ROPES & GRAY

ALERT

Tax

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House Republicans Introduce Long-Awaited Tax Legislation

On Thursday, November 2, 2017, House Republicans introduced the Tax Cuts and Jobs Act, their long-awaited tax reform legislation, followed quickly by an amendment introduced on November 6 by House Ways and Means Committee Chair Kevin Brady. The bill is expected to evolve significantly in the coming days and weeks. Meanwhile, the Senate is working on its own tax reform proposals.

If enacted in its current form, the bill as amended would produce the most sweeping changes to the tax code in over a decade:

- The maximum federal corporate tax rate would be reduced to 20%, business interest deductions would be capped at roughly 30% of EBITDA, and investments in tangible personal property would be deductible when made.
- The maximum income tax applicable to an individual's business income from partnerships, S corporations, and sole proprietorships would be reduced to 25% in certain cases. The reduction would generally apply to only 30% of the individual's income from the business, and would not be available for most service businesses. In many cases, self-employment taxes on limited partners and S corporation shareholders would go up.
- Taxation of U.S. multinationals would move towards a territorial system. A new minimum tax would be imposed on future foreign earnings as part of an expansion of the "Subpart F" rules, there would be a one-time mandatory deemed repatriation of existing foreign earnings, an excise tax would be imposed on most related-party payments, and multinationals' interest deductions would be subject to additional limitations.
- Carried interests in investment partnerships (including private equity, real estate and venture capital funds) would be eligible for long-term capital gains treatment only if a three-year holding period requirement is met.
- Nonqualified deferred compensation would be taxed when service-based vesting occurs, although an election would allow certain private corporation employees to defer tax on stock received under stock options and restricted stock units for up to five years. The bill would strengthen the existing $1 million per-executive deduction limitation for a publicly traded corporation's pay to top officers, and alter the tax treatment of certain common retirement, health, and welfare benefits.
- An excise tax would be imposed on the endowment income of large private educational institutions, tax-exempt bonds would be limited to public issuers, and governmental plans would be subject to the unrelated business income tax.
- Tax rates applicable to individuals would be simplified, with the top rate remaining at 39.6%. Although the standard deduction would increase, personal exemptions would be eliminated, the mortgage interest deduction would be limited to $500,000 of debt, and the deduction for state and local taxes would be limited to $10,000 of property tax.
- The exemption amount for gift and estate taxes and the GST would double. The estate tax and the GST would be eliminated starting in 2024, but the basis step-up at death would be retained.

Below is a discussion of the key provisions of the bill, taking into account the November 6 Brady amendment (the "Amended Bill"). Except as otherwise noted, the Amended Bill would be effective for taxable years beginning after 2017.

Business Taxes

- ***Reduction of Corporate Income Tax Rate.*** The maximum corporate tax rate would be reduced from 35% to 20%. The maximum rate for personal service corporations would be 25%.
- ***Cap on Deductions for Business Interest.*** Corporations and other business taxpayers would be barred from deducting net business interest expense in excess of 30% of "adjusted taxable income," defined as taxable income determined without regard to non-business income, net interest income or expense, net operating loss deductions, and deductions for depreciation and amortization. This rule would not apply to businesses with average gross receipts of $25 million or less, real estate businesses, certain utilities businesses, or the trade or business of performing services as an employee. Taxpayers would be permitted to carry forward disallowed interest deductions for five taxable years. The current earnings-stripping limitations on interest paid to foreign and tax-exempt creditors would be repealed. There would be no transition rule for interest paid on existing obligations.
- ***Accelerated Expensing of Tangible Personal Property.*** Corporations and other business taxpayers would be entitled to expense 100% of the cost of tangible depreciable personal property acquired and placed in service after September 27, 2017 and before January 1, 2023. Expensing would not be available for real estate, most intangible property, and property of real estate businesses and regulated public utilities. The requirement that the use of the property begin with the taxpayer would be repealed, as would the election to use alternative minimum tax ("AMT") credits in lieu of accelerated expensing.
- ***Cap on Use of NOLs.*** The deduction for net operating loss ("NOL") carryovers and carrybacks in a taxable year would be capped at 90% of taxable income for the year (thus replicating the equivalent provisions of the corporate AMT). With certain exceptions, carrybacks would be phased out entirely for losses arising in taxable years beginning after 2017. NOLs arising in tax years beginning after 2017 that are disallowed with respect to a particular year would be increased by an interest factor for each year they are carried forward equal to the applicable federal short-term rate plus 4%.
- ***Expansion of Cash Method of Accounting.*** The ceiling for corporations permitted to use the cash method of accounting would be increased from $5 million to $25 million in average yearly gross receipts, with automatic yearly adjustments for inflation. Any business with gross receipts below the ceiling would be entitled to use the cash method, regardless of whether the business owns inventory.
- ***Repeal of Deduction for Domestic Production Activities.*** Under current law, taxpayers are generally entitled to a deduction equal to 9% of the lesser of the taxpayer's qualified production activities income or the taxpayer's taxable income for the tax year. This deduction would be repealed.
- ***Repeal of Deduction for Entertainment Expenses.*** Deductions would not be allowed for entertainment, amusement, or recreation activities. Transportation fringe benefits and on-premises gyms and amenities provided to employees that are not directly related to the employer's trade or business would be allowed only to the extent such benefits are included in the employee's taxable compensation. The current 50% limitation on deductions for food and beverages and qualifying business meals would be retained.
- ***Repeal of Various Tax Credits.*** The credit for clinical testing expenses for certain rare-disease drugs would be repealed, as would the employer-provided child care credit, the historic/old building rehabilitation credit, the work opportunity credit, the carryback of unused business credits, and certain other credits.

