Client Update
Tax Reform Frame Released – Picture Missing

On September 27, 2017, the Administration and leaders of the Congressional tax-writing committees released a "unified framework" for tax reform legislation. The framework upends many fundamental and long-standing principles of the U.S. income tax system (*e.g.*, **by eliminating most itemized deductions, limiting the deductibility of business interest expense and changing the taxation of foreign earnings**).

The framework drops the **border adjustment tax**, a controversial provision of the "Blueprint" policy paper issued by House Republicans in June 2016, which would have exempted export income from tax but denied a deduction for the costs of imported goods and services.

Many of the framework's provisions are still vague, and some of the provisions are likely to meet resistance from Congressional Democrats. Any actual legislation will undoubtedly be different from the framework in many respects and will likely include extensive transition rules. The vagueness of the framework on key points and its unclear fate in Congress will add uncertainty to the deal-making environment.

INDIVIDUALS

- The top **individual rate** on ordinary income will be **35%** instead of 39.6%. However, the framework invites Congress to add a yet-unspecified **super rate** to apply to the highest earners to ensure that the reformed code "is at least as progressive as the existing tax code." The **individual alternative minimum tax** will be repealed. There is no indication of the income level at which the super rate will apply.
- There is no mention of a special reduced rate on **capital gains and interest income**. The Blueprint had called for a maximum 16.5% rate on capital gains, interest and dividends. The framework states that Congress may consider new measures to reduce the double taxation of corporate earnings. This could lead to a special reduced rate on **dividend income** (which is currently taxed at 20% plus a Medicare tax of 3.8%).

- There is no mention of repealing the beneficial treatment of **carried interest**, which allows long-term capital gains to flow through to fund principals.

  Comment: Given the possibility of a super rate applying to top earners, the fate of the carried interest benefit will take on added importance.

  Comment: The reservation of a super rate is likely intended to attract Democratic support for tax reform legislation.

- All itemized deductions will be eliminated other than those for mortgage interest and charitable donations.

  Comment: The elimination of the deduction for state and local income and property taxes will disproportionately affect taxpayers living in jurisdictions with high state and local tax rates (*e.g.*, New York, New Jersey, Connecticut and California). Taxpayers will effectively pay federal tax on state and local tax.

- The **estate tax** will be **eliminated.** The fate of the gift tax and the basis step-up upon death is unclear.

BUSINESSES

- The top corporate tax rate will be 20%. The corporate alternative minimum tax will be repealed.

- Business income earned by **small and family-owned businesses** through proprietorships or pass-through entities (partnerships, LLCs and S corporations) will be taxed at a maximum rate of **25%**. There is no discussion of what constitutes a small or family-owned business.

  Comment: Provisions are to be introduced to forestall the transformation of personal income into business income to "prevent wealthy individuals from avoiding the top personal tax rate." Secretary Mnuchin has previously stated that firms providing personal services such as law and accounting services will not benefit from the 25% rate.

- All **new business investment** in depreciable property (not including structures) will be **expensed** (written off entirely in the year of acquisition). This favorable provision is to stay in place for **at least five years**.

  Comment: The expensing provision applies to "new" business investment. It is unclear if expensing will be confined to property that will first be placed in service by the taxpayer or will extend to used property purchased by the taxpayer. Accordingly, it is unclear whether M&A purchasers of existing businesses will be entitled to expense purchased depreciable assets. If expensing extends to used property, sellers of unincorporated businesses (including private equity firms holding businesses in transparent form) will be incentivized to sell before the expensing provision sunsets, so that they can share in the tax benefit to buyers.

- In the case of a C corporation, the deduction for **net interest expense** will be **partially limited**. The framework leaves to Congress whether to extend the partial limitation to non-corporate taxpayers. There is no specific description of the limitation, and there is no mention of special rules for financial services companies such as banks, insurance companies and leasing companies.

  Comment: The disallowance of interest expense might encourage alternative forms of financing such as leasing if rental expense is deductible. However, leased property cannot be expensed (in contrast to purchased property).

  Comment: If non-corporate taxpayers are entitled to deduct interest expense without limitation, then purchasers of businesses such as private equity funds should seriously consider effecting purchases through transparent (*i.e.*, non-corporate) vehicles; interest expense flowing through to individual investors will remain deductible under the framework because business interest expense is not an itemized deduction. (Of course, funds will have to consider the other tax issues arising from investments in transparent deals for their foreign and tax-exempt investors.)

- The framework calls for the repeal of most business credits, other than the credit for **research and development** and **low-income housing**.

- The framework includes a **catch-all** that invites Congress to modernize special tax regimes that apply to certain industries and sectors. The framework states the goal of these changes will be to ensure that the tax code better reflects economic reality and reduces the opportunity for tax avoidance.

  Comment The tax rate reductions in the framework will create a strong incentive for Congress to seek new sources of revenue to offset the cost of the reductions. The catch-all gives Congress cover to revisit longstanding industry-specific rules.

- Prospectively, the United States will adopt a "**territorial system**," under which it will **exempt** dividends received by a U.S. corporation from a 10% or greater foreign subsidiary. This is a significant change to the taxation of U.S. companies with foreign activities. However, the effect of this change may be undercut by a new global tax on foreign profits (discussed below).

  Comment: The framework does not address the fate of the existing **controlled foreign corporation** and **passive foreign investment company** anti-deferral regimes. It also does not discuss whether foreign **branch income** of a U.S. corporation will also be exempt from U.S. tax.

- To transition to the new territorial system, there will be a **one-time tax** on all **existing foreign earnings**. Foreign earnings held in illiquid assets will be taxed at a lower rate, and payment of the ensuing tax liability will be spread over several years.

Comment: The framework does not specify the rates for the one-time tax (or whether there will be rules to prevent taxpayers from restructuring to take advantage of the lower rate on illiquid assets). Given that there are approximately $2.6 trillion of existing unrepatriated earnings, a one-time tax at a blended rate of only 5% would raise $130 billion.

- To stop U.S. companies from shifting profits to low-tax jurisdictions, foreign profits of U.S. global multinational corporations will be **taxed on a global basis** at an unspecified "reduced rate."

Comment: Absent the special tax, U.S. multinationals would have an incentive to transfer operations (and jobs) to low-tax countries, particularly if profits could then be repatriated without U.S. tax. The framework, however, omits specifics, including whether the special tax rate is intended to penalize U.S. companies for earning profits offshore, to reduce but not eliminate the benefits of earning profits offshore, or to achieve neutrality, or whether foreign taxes paid on global income will be creditable. The special tax effectively constitutes a "worldwide" tax system at a "reduced" rate, undoing many of the beneficial effects of adopting a "territorial non-U.S. system."

Comment: If the special tax applies to unrepatriated foreign profits, the new system could be viewed as less advantageous than the current system.

There are no effective dates for the proposed reform provisions other than the September 27, 2017 effective date for expensing new capital investment.

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Please do not hesitate to contact us with any questions.

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