U.S. Tax Reform: The Current State of Play

Key Business Tax Reforms

	House Bill	Senate Bill	Commentary
Corporate Tax Rate	• Maximum rate reduced from 35% to 20% rate beginning in 2018. • Personal service corporations would be subject to flat 25% rate. • Repeals the corporate AMT. • New rates do not sunset.	• Same new rates, but beginning in 2019. Rates do not sunset. • Personal service corporations would generally be subject to a flat 25% rate. • Will not repeal the AMT.	• Lower corporate tax rates are generally expected to boost U.S. business growth. • The Senate Bill preserved the AMT in an effort to obtain Senator Corker's vote, who nevertheless voted against the bill.
Tax Rate on Passthroughs	• Passive owners of partnerships and S corporations would be taxed at a maximum 25% rate. • However, owners actively involved in the business would pay the 25% rate on only 30% of their share of the income from income, with the remaining 70% being taxed at highest marginal rates. • Active owners of capital-intensive businesses may be able to apply the 25% rate to a larger percentage of their income, using a ratio calculated based on a return of capital. • The new rates for passthroughs will not apply to professional services firms (e.g., accounting, law, health, consulting, financial services, and investing or trading in securities), which will continue to be taxed at highest marginal rates.	• An individual could deduct 23% of their share of any "domestic qualified business income" of a passthrough (including REIT dividends). • Like the House Bill, the deduction would not apply to income from professional services, except in the case of individuals whose taxable income would not exceed \$75,000 (\$150,000 for married individuals filing jointly). • Qualified business income would not include investment-related income, other than certain dividends from REITs. • The amount of the deduction generally would be limited to 50% of the taxpayer's pro rata share of domestic wages paid by the business. • W-2 wage limit is phased in for individuals with taxable income exceeding \$500,000 (or \$250,000) amount over the next \$100,000 (or \$50,000) of taxable income.	• Unlike the House Bill, by structuring the benefit as a deduction, the Senate proposal could benefit taxpayers who otherwise would not be subject to a 25% marginal rate. • Certain retired and other passive owners of professional services firms may be eligible for the new 25% rate.
Limitation on Carried Interest	• The House Bill would require a three-year holding period before a carried interest is entitled to preferential capital gains rates. • Could also capture typical profits interests awarded to employees of pass-through businesses.	Same	• The three-year holding period may impact some hedge funds, but generally would not be expected to impact private equity promote structures. • As drafted, the provision may capture other types of profit sharing arrangements, not merely carried interest.

Timing of Income Recognition	Retains current law.	Corporate taxpayers would be required to recognize items of income no later than the taxable year in which such items were taken into account under GAAP or on similar financial statements, to the extent such financial statements are publicly filed or otherwise used non-tax filings, credit purposes, reports to shareholders, etc.	There has been little commentary on this component of the Senate proposal. Given current practices of establishing deferred tax assets and liabilities, created to track book tax differences, it is difficult to anticipate the impact of the proposal.
Immediate Expensing	• The cost of capital expenditures for property (other than real estate) acquired or placed in service after September 27, 2017 and before January 1, 2023, would be fully deductible.	Initially allows for full expensing for all property placed in service after Sept. 27, 2017, but subject to a phase out beginning with property placed in service after Jan. 1. 2023.	As with the reduced corporate tax rates, this benefit provides added incentive for U.S. businesses to make capital expenditures that generate growth.
Limitation on Interest Deduction	• The deduction for net business interest would be effectively capped at 30% of adjusted taxable income. • Disallowed deductions could be carried forward for five years. • Certain real estate firms, public utilities, electric co-ops, and small businesses (with $25 million or less of gross receipts) would be exempt from this limitation.	• The deduction for net business interest would be effectively capped at the sum of 30% of adjusted taxable income, certain business interest income, and certain other items. • The limitation would not apply to real property trades using the alternative depreciation system. • Disallowed business interest can be carried forward indefinitely, and the limitation on interest deduction does not apply to taxpayers with average gross incomes of less than $15 million.	• The limitation on the interest deduction could impact highly leveraged LBO and private equity transactions. • No relief appears to be provided for debt in place before the new legislation takes effect. • The limit on interest deductibility may cause private equity funds to start utilizing preferred equity in lieu of debt. • This change effectively imposes an interest deduction limitation on all taxpayers that is comparable in kind to the limitation formerly imposed only on certain cross-border interest payments among affiliates.
NOLs	• Net operating losses would be deductible only to the extent of 90% of the taxpayer's taxable income (similar to the current AMT rules). • NOLs carried forward indefinitely but not carried back. • Carryforwards increased by an interest factor.	Same, but limits the deduction to 80% of taxable income in taxable years beginning after December 31, 2022.	Increasing NOLs by an interest factor would prevent NOLs from losing their value on a time-value basis.