Pass-through and Direct Business Income Taxes

- ***Tax Rate on Certain Pass-through and Direct Business Income Reduced to 25%.*** The Amended Bill generally would impose a maximum marginal rate of 25% on a portion of the "net business income" earned by an individual, whether directly or through a partnership, limited liability company, or S corporation. Net business income generally would not include passive income.
- ***Material Participation.*** In cases where an individual "materially participates" in the business, a portion of the individual's business income would be deemed to be compensation for services and would not be eligible to be taxed at the 25% rate.
  - The default rule would be that 30% of the net business income from the relevant business activity is eligible to be taxed at the 25% rate.
  - As an alternative, an individual could elect to use the "applicable percentage" to calculate the amount of business income eligible for the 25% rate. The applicable percentage would represent the portion of the net business income deemed to be a return on capital rather than compensation, and would be calculated by reference to a deemed rate of return applied to the adjusted tax basis of property used in the business.
  - Any election to use the "applicable percentage" instead of the 30% default percentage would be binding for a five-year period.
  - If an individual does not "materially participate" in the business, 100% of the individual's net income from the business would be eligible for the 25% rate.
- ***Service Businesses.*** The 25% rate generally would not apply to income from certain service businesses in which an individual materially participates.
  - Service businesses for this purpose would include law, accounting, financial, and consulting firms, and any other business where the principal asset is the reputation or skills of its employees. Firms providing investment services, such as private equity and hedge fund managers, would be treated as service businesses.
  - If such a service business is capital-intensive and has an "applicable percentage" at least equal to 10%, an individual could elect to apply the 25% tax rate to the applicable percentage of business income.
- ***REIT Dividends.*** Individuals would be eligible to be taxed at the maximum 25% rate on dividends from Real Estate Investment Trusts ("REITs") that do not otherwise qualify to be treated as long-term capital gains.
- ***SECA Tax.*** Self-employment tax would generally apply to the portion of an individual's business income that is not eligible for the 25% rate. There would no longer be any special exemptions for "limited partners" or shareholders of S corporations.
- ***Three-Year Holding Period for Carried Interests in Investment Funds.*** Gains allocated or recognized in respect of an "applicable partnership interest" would qualify for favorable long-term capital gain treatment only to the extent that they are attributable to assets of the partnership held for more than three years. An interest in a partnership would be an "applicable partnership interest" if received in connection with the performance of services in a trade or business of raising or returning capital and investing in or developing securities, commodities, real estate, options, or derivatives on those assets. The longer holding period requirement would not apply to a partnership interest held by a corporation, or to one that participates in gains in a manner commensurate with either contributed capital or an amount previously included in taxable income as compensation.

