Client Update
House Releases Sweeping Tax Reform Legislation

On November 2, 2017, the House Committee on Ways and Means released the legislative language of its long-awaited tax reform proposal, H.R. 1, the “Tax Cuts and Jobs Act” (the “Bill”). As previewed in the “unified framework” for tax reform legislation released in September, the Bill 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 Bill contains provisions not previewed in the framework, including changes to the taxation of insurance companies and radical changes to the taxation of deferred compensation. Although the Bill does not contain the **border adjustment tax** (a controversial proposal to exempt export income from tax but deny a deduction for the costs of imported goods and services), the Bill contains broad “base erosion” provisions aimed at effectively eliminating the tax deductibility of cross-border payments (other than interest) from U.S. companies to related foreign parties.

The Bill is just the beginning of what is likely to be a complex legislative process. The Bill will no doubt encounter lobbying efforts from affected industries and advocates. In particular, the elimination of the deduction for state and local income taxes has met with opposition from both Democrats and “Blue State” Republicans. Also, some of the international provisions may provoke foreign industrialized countries into enacting retaliatory legislation targeting U.S. multinationals. It remains to be seen if the forthcoming Senate bill will differ from the Bill in material respects, and the unclear path forward for the Bill in Congress will add uncertainty to the deal-making environment.

Unless otherwise indicated, all changes are effective for tax years beginning after December 31, 2017.

INDIVIDUALS

- The seven current individual income tax brackets will be replaced with four brackets, with rates set at 12%, 25%, 35% and with the top individual rate remaining at 39.6%. The 39.6%

rate will apply to taxable income over $1 million for joint filers ($500,000 for any other individual).

- The **individual alternative minimum tax** will be repealed. The Bill includes rules allowing taxpayers with AMT credit carryforwards to claim refunds of those credits beginning in 2019.
- There will be no changes to current rates for **capital gains and interest income**.
- The beneficial treatment of **carried interest** is retained, which allows long-term capital gains to flow through to fund principals.
- Most itemized deductions will be eliminated. The **standard deduction** will almost double, and personal exemptions will be repealed.
- The only **state and local taxes** (other than those incurred in a trade or business) that will be deductible are property taxes. The deduction for property taxes will be capped at $10,000. The limit on loan size for the **mortgage interest deduction** will be lowered from $1 million to $500,000 for houses financed after November 2, 2017. Charitable donations will remain deductible.

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

- The exclusion from **estate tax** will be doubled to $10 million. The estate tax will be **eliminated** after 2023. The top rate for **gift tax** will be reduced from 40% to 35% for gifts made after 2023. The basis step-up upon death will remain.

BUSINESSES

- The top corporate tax rate will be **20%**. The corporate alternative minimum tax will be repealed.
- **Passive business income** and a portion of **active business income** earned by proprietorships or through pass-through entities (partnerships, LLCs and S corporations) will be taxed at a maximum rate of **25%.** The Bill generally presumes that 30% of active income is taxed at 25%, and the balance is taxed at ordinary rates. An anti-abuse rule limits the amount of wages and income from the provision of services that may be treated as business income.

Comment: Active business income of a taxpayer from a personal service business (such as a law firm, accounting firm or consulting firm) generally will not be eligible for the 25% rate.

- All **new business investment** in qualified depreciable property (not including structures or intangible assets) will be **expensed** (written off entirely in the year of acquisition). This favorable provision is to stay in place for **five years,** with an additional year for certain property with a longer production period, and applies to property even if not originally placed in service by the taxpayer.

Comment: M&A buyers will be incentivized to purchase assets or businesses in **flow-through form** so that they can immediately expense the cost of depreciable property. M&A sellers (including private equity firms holding businesses in transparent form) will be incentivized to sell before the provision **sunsets** at the end of **2022** so that they can share in the accelerated tax benefit to buyers.

- The deduction for **net interest expense** will be **limited** to 30% of a business's adjusted taxable income (computed before interest, net operating losses, depreciation and amortization). For partnerships, the limitation will be determined at the partnership level. Any disallowed amounts will be carried forward for **five years**. Special rules will allow a pass-through business's unused limitation to be used by its owners. A business with average gross receipts of $25 million or less will be exempted from this provision.

