Comprehensive Tax Reform: The House and Senate Proposals at a Glance

November 13, 2017

On November 9, 2017, the Joint Committee on Taxation (the "JCT") released a summary of the Senate's proposal (in the form of a description of the Chairman's Mark of the "Tax Cuts and Jobs Act," referred to in this alert as the "Senate Bill") to reform the tax code. H.R. 1, which is the House of Representative's version of the Tax Cuts and Jobs Act (referred to in this alert as the "House Bill"), had previously been released by the House on November 2 and was finally approved by the House Ways and Means Committee (as amended) for a full vote in the House earlier in the day on November 9.

As of November 13, we do not have the actual legislative text of the Senate Bill, but based on the JCT summary of the Senate Bill, it appears to differ in significant ways from the House Bill.

Both bills taken together provide a roadmap for the most fundamental tax reform that Congress has undertaken in over thirty years. We do not expect a vote on either bill until after Thanksgiving, and it is unclear whether any of the proposed provisions will become law. Nonetheless, we provide this alert to highlight key areas of each bill, which would change current tax law in significant ways for our clients (as well as noting areas in which the bills differ).

This **chart** compares the bills side by side with additional detail.

If you have any questions about this alert or tax reform in general, please reach out to a member of your Cooley tax or compensation and benefits teams.

Key takeaways

Corporate tax provisions

- **Lower tax rates:** Both bills reduce the corporate income tax from 35% to 20%. The Senate Bill delays implementation until 2019; under the House Bill the reduction would take place in 2018.
- **Net operating losses:** Both bills limit the use of net operating losses (NOLs) to 90% of a corporation's income and repeal existing NOL carryback rules. Disallowed losses may be carried forward indefinitely. The House Bill indexes NOL carryforwards to inflation to preserve their value.
- **Dividends received deduction:** Beginning in 2019, the Senate 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).
- **Expensing:** Both bills allow for immediate 100% "expensing" for certain business assets for a limited period of time (for property placed in service prior to 2023).
- **Deductibility of interest:** Both Bills limit corporations' deductions for interest to 30% of "adjustable taxable income" (essentially a proxy for EBIT (House) and EBITDA (Senate)). Disallowed amounts are carried forward to subsequent years. Both bills do not apply to certain small businesses. Both bills repeal the 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.

Partnership tax

- **"Pass-through" income:** Both bills apply a lower income tax rate to business income earned through certain S corporations, partnerships and LLCs. The Senate Bill allows owners of such "pass-through" businesses to deduct 17.4% of their business income from their taxable income. The House Bill imposes a 25% tax rate on pass-through income, but contains a complicated set of rules for determining what income is eligible for the 25% rate.
  - *Exception:* Neither bill appears to allow owners of service partnerships (e.g., law firms, accounting firms, medical practices, etc.) to benefit from the lower pass-through rate; instead, income from their businesses would be subject to the regular tax rates.
- **Carried interest:** The House Bill imposes a three year holding period for eligibility for investment managers to be taxed at long-term capital gains rates on "carried interest" (the share of partnership profits received by an investment manager in an investment fund). The Senate Bill does not address carried interest; however, it is expected to be addressed in a mark-up.
- **Look-through treatment of gain on sale of partnership interests:** The Senate Bill would require non-US sellers of interests in pass-through vehicles conducting business in the US to pay tax on the portion of the seller's gain which is deemed to be connected with the vehicle's US trade or business.
  - *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. Now such investments will remain more complicated to structure.

