Cooley

Analysis of the Final Tax Reform Bill

December 20, 2017

On December 15, 2017, the conference committee released the final legislative text of HR 1, entitled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" (referred to in this alert as the "Final Bill"), which reconciles differences between the House and Senate versions of the legislation that we **previously covered**.[1] The Final Bill passed the House and Senate on December 19 (and was re-approved by the House today to include minor changes needed to comply with certain Senate budget rules), and is expected to be signed by President Donald Trump in the coming days.

The Final Bill lowers most business and individual tax rates, modernizes US international tax rules, and generally represents the most sweeping reform of the US tax code in more than 30 years. The Final Bill affects how businesses are organized and capitalized, decisions on whether and to what extent businesses should operate in foreign jurisdictions, and myriad other day to day transactions. While nearly all of the Final Bill's provisions will take effect on January 1, 2018, many of the Final Bill's provisions affecting individual taxes are not permanent and are scheduled to sunset after December 31, 2025, unless a future Congress acts to extend those provisions.

Included below is an updated summary of the key changes to current tax law contained in the Final Bill (key takeaways). Following the key takeaways, we also provide a short reference chart comparing current tax law with changes under the Final Bill. In the coming weeks, we will also be sending out separate alerts that focus on certain aspects of tax reform that matter most to our clients, so please stay tuned.

If you have any questions about this alert or tax reform in general, please reach out to any member of the Cooley tax or compensation and benefits practice groups, or any other Cooley attorney whom you normally consult.

Key takeaways

Corporate tax provisions

- **Lower tax rate**: Starting in 2018, corporations will be subject to a flat rate of 21%, replacing current law's graduated rate structure.
  - **Cooley comment:** This new, significantly lower rate may affect a client's decision as to whether to organize their business as a corporation or a "pass-through" vehicle (e.g., an LLC or S corporation).
- **Repeals corporate AMT**: The corporate AMT is repealed. Corporations that previously were subject to the AMT are eligible for a refundable credit (subject to limitations until 2022) against their regular tax liability.
- **Net operating losses**: Starting in 2018, the deduction for net operating losses (NOLs) is limited to 80% of a corporation's income. The Final Bill repeals existing NOL carryback rules. Excess losses may be carried forward indefinitely.
  - **Cooley comment:** Companies that engaged in taxable transactions in 2017 with the expectation that they would be able to carry back losses in future years to offset 2017 tax liability will no longer be able to do so.

- **Deductibility of interest**: The Final Bill limits corporations' deductions for net interest expense to 30% of adjusted taxable income (ATI), a proxy for EBITDA. Starting in 2022, the ATI limitation will be determined without adding back deductions for depreciation, amortization or depletion (i.e., a proxy for EBIT instead of EBITDA). Disallowed amounts can be carried forward indefinitely. Companies with average gross receipts of $25 million or less during a 3-year look-back period are exempt. The Final bill repeals existing "earnings stripping" limitations on interest deductions.
  - *Impact:* These rules may make debt-financed acquisitions such as LBOs less attractive; however, the reduction in the general corporate tax rate may mitigate the impact.
- **Expensing**: 100% of the cost of certain new and used business assets may be immediately expensed if placed in service after September 27, 2017, and before 2023. For assets placed in service after 2023, this "bonus" depreciation percentage will phase down from 80% (in 2023) to 0% (in 2027).
- **Reduction in credit for costs of testing "orphan drugs"**: The Final Bill reduces the 50% business tax credit for clinical testing expenses incurred with respect to "orphan drugs" to 25%.
- **Dividends received deduction**: Starting in 2018, the Final Bill reduces the dividends received deduction from 70% to 50% (in the case of less-than-20%-owned subsidiaries), and from 80% to 65% (in the case of less-than-80%-owned subsidiaries).
- **Domestic production activities deduction**: The Final Bill repeals the deduction under Section 199 for qualified production activities income.
- **Timing rules; deferred revenue**: The Final Bill codifies existing IRS guidance (Rev. Proc. 2004-34) which permits an accrual method taxpayer (e.g., most corporations) to receive a payment in one year, but report it in the next year, if generally consistent with the taxpayer's financial accounting.

