CLIENT ALERT

Business Tax Changes in the Tax Cuts and Jobs Act

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Introduction

On November 2, 2017, the House of Representatives Committee on Ways and Means unveiled the first draft of its long awaited tax reform bill, the Tax Cuts and Jobs Act (the "Bill"). After much debate and speculation, the Bill includes sweeping changes to the tax code that have been teased by lawmakers in recent months, including a reduction in the corporate tax rate, new rules for taxing pass-through entities, and a shift from a worldwide to a largely territorial system of taxation. House Speaker Paul Ryan has characterized the bill as "pro-growth" and commentators have suggested that it favors businesses. On Monday, November 6, the Bill entered four days of debate on the House floor, a first step in the long process to becoming law. The Senate is expected to release its own version of tax reform within the next week.

Set forth below is a high-level analysis of the portions of the Bill affecting domestic and cross-border taxation of business enterprises, as well as certain rules applicable to insurance companies.

Domestic Provisions Affecting Business Entities

Reduction in the Corporate Tax Rate
Under the Bill, the current four tier schedule of corporate rates is replaced by a flat rate of 20%. The corporate alternative minimum tax will be repealed.

Special Pass-Through Rate
The Bill would provide for a maximum 25% rate on "business income" reported by individuals, including pass-through entities such as partnerships and S corporations. The rationale for such lower rate appears to be that such income represents a return of invested capital, not compensation for labor.

All income reported by individuals derived from passive business activities will qualify for the reduced rate. Whether an activity qualifies as a passive business activity will be determined based on currently existing law.

A certain percentage (the "capital percentage") of income derived from active business activities would qualify for the reduced rate. Owners generally would be allowed to elect a capital percentage of 30% for income derived from active business activities, or to otherwise elect to apply a facts-and-circumstances based formula to determine a higher capital percentage (which such formula would measure the capital percentage based on a rate of return equal to the short-term AFR plus 7% multiplied by capital investments of the business). An election of the alternative formula would be binding for five years.

Owners of certain professional services businesses (e.g., businesses providing legal, accounting, consulting, engineering, financial or performing arts services) would not be eligible for application of the default 30% capital percentage, but they would be eligible to elect to apply the alternative formula.

To prevent the recharacterization of actual wages paid with respect to active business activities as income eligible for the reduced rate, an owner's capital percentage would be limited to the percentage of net business income derived from such active business activity that does not consist of wages or compensation.

Income subject to preferential rates, such as capital gains and qualified dividend income, would be excluded from any determination of a shareholder's capital percentage. Certain other investment income that is subject to ordinary rates such as short-term capital gains and non-qualified dividends would not be eligible to be recharacterized as income subject to the reduced rate, though interest income properly allocable to a trade or business would be eligible.

Carried Interest

On Monday, November 6, the House of Representatives introduced a number of amendments to its tax reform plan during the Bill's "mark-up" session. One such amendment would change how carried interest is taxed, closing a perceived "loophole" that lawmakers from both parties have promised to address.

The amendment would increase the holding period of assets to three years, up from one year, before a taxpayer would be eligible for long-term capital gains rates with respect to income earned from such assets attributable to certain partnership interests. Such partnership interests would include partnership interests received in connection with the performance of substantial services in a trade or business relating to (i) raising or return of capital and (ii) either investing in (or disposing of) certain securities, commodities, real estate, cash or cash equivalents, or derivatives or developing such assets.

Interest Deductibility

Under current law, business interest is generally allowed as a deduction in the taxable year in which it is paid or accrued, subject to a number of limitations. For example, under current law, the earnings stripping rules of Code Section 163(j) limit the ability of a corporation to deduct disqualified interest (generally, where the interest is paid to a related payee that is exempt from U.S. federal income tax with respect to the interest) paid or accrued if the following tests are met: (1) the payor corporation's debt-to-equity ratio exceeds 1.5 to 1, and (2) the payor corporation's net interest expense exceeds 50% of its adjusted taxable income (computed without regard to deductions for interest, net operating losses, domestic production activities under Code Section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules (the "earnings stripping" rules) can be carried forward indefinitely.

Under the Bill, for taxable years beginning after December 31, 2017, the current interest "earnings stripping" rules would be repealed, and under an amended Code Section 163(j), every business (other than certain small businesses with average gross receipts of $25 million or less) would be subject to a disallowance of a deduction for net interest expense in excess of 30% of the sum of a business's adjusted taxable income (computed without regard to any item of income, gain, deduction or less not properly allocable to a trade or business, deductions for interest, net operating loss deductions, depreciation, amortization, and depletion). Any disallowed interest expense under this provision could be carried forward for up to five years.

The Bill also would add new Code Section 163(n) to limit the deduction for interest paid by a domestic corporation that is a member of an international financial reporting group ("IFRG"). For this purpose, an IFRG means, for any reporting year, any group of entities which: (1) includes at least one foreign corporation engaged in a trade or business within the United States, or at least one domestic corporation and one foreign corporation; (2) prepares consolidated financial statements with respect to such year, and (3) has average annual global gross receipts of more than $100 million for the three-year reporting period ending with the reporting year.