Comment: The Bill does not provide any special rules for financial services companies such as banks, insurance companies and leasing companies, and it is unclear how interest income earned by insurance companies will be taken into account for purposes of the limitation.

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).

- The Bill calls for the repeal or modification of most business credits, other than the credits for **research and development** and **low-income housing**.
- **Net operating losses** will be carried forward indefinitely and increased by an interest factor. A net operating loss carryforward may offset only 90% of taxable income determined before the carryforward. The Bill eliminates the carryback of net operating losses.
- The Bill eliminates the ability to engage in a tax-free **like kind exchange** of any property other than real property, or of U.S. real property for non-U.S. real property, with grandfathering rules for exchanges that are in progress in 2017.
- The Bill eliminates the exemption for interest on **private activity bonds** issued after 2017.

Comment: Tax-exempt financing will no longer be available for airports, toll roads and other transportation and infrastructure projects that are leased or operated by private businesses.

- Certain tax-exempt state and local entities, including **state and local pension plans**, will be subject to tax on **unrelated business taxable income**.

Comment: Most government-sponsored pension plans take the position that they are exempt from unrelated business taxable income under current law. The Bill will have a meaningful impact on such pension plans investing in private equity and other funds that generate such income, and may cause such public pension plans to reconsider current investment structures.

INTERNATIONAL

- Prospectively, the U.S. will adopt a "**territorial system,**" under which the U.S. will **allow a deduction** for dividends received by a U.S. corporation from a 10% or greater-owned foreign subsidiary to the extent attributable to foreign source income.
  - The basis in such 10% foreign subsidiaries will be **adjusted downwards** to prohibit losses on sales of foreign subsidiaries attributable to deductible dividends.
- To transition to the new "territorial" system, 10% or greater shareholders will be required to pay a **one-time tax** on all existing foreign earnings. Foreign earnings held in illiquid assets will be taxed at 5%, and cash equivalents will be taxed at 12%. Payment of the resulting tax liability can be spread over eight years.

Comment: To avoid gaming the form in which foreign earnings are held, the tax is based on average foreign cash equivalents held over a three-year period.

Comment: This provision is likely to be burdensome for minority U.S. shareholders that will need U.S. tax information from foreign entities that normally do not report such information.

- The Bill imposes a **20% excise tax** on deductible or capitalized payments (other than interest) made by a U.S. corporation to a foreign affiliate. The excise tax applies to payments made or accrued after December 31, 2018.
  - The excise tax is **in addition** to any applicable withholding tax and cannot be deducted by the U.S. payor.
  - Alternatively, the recipient may elect to treat the payments as U.S.-source "effectively connected income" subject to tax at regular corporate rates (and requiring a U.S. tax return filing).

Comment: This provision sharply reduces any tax benefit from making deductible or capitalized payments to foreign affiliates. It will impose a significant economic burden on **foreign entities that export products** to U.S. affiliates and to **foreign insurance companies** that reinsure business written by U.S. affiliates. This provision is designed to discourage imports from, and the payment of deductible royalties to, foreign affiliates.

- The scope of the **"controlled foreign corporation" rules** will be dramatically expanded so that **almost all** foreign corporations in a multinational group that includes a U.S. entity will be treated as CFCs.

Comment: This provision will impose an additional tax burden on 10% U.S. owners of entities in such groups that will be subject to tax on "Subpart F" income. Companies that have adopted structures designed to avoid the CFC rules (such as certain "inverted" groups) will either be forced to restructure or pay tax on certain offshore earnings.

Comment: As with the provision imposing the one-time tax on foreign earnings, this provision is likely to be burdensome for minority U.S. shareholders, as they will need (but frequently not have the leverage to demand) U.S. tax reporting information.

- U.S. shareholders of CFCs will be **taxed on 50% of the CFC's net active income** in excess of a "routine" return on the CFC's investment in depreciable **tangible property**.
  - A "routine" return is defined as **7% plus the short-term AFR**.
  - A limited tax credit is available for foreign taxes paid on income captured by this provision.

Comment: This provision is targeted at CFCs that generate income from **intangible assets** (regardless of whether those assets were migrated from the U.S. or actually created offshore). However, it will also apply to income from successful operating businesses that generate high returns on tangible assets.