Individual tax provisions

- **Lower tax rates**: The Final Bill retains current law's graduated rate structure and seven tax brackets, and temporarily (until 2026) lowers the maximum rate from 39.6% to 37% for income in excess of $500,000 (single taxpayers) or $600,000 (married taxpayers filing joint returns).
- **Deduction for state and local taxes (SALT)**: Starting in 2018, through 2025, a taxpayer may claim an itemized deduction of only up to $10,000 ($5,000 for a married taxpayer filing a separate return) in (i) personal state and local property taxes, and (ii) state and local income taxes (or sales taxes in lieu of income taxes). Current law has no such limitation (although the deduction was limited under other provisions of the Code).
  - **Cooley comment:** Taxpayers who would otherwise claim a SALT deduction in excess of $10,000 in 2018 may consider paying 2017 Q4 estimated taxes and pre-paying 2018 real estate taxes before 12/31/17.
- **Alternative minimum tax**: The Final Bill preserves the individual AMT, which imposes an alternative tax system under which individuals pay the greater of their regular tax and their AMT (the main impact is taxpayers who have high SALT and mortgage interest deductions pay more tax under the AMT). Starting in 2018 through 2025, the Final Bill increases the "exemption amount" and significantly increases the amounts at which the exemption phases out.
- **Capital asset treatment of patents**: The Final Bill eliminates capital gain treatment for the sale of a "self-created" patent (or invention or trade secret). Sale of such assets will now generate ordinary income (similar to current law's treatment of copyrights) to the extent sold by the person who created the patent or who has a transferred basis from the person who created the patent).
  - **Cooley comment:** This provision may change the way in which a taxable sale of a business holding such property is structured (*e.g.*, a sale of such assets by an S corporation may be much less attractive since gain associated with such assets will pass through as ordinary income rather than capital gains to the entity's owners).
- **Mortgage interest**: For mortgages incurred after 12/31/17 but before 1/1/26, taxpayers may deduct interest on up to $750,000 of principal (down from current law's $1 million limit). Starting in 2026, the limit will go back to $1 million principal of acquisition indebtedness. Taxpayers will no longer be permitted to deduct home equity interest until 2026.

- **Miscellaneous itemized deductions**: The Final Bill eliminates the ability to deduct certain miscellaneous deductions (i.e., "Section 212 deductions") currently subject to a floor equal to 2% of adjusted gross income. The proposal is effective starting in 2018, through 2025.
  - *Impact:* Investors in private investment funds will not be able to deduct management fees, even if such fees exceed 2% of the taxpayer's income.

- **Estate tax**: For estates of decedents dying after 12/31/17 and before 1/1/26, the Final Bill doubles the exclusion amount below which the estate tax does not apply to $10 million, indexed to inflation after 2011. The Final Bill retains the 40% tax rate, and does not provide for a scheduled repeal of the estate tax (as the House Bill did). The Final Bill retains the basis step-up heirs receive upon death.

- **Like-kind exchanges**: The Final Bill repeals the "like-kind exchange" rules, which generally exempt from tax the exchange of certain business or investment property for similar property. A limited exception is maintained for non-inventory real estate. The proposal is generally effective to exchanges completed after 12/31/17. However, an exchange that is completed after 12/31/17 may qualify if one leg of the exchange is completed before that date.

Pass-through entity tax provisions (partnerships, LLCs taxable as partnerships, S corporations)

- **"Pass-through" income**: Starting in 2018, individuals may generally deduct up to 20% of qualified business income earned through a pass-through vehicle. The deduction is generally subject to a complicated limitation based on the W-2 wages and capital of the pass-through business. The deduction is available to non-itemizers and expires after 2025.
  - *Exception:* Individuals with taxable income in excess of the threshold amount ($157,500 ($315,000 for joint returns)) plus $50,000 ($100,000 for a joint return) are ineligible to claim the deduction for income from most service partnerships (e.g., law firms, accounting firms, medical practices, etc.).
  - **Cooley comment:** The rules governing this new deduction are extremely complex and the deduction generally will not be available for high income owners of most service partnerships. Owners of operating businesses and certain real estate investments may see a significant benefit.

