HIGHLIGHTS OF H.R. 1, THE TAX CUTS AND JOBS ACT (NOVEMBER 2, 2017)

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The House Ways and Means Committee Chair, Kevin Brady, R-Texas, introduced H.R. 1, The Tax Cuts and Jobs Act, on November 2, 2017 (the "GOP Bill"). The GOP Bill is designed to provide tax cuts to businesses and individuals and to make the return filing process simpler and easier for most Americans. A centerpiece of the bill is the reduction in the maximum corporate income tax rate from 35% to a flat 20% rate. Some critics suggest that the flat 20% rate both over the short and long term will increase the deficit by much more than the budget ceiling for the tax bill, which stands at $1.5 trillion. Perhaps that rate will increase as the legislation moves through Congress. Still there is hope that a permanent corporate tax rate can be set at 20% to increase the competitiveness of U.S. based corporations and help stem the tide of outbound inversions, earnings stripping maneuvers, and other base erosion efforts on the part of U.S. and multinational corporations.

Representative Brady stated that the GOP Bill is estimated to cost $1.51 trillion over a decade. Lawmakers must keep the cost of the bill to $1.5 trillion if they want to pass it along party lines and avoid a filibuster by Democrats under the budget reconciliation procedures in the Senate. Concern for going beyond the budget ceiling has prompted a host of changes on the corporate and individual proposals, including a new twist that would limit the mortgage interest deduction by capping it at $500,000. There may be further "cutting here" and "adding there" as the bill is debated by the House and then handed off to the Senate.

The highlights of the GOP Bill are summarized below, including important changes in the international taxation of U.S. companies with respect to 10% or more owned foreign subsidiaries.

CHANGE IN INDIVIDUAL TAX RATES

The newly released GOP plan establishes three tax brackets, 12%, 25%, and 35%. However, as somewhat of a surprise, the top rate of 39.6% was kept for the highest-income earners, which presumably would be set for individual annual taxable income in excess of $1,000,000. If state and local taxes are not deductible against the 39.6% rate, as in the GOP Bill, there will be an outcry from blue state high-income earners including, among others, physicians, investment managers, architects, lawyers, accountants, and other professionals.

The GOP talking point for the reductions in individual income tax rates is that the GOP Bill will provide needed tax breaks for lower and middle-income Americans.

OTHER INDIVIDUAL CHANGES

The GOP Bill will also do the following:

1. Increase the standard deduction. From $6,350 to $12,000 for individuals and from $12,700 to $24,000 for married couples.

2. Eliminate special-interest deductions that make filing tax returns more complex, the so-called "postcard return" proposal, where there will be less itemized deduction returns filed due to the increased standard deduction and other reforms.

3. Establish a new family credit and expands the child tax credit from $1,000 to $1,600 and provides a credit of $300 for each parent and non-child dependent to help all families.

4. Preserve the child and dependent care tax credit.

5. Create incentives for families to save for and better afford college tuition and other educational expenses.

6. Continue the deduction for charitable contributions with some modification.

7. Preserve the deduction for home mortgage interest expense and maintains the home interest deduction ceiling on newly purchased homes up to $500,000. This is going to be controversial as the GOP Bill is debated in Congress.

8. Allow deductions for state and local property taxes (but not income tax) of up to $10,000. This would adversely affect taxpayers in high property tax states such as New Jersey, New York and California.

9. Retain existing retirement plan savings options such as IRAs and section 401(k) plans.

10. Repeal the alternative minimum tax for both individuals and corporations but reduces the use of net operating loss carryovers to the AMT rule of 90% of base income.

11. Phase out the Federal estate tax, doubling the existing $5.5M exemption per person to $11M for lifetime and testamentary transfers and repealing the estate tax in six years. The phase-out presumably would also apply to the generation skipping transfer tax but this is presently uncertain. The gift tax presumably will be retained as a guard against tax avoidance/evasion strategies. There will be a fair amount of marital formula trusts and wills that will be in need of immediate revision if and when this provision is enacted into law.

MORE NOTEWORTHY PROVISIONS RETAINED OR CHANGED

The GOP Bill also:

1. Retains the like-kind exchange rules for real property (but not for personal property) under section 1031 that was rumored previously to have been on the chopping block. What about section 1033 for involuntary conversions? Presumably unaffected.

2. Cuts back the exclusion on gain from sale of principal residence. While the GOP Bill retains the current exclusion, $500,000 for married filers and $250,000 for others, the benefit would phase out for high income taxpayers, by reducing the exclusion once adjusted gross income reaches $500,000 for married couples and $250,000 for others. As a further change, to qualify for the exclusion the taxpayers must have used the home as their principal residence for five of the prior eight years. Current law requires the taxpayer to have lived there for two of the prior five years.