If new Code Section 163(n) applied, for tax years beginning after December 31, 2017, the domestic corporation's deduction for interest expense paid or accrued during the tax year would be limited to the extent the domestic corporation's share of the IFRG's total interest expense exceeds 110% of the domestic corporation's share of the IFRG's total EBITDA. Any disallowed interest expense under this provision could be carried forward for up to five years.

Net Operating Losses
Under current law, net operating losses may be carried back for two years and carried forward for 20 years. Under the Bill, net operating losses arising in tax years beginning after December 31, 2017, could not be carried back, with the exception of a one-year carryback of eligible disaster losses. The Bill allows net operating losses to be carried forward indefinitely. Carryforwards would be increased by an implied interest amount based on the annual federal short- term rate. In addition, the maximum amount of the deduction for a net operating loss carryforward would be limited to 90% of a taxpayer's income (determined without regard to the net operating loss deduction).

Expensing
Under the Bill, 100% (up from 50%) of new business investment in qualified depreciable property may be expensed (*i.e.*, written off entirely in the first year). Such qualified property must be acquired and placed into service after September 27, 2017, and before January 1, 2023. The 100% expensing rule would apply to both new property and previously used property.

Consistent with the forward-looking prohibition on net operating loss carrybacks, with respect to taxable years that include any portion of the period between September 28, 2017, and December 31, 2017, the amount of any net operating loss for such taxable year which may be carried back is determined without regard to the revised expensing rules.

Like-Kind Exchanges
The existing like-kind exchange exception in Code Section 1031 allows taxpayers to defer gain or loss when they exchange properties of similar character and nature so long as the properties being exchanged are held for productive use in a trade or business or investment. Like-kind exchanges may generally include either personal property or real property. However, the Bill modifies existing law so that all like-kind exchanges completed after December 31, 2017, are limited to exchanges of real property that is not held primarily for sale. There is a brief transition period—this limitation will not apply if the taxpayer disposes the relinquished property, or receives the acquired property, on or before December 31, 2017.

Super-Tax Exempts and UBTI
Organizations that are exempt from U.S. federal income under Code Section 501(a) are still subject to tax on unrelated business taxable income ("UBTI"). Specifically, Code Section 511 imposes an unrelated business income tax on any income derived from a trade or business regularly carried on by an organization that is not substantially related to the tax-exempt purpose of the organization. However, under existing law, it is arguable that Code Section 511 does not apply to certain public pension funds that are exempt from tax under Code Section 115(l). Such public pension funds are commonly referred to as "super tax-exempt investors."

The Bill amends Code Section 511 so that, for taxable years beginning after December 31, 2017, additional exempt entities—including super tax-exempt investors—are subject to tax on their UBTI. If passed, public pension plans will need to analyze alternative structures to minimize any potential UBTI liability, including for existing investments.

International Provisions Affecting Business Entities

Repatriation of Existing Earnings
In connection with the transition to a territorial system, the Bill would impose a one-time tax on a deemed repatriation of foreign earnings. Such deemed repatriated foreign earnings would be taxed at a rate of 12% to the extent attributable to cash or cash equivalents and 5% to the extent attributable to illiquid assets.

This one-time tax would be implemented by amending Code Section 965 to require that, for the last taxable year beginning before January 1, 2018, any U.S. shareholder that owns at least 10% of the voting power of a "deferred foreign income corporation" must include in income its pro rata share of such corporation's accumulated and previously untaxed foreign earnings and profits ("E&P"). A "deferred foreign income corporation" is a "specified corporation" with positive deferred E&P. A "specified corporation" is (i) a controlled foreign corporation ("CFC") or (ii) a non-CFC with at least one domestic corporate 10-percent U.S. shareholder. Passive foreign investment companies ("PFICs") are expressly excluded from the definition a "specified corporation."

A taxpayer that is a 10-percent U.S. shareholder with respect to one or more specified corporations with an E&P deficit reduces its income inclusion by its pro rata share of the aggregate E&P deficit of such specified corporations. In addition, a U.S. shareholder in an affiliated group can utilize the unused E&P deficit of the other members of its group.

The favorable rates on the income inclusion are achieved by allowing a U.S. shareholder a deduction that would reduce the rate to 12% (for cash or cash equivalents) or 5% (for illiquid assets), computed based on the highest corporate tax rate at the time of the inclusion. To avoid a double-benefit, only a portion of the foreign tax credits associated with the U.S. shareholder's income inclusion will be allowed.

A U.S. shareholder can pay the one-time tax attributable to the deemed repatriation in the same manner as its other U.S. federal income taxes or elect to pay the tax in equal installments over eight years.