International Taxes

- ***Modified Territorial Tax Regime.*** The Amended Bill would implement a modified territorial tax regime that would generally provide a 100% exemption for dividends received by U.S. corporate shareholders that own 10% or more of the voting stock of non-U.S. corporations. The exemption would not apply to individual shareholders.
- ***Modifications to CFC Rules.***
  - The Amended Bill would retain the existing "Subpart F" regime of taxing, on a current basis, U.S. shareholders of controlled foreign corporations ("CFCs") on such corporations' passive earnings, but the Section 956 deemed dividend rules would be eliminated for U.S. corporate shareholders.
  - The Subpart F regime would also be expanded to subject, on a current basis, certain U.S. shareholders of CFCs to a minimum tax (applied at 50% of the standard rate) on the active business income of the CFCs in excess of a "normal" return, defined as a deemed rate of return on the adjusted tax basis of the CFC's depreciable tangible assets.
  - The relevant ownership rules would be modified to broaden the class of foreign corporations that would qualify as CFCs.
- ***Repatriation.*** In connection with the transition to the new international regime, certain 10% or greater shareholders of a foreign corporation would be subject to a one-time mandatory repatriation tax on the retained foreign earnings of the corporation. Retained foreign earnings that are cash and cash equivalents would be subject to tax at 12%, and other retained foreign earnings would be subject to tax at 5%. Taxpayers would be allowed to elect to pay this tax in equal annual installments over eight years.
- ***Excise Tax.*** Beginning in 2019, most payments made by a U.S. corporation to a foreign affiliate for inventory, commercial inputs, royalties, and non-routine services would be subject to a 20% excise tax unless the foreign payee elects to treat those payments as subject to U.S. net income tax. The new rule would only apply to groups in which the average payments to foreign affiliates exceeded $100 million annually during the prior three years.
- ***Multinational Interest Cap.*** In addition to the general 30% interest expense limitation on U.S. corporate debt described above, a U.S. corporation in a multinational group with annual gross receipts in excess of $100 million would be prohibited from deducting net interest expense in any taxable year to the extent the U.S. corporation's share of the global enterprise's net interest expense for the taxable year exceeds 110% of the U.S. corporation's share of global EBITDA for the taxable year. No transition rule would be available for currently outstanding related-party debt.

Executive Compensation and Retirement and Health and Welfare Benefits

- ***Elimination of Deferred Compensation Opportunities.*** The Amended Bill would replace the current overlapping nonqualified compensation deferral tax regimes for taxable and tax-exempt (or tax-indifferent) employers with a single rule that eliminates the possibility for significant tax deferral following the satisfaction of service-based vesting criteria. The new rule would cover stock options (excluding arrangements under which employees receive "qualified stock" as defined below) and stock appreciation rights, as well as more traditional forms of deferred compensation and severance. The Amended Bill does not specify how income inclusion would be determined. Deferrals of compensation for services performed before 2018 could remain grandfathered through as late as 2025.
- ***Election to Defer Tax on Stock Options and RSUs.*** An exception to the new deferred compensation rules would be available for certain private corporation employees who receive stock options or restricted stock units under a broad-based equity award program. These employees would be permitted to elect to defer tax

otherwise due for up to five years. Corporations issuing stock under such programs ("qualified stock") would be required to give notice of the election opportunity, and any employer deduction associated with the qualified stock issuance would also be delayed during the deferral period. The exception would not be available for certain top officers and 1% shareholders, among others.

- ***More Limited Public Company Executive Compensation Deductions.*** Under current law, the deduction available to a publicly traded corporation for compensation paid in any year to its CEO or to any of the corporation's other three most highly compensated officers other than its CFO is limited to $1 million. A number of exemptions and coverage limitations currently diminish the practical effect of this limitation. Among other changes, the Amended Bill would eliminate the performance-based compensation exemption, and expand the limitation to include a company's CFO and any employee who had been one of the top-five group in a prior year beginning after 2016. It would also extend the limitation to certain debt and equity issuers that are required to make public filings.
- ***Excise Tax on Tax Exempt Organization Executive Compensation.*** A tax-exempt organization would be subject to a new excise tax equal to 20% of the remuneration in excess of $1 million paid to any employee that is (or in a prior year beginning after 2016 was) among its five highest paid employees, plus 20% of any "excess parachute payments" – generally speaking, severance or severance-type compensation equal to or in excess of three times the employee's average annual compensation over a specified look-back period.
- ***Changes to Retirement Plans and IRAs.*** The Amended Bill does not include a reduction in the elective deferral limits under a traditional 401(k) plan as had reportedly been contemplated. However, a number of more technical changes would be made to qualified retirement plans and IRAs, including a relaxation of in-service distribution rules for certain plans, liberalized rules around plan loan rollovers and hardship distributions, and limited relief from nondiscrimination rules for defined benefit plans that have been closed to new participants.
- ***Changes to Health and Welfare Benefits.*** The Amended Bill would repeal certain tax exclusions for benefits offered under dependent care assistance programs, adoption assistance programs, Section 127 educational assistance programs, and qualified tuition reduction programs. The tax exclusion for employee achievement awards and employer-reimbursed qualifying moving expenses would also be repealed. The dependent care repeal would be effective for tax years after 2022.