3. Repeals itemized deduction for medical expenses which may adversely affect many families incurring large medical expenses.

4. Repeals the tax credit for adoption.

5. Repeals the deduction for student loan interest. This change would adversely affect students with high loans to afford the ramped up cost of secondary education.

6. Maintains the deductibility of charitable contributions. They still will not to be treated as "above-the-line" expenditures as some commentators had suggested.

MORE PROVISIONS AFFECTING BUSINESSES

1. Immediate expensing for the full cost of new equipment. Presumably depreciation on real property improvements will be retained under current rules but perhaps with shorter cost recovery periods.

2. Pass-through owners of "Main Street" businesses will not be taxed at a rate greater than 25% on a portion of their ordinary business income. This 25% maximum rate of income tax rule on owners of pass-through entities will not apply to personal service partnerships or sole proprietorships. Competition between the corporate tax rate world of 20% and the pass-through business world of 25% was indeed a compromise. Owners or shareholders receiving net income from active business activity may elect to apply a capital percentage of 30% to the net business income to determine their business income eligible for the 25% rate. The applicable percentage for professional service organizations is 0%, which results in high-income professionals still being subject to a Federal income tax rate of 39.6% or 35%.

3. Executive compensation changes. Covered employees, such as the CEO of a publicly held corporation, subject their employers to a deduction limitation for compensation or other remuneration paid to $1,000,000 under section 162(m). There have been exceptions for performance-based compensation awards, including stock options, and commissions. The GOP Bill eliminates the commission and performance-based compensation exceptions.

4. Low-income housing credit deals are still available. With a 39.6% highest marginal income tax bracket and no deductibility of state and local taxes, credit deals that are still going to be popular. They also serve important social goals and the need for affordable housing.

5. The research and development tax credit would be maintained, but with revised rules and conditions.

6. Tax-exempt bonds would no longer be available to use to build professional sports stadiums.

7. Private colleges and universities with assets exceeding $100,000 per student would be subject to a new excise tax of 1.4% on their net investment income. This is undoubtedly a carve-out of the UBIT rules, and the provision seems weak on issues of "horizontal equity", i.e., it may not apply to other section 501(c)(3) entities.

8. The allowance of deductible entertainment expenses would be tightened, but the current rules for business meals would be retained.

9. Global minimum tax for multinational corporations. The bill proposes to have a global minimum tax of 10% to income that American companies earn anywhere in the world. A sort of universal CFC type rule which knocks through the same-country and manufacturing exceptions. Stay tuned for what happens to the global tax of 10%, which is only half of the Trump desired 20% flat rate so there is still incentive to go offshore (at least that would be the initial reaction). The participation exemption, as discussed below, may have an uncertain limit or boundary.

10. Repatriation of foreign earnings in cash or cash equivalent would face a one-time 12% tax, while noncash assets would be taxed at 5%, payable for a period of up to 8 years if the taxpayer so elects.

REACTION OF HOUSE WAYS AND MEANS DEMOCRATS

The other side of the aisle may not be pleased with the non-deductibility of state and local tax rule, which is bound to lose even Republican votes, especially blue state Republicans. Democrats may contend that the tax cuts are too "rich" and increase the deficit too much. Still there is that 39.6% maximum income tax bracket. The international tax rules will be examined closely for avoidance techniques as well. The budget reconciliation process of 51 votes in the Senate is the driver for getting legislation now or shortly into the next session of Congress.

A MORE IN-DEPTH LOOK AT H.R. 1, THE TAX CUTS AND JOBS ACT

The Majority Tax Staff of the House Ways and Means Committee issued a Section-by-Section Summary of the GOP Bill and also included technical language that would amend, delete, or modify the Internal Revenue Code. Some of the more noteworthy explanations and comments set forth in the Majority Tax Staff summary are examined in more detail below.

GOP Bill, Section 1004. Maximum Rate on Business Income of Individuals. Under the proposed new rates of tax on pass-through business entities, a portion of net income distributed by a pass-through entity to an owner or shareholder may be treated as "business income" subject to a maximum rate of 25%, rather than treated as ordinary income. The remaining portion of net business income would be treated as compensation and taxable at ordinary rates. Each owner or shareholder would separately determine his or her proportion of business income which for this purpose would include income derived from a passive business activity. Owners or shareholders receiving net income from active business activity (including wages) would determine their business income by reference to their "capital percentage" of the net income from such activities. Under the proposed legislation, owners generally could elect to apply a capital percentage of 30% to the net business income derived from active business activities in determining their business income eligible for the 25% rate. The balance would be subject to the regular and possibly significantly higher rates.