New CFC Rules/Routine Return

Generally, current law prevents deferral of certain foreign income by subjecting 10-percent U.S. shareholders of CFCs to current U.S. federal income tax on their portion of the CFC's subpart F income even without a distribution of such income to the U.S. shareholder. CFCs are foreign subsidiaries that are more than 50% owned by U.S. persons (each of whom must hold at least 10% for the 50% determination), with such persons treated as constructively owning stock held by certain related persons, affiliates, etc. While under current law, U.S. corporations are not treated as constructively owning stock held by their foreign shareholders, the Bill would require such attribution. Accordingly, many foreign subsidiaries which are not CFCs under current law would be CFCs under these changes. This will require multinationals to reconsider structures that were implemented under the current law attribution rules.

The Bill also would eliminate the rule providing that a 10-percent U.S. shareholder is subject to current U.S. federal income tax on its portion of the CFC's subpart F income only if such 10-percent U.S. shareholder owns stock in the foreign subsidiary for an uninterrupted period of 30 days or more during the year.

Additionally, the Bill would make permanent the current "look-through" rule that provides that passive income received by one foreign subsidiary from a related foreign subsidiary generally is not included in the taxable income of a 10-percent U.S. shareholder, if the income is not subject to current U.S. federal income tax and does not constitute income effectively connected with the conduct of a U.S. trade or business ("ECI").

While current law prevents deferral of subpart F income, current transfer pricing rules permit foreign subsidiaries to earn more than a routine profit in certain instances which are not subject to subpart F, often resulting in large deferred profits at foreign subsidiaries. The Bill restricts this deferral by subjecting a U.S. parent to current U.S. federal income tax on 50% of the U.S. parent's foreign subsidiaries' aggregate net income in excess of a "routine" return (7% plus the federal short-term rate of the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense), such excess a "Foreign High Return." Foreign High Returns would not include ECI, subpart F income, certain related-party payments, and certain other types of income.

Like current subpart F income, Foreign High Returns would be subject to current inclusion by the U.S. parent but would allow a foreign tax credit. For purposes of Foreign High Returns, the foreign tax credits would be limited to 80% of the foreign taxes, would not be allowed against U.S. federal income tax imposed on other foreign-source income (*i.e.*, only offsets U.S. federal income tax on Foreign High Returns), and would not be allowed to be carried back or forward to other tax years.

Excise Tax on Transactions with Non-U.S. Affiliates

Under current law, foreign corporations generally are subject to U.S. federal income tax only on (i) U.S.-source fixed or determinable annual or periodical ("FDAP") income and (ii) ECI. Income tax treaties between the United States and other countries frequently reduce or entirely eliminate U.S. federal income tax imposed on FDAP income. In addition, a foreign corporation generally is not treated as conducting a U.S. trade or business when it does not own property, have employees, or direct agents located in the United States. Multinational enterprises commonly have been able to reduce their U.S. tax base by making deductible payments to their foreign affiliates, which payments are not subject to U.S. federal income tax in the hands of such foreign affiliates.

The Bill imposes a 20% excise tax on payments (other than interest) made by domestic corporations to their foreign affiliates for both tangible and intangible property. The proposed excise tax is intended to eliminate the U.S. tax benefit afforded to U.S. corporations that make such deductible payments to their foreign affiliates without a corresponding increase in U.S. taxable income elsewhere in the multinational group.

This excise tax would cover any payment that would be deductible, includable in cost of goods sold, or includable in inventory or the basis of a depreciable or amortizable asset. The excise tax would not apply (i) if the applicable foreign affiliate elects to treat such payment as ECI, (ii) to any payment subject to the full 30% U.S. withholding tax, or (iii) to any payment for intercompany services charged at cost or to any payment in certain commodities transactions. In the event the foreign affiliate elects to treat such payment as ECI, the foreign affiliate's expense deductions attributable to the payment would be determined by reference to the profit margins reported on the group's consolidated financial statements for the relevant product line.

The excise tax only would apply to U.S. corporations (and partners of partnerships) of certain international financial reporting groups with average payments to foreign affiliates (determined in the aggregate with respect to all entities in the group) totaling at least $100 million in any particular year, based on a three-year period ending with such year. The excise tax would apply to amounts paid or accrued after December 31, 2018.

Special Provisions Relating to Insurance Companies

Under the Bill, special tax benefits available to insurance companies would be reduced. The areas of change for insurance companies would include:

- less favorable carryback and carryforward periods for net operating losses of life insurance companies;
- repeal of deductions for small life insurance companies;
- less favorable rules relating to deductions for reserves;
- repeal of rules permitting deferral for policyholder surplus accounts;
- modification of the deferred acquisition cost rules and discounting rules;
- a reduced period for accounting for changes to accounting methods relating to reserves; and
- a reduction of the dividends received deduction available to life insurance companies to 40% of such deduction.

In addition, the Bill would modify the application of the PFIC rules to foreign insurance companies. Under the Bill, in order to qualify for the active insurance business exception to the PFIC rules, a foreign insurance company must have insurance liabilities, measured by loss, loss adjustment expenses, unearned premiums and certain reserves, that exceed 25% of the foreign corporation's total assets (with a limited exception of 10% of such foreign corporation's total assets if due to temporary circumstances).

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