Executive Compensation	• Repeals exceptions for deducting amounts paid for executive compensation relating to commissions and performance-based compensation. • No deduction for compensation above $1M to public company CEO, CFO and the other top 3 executives. • Once a person qualifies as a covered employee, deduction limit would apply to them so long as the corporation pays them.	• Also repeals exceptions for deducting performance-based compensation. • Same deduction limitation for public companies; proposed change would not apply to remuneration under a contract in effect on November 2, 2017,and which was not subsequently modified, and to which the right of the employee was no longer subject to a substantial risk of forfeiture on or before December 31, 2016. • Like the House Bill, allows qualified employees to elect to defer income attributable to qualified stock transfers.	The original House bill and Senate proposals included provisions that would have caused deferred compensation to be taxed when such amounts vested (as opposed to when paid), and would have required only the passing of a service requirement to be considered vested. Subsequent amendments removed this change.
Business Tax Incentives	Special business tax incentives would be repealed, except for R&D credit, certain renewable energy credits and low income housing.	Reduces fewer business tax incentives than House Bill.	Eliminating these incentives is consistent with the Republican objective of lowering rates while simplifying the Internal Revenue Code.
Real Estate Related Changes	• Maximum rate of tax on REIT dividends would be 25%. • Deferral of gain on like-kind exchanges is now limited to real property. • As discussed above, the limitation on the interest deduction would not apply to certain real estate businesses.	Same proposal for like-kind exchanges.	The withholding tax on REIT dividends to foreign investors, however, remains unchanged.
Dividends Received Deduction	The current dividends received deduction would be reduced: • 80% to 65% for dividends from greater than 20% owned domestic corporations; and • from 70% to 50% for dividends received from other domestic corporations.	Same as the House version of the House Bill.	This change is designed to preserve the current law approach to preventing multiple levels of corporate tax on dividends, while reflecting the newly reduced corporate tax rates.

Key International Changes			
Establishment of Participation Exemption Regime	The House Bill would substantially modify the existing international tax rules for U.S. domestic corporations with what amounts to a territorial regime for income earned through foreign corporate subsidiaries: • Dividends from 10% owned foreign subsidiaries would be exempt from U.S. taxation, under a participation exemption. • However, gain on the sale of a foreign subsidiary does not appear to be exempt from tax (unlike other participation regimes). • A new 10% tax would be imposed on certain high profit foreign subsidiaries. • The Subpart F regime (which requires immediate taxation of certain passive or portfolio income of foreign subsidiaries) would be largely preserved. • The treatment of U.S. corporations that operate through foreign branches would not be changed.	Generally, similar to the House Bill, but with some additional elements: • Treats gain on sale of foreign subsidiary stock as a dividend, and would be exempted under circumstances in which the participation exemption would apply. • Denies a deduction on payments to certain hybrid foreign entities (i.e., entities not subject to tax on receipt of the deductible payment). • Imposes a current tax on a U.S. parent in respect of certain intangible property royalties earned by its foreign subs. With deductions and credits, this tax results in 12.5% tax on such income. • U.S. corporate shareholders would be subject to a minimum tax on so-called "global intangible low-taxed income" earned by a CFC. • Effectively eliminates the U.S. tax on distributing intangible property back to the U.S. • Eliminates the 20% dividend tax rate for dividends from companies that have undergone an inversion. • Includes an interest deduction limit for U.S. multi-nationals. • Expands the definition of U.S. shareholder. • Confirms IRS authority regarding outbound transfers of goodwill and going concern value. • Accumulated deferred foreign income is excluded from the REIT gross income test. • Provides for an election to increase the percentage of domestic taxable income offset by overall domestic loss treated as foreign-source income.	• These changes are generally expected to increase the ability of U.S. multinationals to compete with their foreign counterparts. • Cross-border taxation is complex, and adjusting to the new rules likely will involve a significant compliance effort for U.S. multinationals. • Expanded definition of "U.S. shareholder" will make the subpart F regime (as amended) more widely applicable.
Deemed Repatriation Tax	• The retained earnings of a U.S. corporation's foreign subsidiaries would be subject to an immediate 7% tax (14%, if held in cash or cash equivalents), whether or not actually distributed. • The tax can be offset by foreign tax credits and paid over 8 years in equal installments.	• Deemed repatriation tax rate would be 7.5% (for property other than cash equivalents) and 14.5% (for cash equivalents). • Similar tax credit offset and installment payment rules as under the House Bill.	Many companies have accumulated significant offshore earnings and profits. Although these amounts will now be subject to tax, the amount of tax is significantly less than a repatriation at current rates.