Tax-Exempt Organizations

- ***New Excise Tax on Private College and University Endowments.*** Private colleges and universities with at least 500 full-time equivalent students and investment assets valued at least $250,000 per student would be subject to an excise tax of 1.4% on their net investment income.
- ***Interest on Non-Governmental Bonds and Advanced Refunding Bonds No Longer Tax-Exempt.*** The Amended Bill would repeal the tax exemption for interest on newly issued bonds for non-governmental organizations, "private activity bonds" such as mortgage bonds, tax credit bonds, and all advance refunding bonds. For bonds issued after 2017, only interest on governmental bonds and current refundings of governmental bonds would be eligible for tax-free treatment to bondholders.
- ***State and Local Government Pension Plans Subject to UBIT.*** State and local government pension plans would be subject to the unrelated business income tax.
- ***Excise Tax on Private Foundation Investment Income Simplified.*** The existing two-tier excise tax rate on private foundation net investment income would be collapsed into a single rate of 1.4%.
- ***Churches Permitted to Make Political Endorsements.*** As an exception to the general rule that prohibits tax-exempt organizations from engaging in political campaign intervention (the so-called "Johnson Amendment"), religious organizations would be permitted to make statements in favor of or in opposition to

a political campaign so long as the speech is made as part of a sermon or presentation at a religious service or gathering and only results in incurring *de minimis* expenses.

Individual Taxes

- ***Reduction of Income Tax Brackets.*** Individual income tax brackets would be reduced to four: 12%, 25%, 35% and 39.6%. The benefit of the 12% rate would be phased out for high income earners, creating a "bubble bracket" where the effective tax rate would be 45.6% for up to $200,000 of incremental income for affected taxpayers. There would remain three brackets for capital gains: 0%, 15% and 20%.
- ***Repeal of the AMT.*** The individual AMT would be repealed.
- ***Standard Deduction and Repeal of Personal Exemption.*** The standard deduction would be increased to $24,400 for married individuals filing jointly ($12,200 for unmarried individuals) and adjusted for inflation. The deduction for personal exemptions (currently $4,050 per person) would be repealed.
- ***Simplification and Reform of Deductions.***
  - ***"Pease" limitation.*** The limitation on the amount of itemized deductions for certain high-income taxpayers (also known as the "Pease" limitation) would be repealed.
  - ***Mortgage Interest Deduction.*** Under current law, taxpayers are allowed to deduct interest payments on up to $1 million of mortgage debt on a principal residence. The Amended Bill would decrease the limit to $500,000 for mortgage debt incurred after November 2, 2017.
  - ***State and Local Taxes.*** Taxpayers would no longer be able to deduct state and local income taxes, except for taxes incurred in carrying on a business. Taxpayers would be allowed a deduction for real property taxes up to $10,000.
  - ***Charitable Contributions.*** The Amended Bill would increase the allowable deduction for cash contributions to public charities and certain private foundations from 50% to 60% of the donor's adjusted gross income.
  - ***Miscellaneous Deductions Repealed.*** Taxpayers would no longer be allowed deductions for tax preparation expenses, medical expenses, alimony, moving expenses, contributions to medical savings accounts, and expenses attributable to the trade or business of being an employee.
- ***Simplification and Reform of Credits and Exclusions.***
  - ***Child and Dependent Credits.*** The child tax credit would be increased to $1,600 and refundable up to $1,000. Caregivers would also be entitled to additional modest credits. These credits would begin phasing out for income over $230,000 for married individuals filing jointly. The adoption tax credit, which is currently worth up to $13,570 per child, would be repealed.
  - ***Limitation on Exclusion of Gain from the Sale of a Principal Residence.*** The excludability of up to $500,000 of gain on sale of a principal residence would be limited to taxpayers who have used the home as a principal residence for five out of the past eight years, and the exclusion could only be taken once every five years. The exclusion would be phased out by one dollar for every dollar by which the taxpayer's adjusted gross income exceeds $500,000.
- ***Estate and Gift Taxes***
  - ***Doubling of Estate Tax and GST Exemptions.*** The exemption available for the gift tax, the estate tax, and the generation-skipping transfer ("GST") tax would double from $5 million (as adjusted for inflation from 2011) to $10 million (as so adjusted).

- ***Repeal of Estate Tax and GST Tax.*** Effective starting in 2024, the estate tax and the GST tax would be repealed. Even after repeal, basis step-up (marking to market a decedent's assets at death for capital gains tax purposes) would continue to be available with respect to assets acquired from a decedent.
- ***Gift Tax Retained.*** The gift tax would remain in effect in 2024 and later years, with the same $10 million cumulative exemption (as adjusted for inflation from 2011), but with a maximum rate of 35%.