- **Carried interest**: The Final Bill imposes a three year holding period for eligibility for investment managers to be taxed at long-term capital gains rates on "carried interest" (that is, the share of partnership profits received by an investment manager in an investment fund). Otherwise, carried interest would be taxed as short-term capital gains at a top marginal rate of 37%. The new rules generally should not apply to "profits interests" granted to service providers of LLCs and partnerships who are employed by an entity related to the company granting the profits interest.
  - **Cooley comment:** Venture capital fund managers already have an incentive to hold on to investments for five years to meet the qualified small business stock holding period. The new rules on carried interest also will apply to gains allocated to fund managers in respect of any "cashless contribution" or "management fee waivers" they have used in their funds.
  - *Impact for Massachusetts-based managers*: Massachusetts taxes short-term capital gains at a 12% rate. If Massachusetts applies the 12% rate to carried interest that does not meet the three year holding period, a Massachusetts resident fund manager could be subject to an approximate 50% rate on her carried interest. Other states' tax laws may produce other unfortunate results.

- **Look-through treatment of gain on sale of partnership interests**: For sales on or after November 27, 2017, non-US sellers of interests in pass-through vehicles conducting business in the US must pay tax on the portion of the seller's gain which is deemed to be connected with the vehicle's US trade or business. Starting in 2018, the buyer is required to withhold 10% of the amount realized on the sale or exchange unless the seller certifies it is not a non-US person. The pass-through vehicle is required to withhold from distributions to the buyer to the extent the buyer fails to withhold the correct amount from a non-certifying seller.
  - *Impact:* The provision seeks to overrule a recent Tax Court case, *Grecian Magnesite*, which generally appeared to make it easier for non-US investors to invest in US-based pass-through vehicles. See **related coverage**. Now such investments will remain more complicated to structure.

Executive compensation tax provisions

- **Deferred compensation**: The Final Bill retains Section 409A without change.
  - **Cooley comment:** Both the House and Senate originally proposed, and ultimately dropped, proposals to replace Section 409A with new rules that would have taxed deferred compensation upon service-based vesting, which would have resulted in taxes being due on non-qualified stock options at vesting rather than on exercise.

- **Income tax deferral election for private company equity awards**: Certain eligible employees of qualifying private companies may elect to delay federal income taxes normally arising on an option exercise or RSU settlement for up to 5 years, subject to early acceleration on certain triggering events.
  - **Cooley comment:** This new law seeks to give employees in pre-IPO companies extra time to pay federal income taxes on stock compensation, and is also intended to promote broad-based employee ownership. It remains to be seen how widely used this new deferral election will be in practice, particularly given the eligibility restrictions (summarized in the accompanying chart).

- **Deduction limit on executive compensation paid by public companies**: Public companies will no longer be able to exclude performance-based compensation and commissions from the $1 million deduction limit under Section 162(m). The new rules also expand the scope of covered employees to include the CFO (in addition to the CEO and the next three highest paid officers), and provide for continued application of the deduction limitation for as long as the individual (or any beneficiaries) receives any compensation.
  - *Impact:* Public companies will likely continue to include performance-based compensation as a component of their executive compensation programs, given the focus on pay for performance by shareholders and proxy advisory firms. However, companies will want to consider how they design future compensation arrangements, and will also want to address the impact of this change in upcoming proxy statements.

International tax provisions

The Final Bill makes several fundamental changes to how the United States taxes US-based corporations with operations and activities outside the United States, effectively moving to a modified "territorial" tax system (rather than the "worldwide" tax system that exists under current law). The stated goals of these tax reforms are to encourage businesses to locate operations in the United States and discourage "offshoring" and other transactions which seek to move profit-making operations to a low-tax jurisdiction. Whether those goals will be met is to be determined.

Below is a high-level summary of certain of the most important changes; however the provisions are extremely complex and rely on very technical formulas and testing provisions. Clients who have or who are considering overseas operations should carefully review their existing corporate structure and planned transactions to understand the impact of the new rules.

- **Introduction of "participation exemption" for foreign dividends**: Starting in 2018, a 100% dividends received deduction (DRD) applies to the foreign-source portion of dividends paid by certain foreign corporations to US corporate shareholders owning at least 10% of the foreign corporation. This rule is similar to the "participation exemption" from tax that many other countries include in their tax systems. This provision moves the US corporate tax system away from a "worldwide" tax system and towards a "territorial" system (by excluding from the US tax base certain income earned through foreign subsidiaries). No DRD is allowed for "hybrid dividends" – generally, dividends where the foreign corporation received a deduction (or other tax benefit) with respect to taxes imposed by any foreign country. No foreign tax credit is allowed for any taxes paid with respect to the portion of a dividend that qualifies for the DRD.
  - **Cooley comment:** An example of such a hybrid instrument would be a profit participating loan issued by a Luxembourg financing company that is treated as debt for Luxembourg tax purposes but equity for US federal income tax purposes.
  - **Cooley comment:** The House Bill had proposed repealing a provision (Code Section 956(c)) that taxes US shareholders on the undistributed earnings of certain foreign subsidiaries to the extent reinvested in "United States property" (*e.g.*, debt or

equity interests in US affiliates). The Senate Bill had a similar provision, but only for US corporate shareholders. The Final Bill did not adopt either proposal. The impact of these rules not being repealed is that US borrowers under credit facilities with lenders will generally need to continue to exclude foreign subsidiaries from acting as guarantors of the US borrower's obligations under those facilities.