Compensation and benefits tax provisions

- **Deferred compensation:** The Senate Bill contains a provision (removed from the House Bill on November 9) that would repeal Section 409A beginning in 2018. Under the proposed replacement Section 409B, deferred compensation (other than certain tax-qualified arrangements), including stock options and RSUs, would be taxable once time-based vesting lapses, not upon later payment of the compensation or exercise of the option.
  - *Impact:* If enacted, the new rules would effectively eliminate the ability to defer taxes on the vast majority of incentive compensation arrangements, most notably non-qualified stock options and RSUs. Since this proposal was ultimately removed from the House Bill prior to passage by the House Ways and Means Committee, it may not survive markups by the Senate Finance Committee and/or any reconciliation process.
  - *Comment:* The Senate Bill does not make any changes to the tax code sections governing incentive stock options (ISOs) and employee stock purchase plans (ESPPs) and so ISOs and ESPPs may continue to offer preferential tax treatment.
- **Tax deferral election for "rank and file" private company employees:** The House Bill would permit rank-and-file employees of a private company to elect to delay the income tax event normally arising on an option exercise or RSU settlement for up to 5 years after vesting, subject to certain earlier triggering events.
  - *Comment:* Although not included in the Senate Bill, this concept was incorporated in a separate bill introduced in the Senate in June 2017, and therefore it is possible we may see a similar provision added to the Senate Bill in future markups.
- **Changes to section 162(m):** Both bills contain identical provisions that would eliminate the ability of public companies to exclude performance-based and commission compensation from the $1 million dollar deduction limit under Section 162(m). The proposed new rules also expand the scope of covered employees.
- **Worker classification safe harbor:** The Senate Bill contains an objective safe harbor test to determine independent contractor status, and confirms that a third party provider of an internet or mobile application to facilitate "gig economy" service provider arrangements will not be treated as an employer.

- **Retirement accounts:** The Senate Bill would eliminate catch-up contributions for high-wage employees. The House Bill and Senate Bill also contain various separate technical proposals. Neither bill would make changes to current law regarding the ability to make pre-tax contributions to 401(k) or other tax-qualified retirement plans.

International tax provisions

- **Introduction of deduction for foreign dividends:** Both bills contain a new 100% deduction for dividends received from 10%-owned foreign subsidiaries of US corporations. This rule is similar to the "participation exemption" from tax that many other countries include in their tax system. This provision moves the US corporate tax system away from a "worldwide" tax system and towards a "territorial" system.
- **Deemed repatriation of foreign earnings and profits:** In general, both bills provide that accumulated earnings and profits of foreign subsidiaries of US corporations are required to be deemed repatriated to their US parent and subject to tax beginning in 2018. Both bills allow the tax to be paid over an 8 year period. The tax rates in the House Bill are 14% for offshore cash and 7% for non-cash accumulated earnings. The corresponding rates in the Senate Bill are 10% and 5%.
- **Other international tax changes:** The Senate Bill in particular contains several other changes to the taxation of US multinational groups and their foreign subsidiaries, including a new minimum tax on certain income from intangibles and "passive" or "mobile" income and taxes to prevent "base erosion". The general intent of most of these changes is generally to prevent US companies from manipulating transfer pricing and other complex rules to keep earnings outside the United States free from US tax.
- **Modification of US shareholder rules for controlled foreign corporations:** The "US Shareholder" test is now 10% by vote or value.
    - *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.

Individual tax provisions

- **Lower tax rates:** Both bills lower individual tax rates. The Senate Bill provides a maximum rate of 38.5% that would apply to income in excess of $500,000 for individuals and $1,000,000 for married filers. The House Bill retains the current maximum rate of 39.6% at the same high income levels.
    - *Impact:* Overall the Senate Bill would generally result in lower taxes for higher earners.
- **Deduction for state and local taxes:** Both bills eliminate the deduction for state and local income taxes. The House Bill retains the deduction for property taxes up to a $10,000 cap; the Senate Bill eliminates that deduction. The Senate Bill also makes clear that owners of pass-through businesses generally cannot deduct state and local income taxes imposed on income from those businesses.
- **Alternative minimum tax:** Both bills repeal the AMT.
- **Mortgage interest:** The Senate Bill retains the deduction for mortgage interest. The House Bill limits the deduction for new mortgages of $500,000 or less (down from $1,000,000). Both bills eliminate the deduction for home equity interest.
- **Miscellaneous itemized deductions:** The Senate Bill eliminates the ability to deduct certain miscellaneous deductions currently subject to a 2% floor. The House Bill does not address these.
    - *Impact:* Investors in private funds will not be able to deduct management fees, even if such fees exceed 2% of the taxpayer's income.
- **Estate tax:** Both bills double the exclusion amount below which the estate tax does not apply to $10 million, indexed to inflation after 2011. Both bills retain the 40% tax rate. The House Bill would eliminate the estate tax after 2024. Both bills retain the basis step-up heirs receive upon death (which, in the case of the House Bill, arguably results in a massive windfall to inheritors of large estates).

- **Like-kind exchanges:** Both bills repeal the "like-kind exchange" rules except for real estate.

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