CURTIS INSIGHT

House Tax Bill – November 3, 2017

The House of Representatives released its tax reform bill, the Tax Cuts and Jobs Act of 2017 (the "House Bill"), on November 2. The House Bill retains most of the key features present in the "unified framework" released on September 27, 2017 (the "Framework").

Key provisions include:

Changes to Individual Tax Brackets

The House Bill establishes 5 new tax brackets to replace the 7 existing brackets. Under the new brackets, joint return filers will be taxed at:

- 0% for incomes up to $24,000
- 12% for incomes up to $90,000
- 25% for incomes up to $260,000
- 35% for incomes up to $1 million
- 39% for incomes in excess of $1 million

Standard Deduction and State and Local Taxes

The House Bill doubles the standard deduction to $24,000 for joint filers but eliminates the deduction for state and local income taxes and caps the deduction for state and local property taxes at $10,000/year.

Mortgage Interest Reduction

The House Bill limits the mortgage interest deduction so that interest may only be deducted on the first $500,000 of indebtedness (for joint filers). Mortgage interest on indebtedness incurred prior to November 2, 2017 will remain subject to the $1 million limitation under existing law.

Retirement

The House Bill does not make any substantial changes to 401(k)s and individual retirement plans.

Charitable Deductions

The House Bill increases the annual adjusted gross income limitation on the deductibility of cash contributions to public charities from 50% to 60%

Estate, Gift and Generation Skipping Transfer Taxes

The estate tax and GSTT will be eliminated for decedents dying after December 31, 2023. In the interim, the exemption amount for estates will be increased from $5 million to $10 million.

The gift tax will be retained but the lifetime gift exemption will be increased to $10 million and the top gift tax rate will be reduced to 35%.

The basis step-up will be retained.

Alternative Minimum Tax

The AMT will be repealed for both individuals and corporations.

Corporate Tax Rates

The House bill will lower the top corporate income tax rate to 20%.

Immediate Expensing

The House Bill would permit immediate expensing for most depreciable property acquired by a taxpayer. Real property would not be eligible for immediate expensing.

Immediate expensing would be retroactive for property placed in service on or after September 27, 2017 and will expire after 5 years.

Interest Deductions

The House Bill limits the amount of "business interest" a taxpayer may deduct to the sum of the taxpayer's business interest income plus 30% of the taxpayers adjusted gross income.

Net Operating Losses

Taxpayers will no longer be permitted to carry back net operating losses to prior tax years but they will be permitted to carry forward NOLs indefinitely.

Section 1031

Section 1031 will be amended so that it only applies to provide nonrecognition treatment to like-kind exchanges of real property.

Pass-through Tax Rate

In line with the Framework, the House Bill provides for a 25 % tax rate for qualified income of business owners. Generally, the House Bill would reduce the tax rate to 25 %

for an individual taxpayer's qualified business income except for capital gains, dividends, and interest income which is not properly allocable to a trade or business. Under this rule, subject to certain exceptions, the 25 % rate would apply to all income derived from any passive business activity (generally, any business activity in which the taxpayer does not materially participate). The 25 % rate would also apply to 30 % of the taxpayer's income derived from any other (active) business activity other than professional service activities, and certain taxpayers may elect to increase the amount of the eligible active business income derived from capital-intensive business activities.

The 25 % rate would apply to taxable years beginning after December 31, 2017, and under a transition rule may also apply proportionately (based on the number of days) to any taxable year which includes December 31, 2017.

Carried Interest

The House Bill would retain the current tax treatment of carried interests.

Territorial Tax System

The House Bill aims at eliminating incentives for U.S. companies to accumulate profits offshore. It replaces the current system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when these earnings are distributed with a “territorial system”, i.e. dividend-exemption system. Under the exemption system, 100% of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10 % or more of the foreign corporation would be exempt from U.S. taxation. No foreign tax credit or deduction would be allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend to which the dividend exemption would apply.

Deemed Repatriation

As a transitional step, the House Bill would treat existing offshore earnings as having been deemed repatriated subject to a one-time tax. Offshore earnings invested in illiquid assets would be taxed at a rate of 5% and earnings invested in cash and cash equivalents would be taxed at the rate of 12%. Taxpayers would be allowed to spread out the payments of the tax liability over a period of up to 8 years.

Anti-Base Erosion Provisions

The House Bill contains a number of provisions to prevent erosion of the U.S. tax base. Under current transfer pricing rules, if a foreign subsidiary of the U.S. parent owns assets, undertakes functions, or bears risks in a foreign jurisdiction, that foreign subsidiary may be treated as earning more than a “routine profit”. The adoption of a dividend-exemption system could, on its own exacerbate the problem by allowing profits that have been shifted to low-tax or no-tax jurisdictions to be repatriated with minimal U.S. tax consequences. The House Bill introduces a provision that subjects 50% of a U.S. parent's "foreign high returns" to U.S. tax. "Foreign high returns" are defined as the excess of (i) the U.S. parent's foreign subsidiaries' aggregate net income over (ii) a routine return (7 % plus the Federal short-term rate) on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense. Under the bill the U.S. parent would be taxed on foreign high returns each year, regardless of whether it left those earnings offshore or repatriated the earnings to the United States.

The House Bill also targets multinational enterprises, particularly foreign-parented multinational enterprises, that erode their U.S. tax base by shifting profits to foreign affiliates using current transfer pricing rules. This provides significant tax incentives for U.S. companies to either invert or be acquired by foreign companies. The House Bill introduces a 20% excise tax on certain payments (other than interest) made by a U.S. corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset, unless the related foreign corporation elected to treat the payments as income effectively connected with the conduct of a U.S. trade or business.

Subpart F Modifications

The House Bill modifies the current "Subpart F rules" applicable to controlled foreign corporations ("CFCs"). Under current law, a U.S. parent of a CFC is subject to current U.S. tax on its pro rata share of the CFC's subpart F income, regardless of whether the income is distributed to the U.S. parent. A CFC is defined as a foreign corporation that is more than 50 % owned by one or more U.S. persons, each of which owns at least 10 % of the foreign subsidiary. For these purposes, a U.S. person may be treated as constructively owning stock held by certain related persons, affiliates, and shareholders, but a U.S. corporation generally cannot be treated as constructively owning stock held by its foreign shareholder. Under the House Bill, a U.S. corporation would be treated as constructively owning stock held by its foreign shareholder. Also, under current law, a U.S. parent of a CFC is subject to current U.S. tax on its pro rata share of the CFC's subpart F income, but only if the U.S. parent owns stock in the foreign subsidiary for an uninterrupted period of 30 days or more during the year. Under the House Bill a U.S. parent would be subject to current U.S. tax on the CFC's subpart F income even if the U.S. parent does not own stock in the CFC for an uninterrupted period of 30 days or more during the year.

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