would apply to the foreign earnings attributable to the U.S. shareholder's "aggregate foreign cash position" as of November 2, 2017 (generally, an average of the U.S. shareholder's *pro rata* share of cash and cash equivalents held by its foreign subsidiaries in the three preceding years). Certain cash positions would be disregarded to the extent they could not be distributed by reason of currency or other foreign law restrictions.
- A 5% rate would apply to the remainder of the earnings (i.e., earnings that are treated as reinvested in illiquid assets).

The rules would allow U.S. shareholders to offset the earnings of their foreign subsidiaries with

accumulated deficits of other foreign subsidiaries they owned as of November 2, 2017.

This one-time income inclusion would entitle the U.S. shareholders to a foreign tax credit for the attributable portion of the foreign subsidiaries' foreign tax pools. This foreign tax credit would be subject to a "haircut" given the reduced rate at which the foreign earnings are taxed in the U.S. An extended 20-year carryover period would be allowed for foreign tax credits resulting from this deemed repatriation.

Although the one-time inclusion would occur in the U.S. shareholder's last tax year beginning before January 1, 2018, the taxpayer may elect to pay the resulting U.S. tax liability in up to eight equal annual installments. This installment payment election would be made by the due date for filing the return for the tax year of the inclusion.

Anti- Base Erosion "Foreign High Return" Regime: In an effort to curtail erosion of the U.S. tax base, the proposal would provide for current taxation of "foreign high returns." These rules are expected to affect mainly U.S. multinationals earning significant income from intellectual property in low-tax jurisdictions.

U.S. shareholders would be required to include in income 50% of their *pro rata* share of their CFCs' foreign high return amount (given the 50% inclusion, foreign high returns are effectively taxed at a reduced 10% rate). Similar to Subpart F income, foreign high returns would be taxed on a current basis, regardless of whether the earnings are distributed to the U.S.

The foreign high return amount is the excess of (1) the U.S. shareholder's aggregate net income from its CFCs, *over* (2) a "routine return" amount, determined by applying a specified rate (7% plus the short-term applicable federal rate) to the aggregate adjusted bases in the CFCs' depreciable *tangible* property minus the interest expense allocable to the CFCs. Earnings otherwise subject to U.S. taxation (e.g., effectively connected U.S. income, Subpart F income) would be excluded from this calculation.

Income inclusions of foreign high returns would carry foreign tax credits. In this case, however, the foreign tax credit would be limited to 80% of the otherwise allowable amount, may only be used to offset "foreign high returns" income and cannot be carried back or forward to other tax years.

Other Subpart F modifications: The proposal would incorporate a number of modifications to the Subpart F regime. Foreign base company oil related income would no longer constitute Subpart F income subject to current U.S. taxation. In addition, the "look-through" exemption for dividends, interest, rents and royalties received from related CFCs would be made permanent (this look-through exemption is currently scheduled to expire after 2019).

Sourcing of inventory sales: The proposal would no longer treat as foreign source income up to 50% of the income from the sale of inventory produced within the United States and sold abroad (or vice versa). Instead, such income would be sourced solely based on the location of the production activity.

Excise tax on non-interest payments to foreign affiliates: The legislation imposes a 20% surtax on non-interest payments from domestic corporations to foreign affiliates. This surtax would cover payments that would be deductible, includable in cost of goods sold, or includable in inventory or the basis of a depreciable or amortizable asset. Thus, payments for both tangible and intangible property would be subject to the tax.

The surtax does not apply if the foreign payee agrees to pay US net income tax on those payments, treating them as effectively connected income (ECI). In that case, the taxable net income of the foreign payee would be determined based on the profit margins reported

on the group's financial statements for the relevant product line.

The surtax would also not apply to payments subject to full 30% percent U.S. withholding tax. In addition, the surtax does not apply to payments for intercompany services charged at cost (i.e., with no mark-up) or to payments in certain commodities transactions.

The surtax would only apply to the extent the U.S. corporations of a group make payments covered by the tax that total at least $100 million on an annual basis, based on the past three-year average.

The excise tax would apply to amounts paid or accrued after December 31, 2018.

Tax Changes for Individuals

New Tax Rate Brackets: The current seven income tax brackets would be reduced to four: 12%, 25%, 35% and 39.6%. For married taxpayers filing jointly, the 25% bracket threshold is $90,000, the 35% bracket threshold is $260,000, and the 39.6% bracket threshold is $1 million. The thresholds for single filers would generally be one-half of those stated above. The 12% bracket would phase-out for high income taxpayers. The new brackets would be effective for tax years beginning after 2017.

Increased Standard Deduction and Repeal of Personal Exemption: The standard deduction would be increased to $24,400 for joint filers and surviving spouses and to $12,200 for individual filers. Single filers with a qualifying child could claim a standard deduction of $18,300. These amounts would be adjusted for inflation and are effective for tax years beginning after 2017.

The deduction for personal exemptions and the personal exemption phase-out would be repealed effective for tax years beginning after 2017.

Mortgage Interest Deduction: For debt incurred after November 2, 2017, the deduction for mortgage interest would be limited to the interest on acquisition indebtedness of not more than $500,000 on the taxpayer's principal residence only. Contrast this with current law, which permits the deduction of mortgage interest on up to $1 million in acquisition indebtedness for a principal residence and one other residence, as well as interest on up to $100,000 of home equity indebtedness.

No Deduction for State Income Taxes: For tax years beginning after 2017, individuals would not be allowed to deduct state and local income taxes or sales taxes not paid or incurred in carrying on a business or producing income. Real property taxes remain deductible up to $10,000 per year.

Repeal of Individual AMT: The AMT would be eliminated for individuals.

Repeal of Estate Tax: The proposal would phase-out the estate and generation-skipping transfer taxes and repeal them after six years. The step-up in basis at death would be retained.

What to Expect

The legislation will continue to evolve over the next few weeks. Some changes are to be expected as the legislation moves through the process of debate and amendment in the House and Senate. However, given the speed at which Congress intends to move, taxpayers need to make their concerns known to Congressional policy makers immediately.

As noted above, the legislation is being considered under fast track or budget reconciliation rules. These rules allow the legislation to avoid filibuster in the Senate, but also subject the legislation to strict budget constraints. Most relevant is the constraint that legislation is not eligible for the fast track process if it adds to the deficit beyond the ten-year budget window. Thus, the Senate may need to find additional offsets and/or sunset some of the tax relief.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Jason S. Bazar
+1 212 506 2323
jbazar@mayerbrown.com

Lewis J. Greenwald
+1 212 506 2437
lgreenwald@mayerbrown.com

Brian W. Kittle
+1 212 506 2187
bkittle@mayerbrown.com

Kenneth Klein
+1 202 263 3377
kklein@mayerbrown.com

William G. McGarrity
+1 312 701 8928
wmcgarrity@mayerbrown.com

Edward C. Osterberg Jr.
+1 713 238 2666
eosterberg@mayerbrown.com

Warren S. Payne
+1 202 263 3831
wpayne@mayerbrown.com

Lucas Giardelli
+1 212 506 2238
lgiardelli@mayerbrown.com

Oren P. Margulies
+1 202 263 3368
omargulies@mayerbrown.com

Brendan J. Sponheimer
+1 212 506 2489
bsponheimer@mayerbrown.com

Gary B. Wilcox
+1 202 263 3399
gwilcox@mayerbrown.com

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