Tax on Outbound Payments to Affiliates	• U.S. corporations would be subject to a 20% tax on payments to a foreign affiliate that are deductible, includible in cost of goods sold, or includible in the basis of a depreciable or amortizable asset. • Tax would not apply if the foreign affiliate elected to treat the payments as effectively connected to a U.S. trade or business or if there is no markup on a payment for services.	• Does not include the 20% excise tax. • Imposes a "base erosion minimum tax" on deductible payments made by certain corporations to their non-U.S. affiliates. • Incorporates anti-abuse rules.	The House and Senate have taken different approaches to base erosion. As a consequence, these rules will likely be an important component of the reconciliation negotiations.
Key Changes to the Taxation of Individuals			
Simplified Rate Structure	• The current seven tax brackets would be replaced with four brackets of 12%, 25%, 35%, and 39.6%. • The current top rate of 39.6% would be preserved for income in excess of $500,000 for individual taxpayers and $1,000,000 for married couples. • The benefit of the 12% rate on the lowest tranche of income will be phased out for taxpayers with income above the threshold of $600,000 for a married individual filing separately; $1,200,000 for joint return; $1,000,000 for any other individual	• Adjusts the existing seven tax brackets; highest marginal rate of 38.5% for income in excess of $500,000 for individual taxpayers and $1,000,000 for married couples. • No phase out of the tax rate on the lowest tranche of income. • All tax breaks for individuals would sunset after Dec. 31, 2025.	• The phase out of the 12% rate on the lowest tranche of income for high income taxpayers in the House Bill would subject that income to a 39.6% tax rate, effectively increasing the marginal rate above 39.6% during the phase out period. • The sunset of the individual tax break provisions in the Senate Bill plan are intended to keep the measures within budget rules by not adding to the deficit beyond the 10th year.
Standard Deductions; Personal Exemptions	• The current standard deduction would be doubled to $12,200 for individuals and $24,400 for married couples, creating a "zero percent" bracket below these amounts. • Personal exemptions would be eliminated.	• The current standard deduction would be increased to $24,000 for married couples and $12,000 for individuals. • Personal exemptions would be eliminated.	This proposal has the potential to significantly increase the number of taxpayers who will pay no income tax.
Itemized Deductions	• Although the current limit on the total amount of itemized deductions for high earners would be repealed, most itemized deductions would be eliminated (e.g., moving expenses, medical expenses, personal casualty losses). • The charitable deduction, however, is preserved	The Senate Bill suspends the limitation on itemized deductions for tax years 2018-2025. All miscellaneous itemized deductions (such as investment expenses) would be eliminated.	Eliminating most itemized deductions, and imposing limitations on the remaining deductions has the effect of a tax increase on higher income taxpayers who are generally more likely to have expenses in excess of the standard deduction.

State and Local Tax Deduction	• The House Bill places a cap on the deduction for state and local property taxes at $10,000 ($5,000 for a married taxpayer filing separately). • The deduction for state and local income taxes is suspended.	Same as the bill passed by the House, and also suspends the election to deduct state and local sales taxes in lieu of state and local income taxes.	This change is expected to impact taxpayers in high tax states.
Home Mortgage Interest Deduction	• The House Bill reduces the mortgage interest deduction limit to $500,000 for debt incurred after Nov. 2, 2017. • Only applies to a taxpayer's principal residence. • The deduction is grandfathered for existing mortgages.	• Preserves the home mortgage interest deduction for mortgages up to $1,000,000 ($500,000 for a married person filing a separate return). • No deduction for home equity lines of credit.	This change is expected to primarily impact wealthy taxpayers and taxpayers living in areas with expensive housing markets.
Charitable Contributions	The House Bill preserves the charitable deduction.	Same as the House Bill.	With the increase of the itemized deduction, it is expected that the number of charitable deductions will decrease, despite both the House and Senate bills preserving the deduction.
Exclusion for Gain on Sale of Home	• The current law exclusion for gain on the sale of a principal residence would be permitted only if the taxpayer owned and used the residence for five of the previous eight years. • The exclusion would be phased out by one dollar for every dollar by which the taxpayer's adjusted gross income exceeds $250,000 ($500,000 for joint filers).	Same, but the Senate Bill proposal would not phase out the exclusion.	The outcome of this change is expected to disproportionately impact higher income taxpayers.
AMT Repeal	The House Bill repeals the AMT.	Retains AMT, and for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the bill increases the AMT exemption amounts and phase out of exemption amounts.	• Repealing the AMT should offer tax relief to middle-income taxpayers who have increasingly been subject to the AMT, due to the fact that the AMT is not adjusted for inflation. • The Senate Bill preserved the AMT in order to obtain Senator Corker's vote, who nevertheless voted against the bill.
Repeal of Obamacare Mandate	Silent	Repeals the Obamacare individual mandate penalty.	Likely to have the effect of driving up premiums, thereby offsetting some of the tax benefits otherwise achieved.
First in, First Out Sale of Stock	Silent	• Requires that a stockholder selling a portion of shares in the same company must sell its oldest shares first. • Regulated investment companies are exempt.	Shareholders holding multiple blocks of shares in the same company will be limited in their ability to sell shares held at a loss while deferring tax on shares held at a gain.

Key Changes to the Estate, Gift and Generation Skipping Transfer Taxes	• Estate, gift and generation skipping transfer tax exclusion would be increased to $10,000,000, with inflation, for gifts made after 2017. • Repeals the estate and generation skipping transfer tax effective for decedents dying after 2024. • Lowers the gift tax rate from 40% to 35% for gifts made after 2024.	• Same as the House Bill, but would go back to $5,000,000 for 2026 and later. • Does not repeal the estate and generation skipping transfer tax. • Does not lower the gift tax rate.	The increased exclusion will create additional wealth transfer planning opportunities.