Comment: This provision is in addition to the existing "Subpart F" inclusion for a CFC's passive income.

- **Net interest deductions** of U.S. corporations with foreign affiliates will be **limited** to the extent the U.S. corporation's share of the group's net interest expense for any given year exceeds 110% of the U.S. corporation's share of the group's EBITDA. The provision also applies to interest expense of foreign corporations engaged in a U.S. trade or business. Disallowed interest deductions can be carried forward for five years.

Comment: This provision prevents U.S. members of a multinational group from benefiting from debt to the extent it is more than 10% above the group's average leverage ratio. This provision applies even to **third-party debt** incurred for non-tax reasons, such as financing an acquisition.

Comment: There is no "grandfathering" exception for existing debt, so this provision will disrupt existing structures.

INSURANCE COMPANIES

- Life Insurance companies will only be able to claim 40% of the **dividends received deduction** ("DRD") for their investment income. P&C companies will also have a reduced benefit from the DRD, and the benefit of tax-exempt interest for insurers will also be reduced.

- Life insurance companies' **deduction for tax reserves** will be decreased to a fixed 76.5% of statutory reserves for future unaccrued claims. This change will be phased in over eight years.
- The tax **deferred acquisition cost** (DAC) rates will increase to 4% for group contracts and to 11% for all other contracts—a 5x increase for annuity contracts—causing significant additional deferral of deductions.
- Property and casualty companies' **deduction for unpaid losses** will be reduced. P&C companies will discount unpaid losses using less favorable discount rates and payment assumptions. Changes to unpaid losses will be phased in over seven years.
- Insurance companies will be forced onto the regular corporate **net operating loss carryover** rules. The special carryforward and carryback rules for insurers will be repealed.
- The bill establishes an inflexible test for foreign insurance companies that rely on the active insurance business exception to the **passive foreign investment company** (PFIC) rules. To qualify for the exception, an insurance company must have insurance liabilities—measured by loss and loss adjustment expenses and life and health reserves—that exceed 25% of its total assets.

COMPENSATION

- It will **no longer be possible to defer compensation**, except for qualified plans and restricted property. Nonqualified deferred compensation will generally be taxable in the year in which it vests (*i.e.*, the right to the compensation is no longer conditioned on continued services).

Comment: Section 409A (which imposes strict limitations on when compensation may be deferred and paid) and Section 457A (which applies to deferred compensation of certain tax-indifferent entities) will no longer apply.

Comment: A performance condition standing alone (*e.g.*, EBITDA targets or a change in control event) without a service requirement will **not** be a permitted vesting trigger for deferred compensation. This will fundamentally change how many companies compensate their employees.

Comment: **Stock options** and **stock appreciation rights** will be taxable when they become vested. This will dramatically alter employers' use of these popular equity awards and make such awards unattractive to employees.

Comment: There will be a transition rule for amounts that are "attributable to services" performed before January 1, 2018 so long as these amounts are taken into income the later of when they vest and 2026. However, the proposed rule does **not** include a transition rule for **current** compensation arrangements that vest based on services performed **after** December 31, 2017.

- The **$1 million** deduction limitation under Section 162(m) **that applies to public companies** will be expanded to deny a deduction to **more** companies for **more** compensation payable to a **larger** group of employees.

  Comment: Performance-based compensation, including equity awards, will no longer be exempt from the 162(m) deduction limitation. This is likely to have a significant impact on how public companies compensate their top executives.

  Comment: The "covered employees" to whom the deduction limitation will apply include the CEO, the CFO and the next three most highly compensated employees (whether or not serving as executive officers as of the end of the year). In addition, once considered a "covered employee" for a given year, the individual will be treated as a "covered employee" for all subsequent years.

  Comment: The employers subject to the 162(m) deduction will be expanded to include **Section 15(d) filers** (*i.e.*, companies that issued equity or debt securities to the public in a registered public offering, but have not listed on a securities exchange, such as foreign private issuers and debt issuers).

- A new **20% excise tax** on "excessive compensation" paid by **tax-exempt organizations** will be imposed on compensation paid to each of the five highest-paid employees to the extent such compensation exceeds $1 million in any year and severance payments to any such individual to the extent the severance payments exceed three times the average of the individual's last five years of compensation.

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