- **Deemed repatriation of foreign earnings and profits**: A transitional rule imposes a one-time tax on US shareholders of certain foreign corporations. The tax is assessed on the US shareholder's share of the foreign corporation's accumulated foreign earnings that have not previously been taxed. Earnings in the form of cash and cash equivalents will be taxed at a rate of 15.5%; all other earnings will be taxed as 8%. The tax can be paid in installments over 8 years. In light of strategies designed to avoid the impact of this tax, the Treasury is authorized to issue regulations to adjust the amount of accumulated earnings subject to this tax.
- **Minimum tax on passive/mobile undistributed income of CFCs**: Similar to current law's "subpart F" regime, under a new provision, US shareholders of a controlled foreign corporation (a CFC) will be taxed currently on their shares of what the Final Bill refers to as "global intangible low-taxed income" (GILTI).
  Very generally, GILTI is (i) the US shareholder's pro rata share of the CFC's aggregate net income, *minus* (ii) a deemed 10% return on the CFC's aggregate basis in depreciable tangible property. Certain income (e.g., subpart F income) is excluded from the determination of (i) in the above formula.
  - A US corporation with foreign-derived intangible income (FDII) may deduct 37.5% of its FDII and 50% of its GILTI (if any). At a high level, FDII is the portion of a US corporation's intangible income derived from serving non-US markets. Given the Final Bill's reduction of the corporate tax rate, this results in an effective tax rate of 13.125% on FDII and an effective US tax rate on GILTI (with respect to the US corporate shareholder) of 10.5%. These effective rates are set to increase in 2026. Certain US individual shareholders of a CFC will be subject to tax on GILTI at regular individual marginal rates (up to 37%).
  - *Impact*: These rules are intended to discourage US corporations from holding or moving low-basis business assets in low-tax jurisdictions. However, they do not appear to take away the incentive for a US company to move high-basis assets to such a jurisdiction (e.g., factories, equipment, etc.)
- **Base erosion minimum tax**: Applicable corporations will be subject to a new tax equal to their "base erosion minimum tax amount." The formula for determining this tax is complex, but at a high level, is equal to 10%[2] of the US corporation's modified taxable income (modified by adding back deductible payments to related foreign persons), *minus* the US corporation's regular tax liability (where the income base is reduced by deductible payments to related foreign persons, and the tax liability itself is reduced by certain credits).
  - **Cooley comment:** This provision is intended to apply to US corporations that reduce their US tax liability by making deductible payments to related foreign persons (*e.g.*, interest on intercompany loans; royalties to affiliated entities).
  - The base erosion minimum tax generally applies to C corporations with average annual gross receipts of at least $500 million (based on a 3-year look-back period) and a "base erosion percentage" of at least 3%. Very generally, a corporation's base erosion percentage is equal to the deductions from payments made to related foreign persons divided by the aggregate deductions allowable (with some exceptions) to the US corporation for the taxable year. The applicable US corporation and certain related persons will be treated as one person for purposes of this provision.
- **Modification of US shareholder rules for controlled foreign corporations**: Starting in 2018, the definition of "US Shareholder" for purposes of the CFC rules is expanded to include any US person who owns 10% or more of the total value (instead of only voting power) of shares of all classes of stock of a foreign corporation.
  - *Impact:* This seemingly innocuous change may make it more difficult for private equity funds to invest into foreign corporations that they majority own without adverse US tax consequences.

[Comparison of current tax law with changes under the Final Bill]

Notes

1. The short title of a prior version of the Final Bill, "The Tax Cuts and Jobs Act," was changed in order to comply with parliamentary procedures.
2. A 5% rate applies for one year for base erosion payments paid or accrued in taxable years beginning after December 31, 2017. Starting in 2026, the 10% rate will increase to 12.5%.

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