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

Key Business Tax Reforms

	Tax Cuts and Jobs Act	Senate Chairman's Mark	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. • Also repeals corporate AMT.	Lower corporate tax rates are generally expected to boost U.S. business growth.
Tax Rate on Passthroughs	• Passive owners of partnerships and S corporations would be taxed at a 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, financial services, and investing or trading in securities), which will continue to be taxed at highest marginal rates.	• An individual could deduct 17.4% of their share of any "domestic qualified business income" of a passthrough. • Like the Tax Cuts and Jobs Act, 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. • Further, although unclear, it appears the amount of the deduction generally would be limited to 50% of the domestic wages paid to the taxpayer. • 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 Tax Cuts and Jobs Act, 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 Tax Cuts and Jobs Act would require a three-year holding period before a carried interest is entitled to preferential capital gains rates.	Like the Tax Cuts and Jobs Act, imposes a three-year holding period requirement for qualification as long-term capital gain for interests received in connection with the performance of services.	The three-year holding period may impact some hedge funds, but generally would not be expected to impact private equity promote structures.
Timing of Income Recognition	Retains current law.	Corporate taxpayers would be required to recognize item of income no later than the taxable year in which such item were taken into account under GAAP or on similar financial statements.	There has been little commentary of 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.	Same	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.	Same, except 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.
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 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 Tax Cuts and Jobs Act, 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.
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 Tax Cuts and Jobs Act.	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, but adds a new requirement for corporate taxpayers that pay dividends to shareholders – requires them to report the total amount of dividends paid during the taxable year and the first 2 ½ months of the succeeding year, beginning in 2019.	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			
Repeal of Worldwide Taxation	The Tax Cuts and Job Act 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 Tax Cuts and Jobs Act, but with some additional elements: • Participation exemption rules would apply to all U.S. shareholders, not just corporations. • 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 IP royalties earned by its foreign subs. With deductions and credits, this tax results in 12.5% tax on such income. • Imposes a minimum tax on so-called "global intangible low-taxed income". • Eliminates the U.S. tax on distributing IP 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.	• 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 5% (for property other than cash equivalents) and 10% (for cash equivalents). • Similar tax credit offset and installment payment rules as under the Tax Cuts and Jobs Act.	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. • But see above rules aimed at limiting base erosion.	The House and Senate have taken different approaches to base erosion. As a consequence, these rules 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 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 Tax Cuts and Jobs Act 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 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 remaining itemized deductions would be modified:
	  • No deduction for state and local income taxes or sales taxes;
	  • Deduction for property taxes permitted only up to $10,000;
	  • The charitable deduction would generally be preserved;
	  • The deduction for mortgage interest deduction would be grandfathered for existing mortgages.
	  • For new homes, the deduction would be preserved for mortgages up to $500,000.
		The Senate proposal is similar to the Tax Cuts and Job Acts, with the following key differences:
		• All miscellaneous itemized deductions (such as investment expenses) would be eliminated;
		• All state and local tax deductions eliminated (unless arising from a trade or business);
		• 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.
			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.

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 proposal would not phase out the exclusion.	The outcome of this change is expected to disproportionately impact higher income taxpayers.
AMT Repeal	The Tax Cuts and Jobs Act repeals the AMT.	Same, but the AMT will be reinstated after Dec. 31, 2025.	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.
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 Tax Cuts and Jobs Act, 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.