Alternatively, owners could elect to apply a facts and circumstances formula to determine a capital percentage greater than 30%.

Income already subject to preferential rates, such as net capital gains and qualified dividend income, is excluded from the determination of a business owner's capital percentage. Other investment income would be subject to ordinary rates such as short term capital gains, dividends, and foreign currency gains and hedges unrelated to the business. As mentioned above, the default capital percentage for certain personal services businesses such as law, accounting, consulting, engineering, financial services, or the performing arts would be 0%. Therefore a taxpayer that actively participates in such a business would, in general, not be eligible for the 25% rate on business income with respect to such personal services. But the rate could apply to such personal services businesses with respect to those businesses' capital investments.

GOP Bill, Section 1203. Reforms to Discharge of Certain Student Loan Indebtedness. In general, any cancellation of indebtedness income is taxable unless subject to applicable exclusion under section 108. This includes forgiveness of student loans. Under the GOP Bill, income resulting from the discharge of student debt on account of death or total disability of the student would be excluded from gross income.

GOP Bill, Section 1301. Repeal of Overall Limitation on Itemized Deductions. Under current law otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount, but this limitation (referred to as the "Pease limitation") does not reduce itemized deductions by more than 80%. Under the bill, the 3% overall limitation would be repealed.

GOP Bill, Section 1303. Repeal of Deduction for Certain Taxes Not Incurred in a Trade or Business. Under present law, an individual may claim an itemized deduction for state and local income and property taxes paid. In lieu of the itemized deduction for state and local income taxes, individuals may claim an itemized deduction for state and local sales taxes. Under the bill, individuals would not be allowed an itemized deduction for state and local income or sales taxes, but would be entitled to a deduction for state and local income or sales taxes paid or accrued in carrying on a trade or business or producing income. Individuals would still be allowed to claim an itemized deduction for real property taxes up to $10,000. As mentioned, the GOP believes this change is necessary to "eliminate a tax benefit that effectively subsidizes higher State and local taxes and increased spending at the State and local level."

GOP Bill, Section 1306. Charitable Contributions. Under the GOP bill several changes would be made to section 170. First, the 50% adjusted gross income limitation for cash contributions to public charities and private operating foundations would increase to 60% with retention of the 5- year carryover period. Certain other changes with respect to college athletic seating event rights and recordkeeping requirements are also contained in the bill.

GOP Bill, Sections 1307-1312. Elimination of Various Miscellaneous Itemized Deductions and Other Deductions.

a. Repeal of tax preparation expenses as an itemized deduction.

b. Repeal of eligible medical expenses as an itemized deduction.

c. Repeal of an alimony payments as an "above-the-line deduction, but effective only for any divorce decree or separation agreement executed after 2017 and to any modification after 2017.

d. Repeal of deduction for moving expenses incurred in connection with starting a new job, i.e., one which is at least 50 miles farther from the former residence than the former place or work, etc.

e. Termination of deduction and exclusions for contributions to medical savings account. Existing Archer MSA balances may continue to be rolled over on a tax-free basis to a health savings account (HAS).

f. Denial of deduction for expenses attributable to the trade or business of being an employee. The rationale for this "tough love" type proposal is that the increased standard deduction and lower overall tax rates would simplify the tax laws and recordkeeping requirements for taxpayers who currently claim deductions for employee business expenses.

GOP Bill, Sections 1601-1602. Increase in Credit against Estate, Gift and Generation-Skipping Transfer Tax; Repeal of Estate and Generation-Skipping Transfer Taxes. Under the GOP Bill, the exclusion of the estate and GST taxes would be increased to $10M, indexed for inflation for years after 2017. Beginning after 2023, the estate and GST taxes would be repealed while maintaining a beneficiary's stepped-up basis in estate property. The gift tax top rate is to be reduced from 40% to 35% and the basis exclusion amount of $10M (lifetime) and annual exclusion of $14,000, indexed for inflation.

GOP Bill, Section 2001. Repeal of the Alternative Minimum Tax. For individuals, estates, and trusts, the AMT is imposed on alternative minimum taxable income at either a 28% rate or 26% rate if the resulting tax is greater than the regular tax for that year. There is an exemption amount that shelters up to $84,500 for joint filers for 2017. The corporate AMT rate is 20% with a $40,000 exemption, which phases out as income level increases as is true with the individual AMT. Under the GOP Bill, the AMT would be repealed. If a taxpayer has an AMT credit carryforward, the taxpayer would be allowed to claim a refund of up to 50% of the remaining credits under a set of applicable rules.

GOP Bill, Section 3001. Reduction in Corporate Tax Rate. As mentioned previously, the corporate tax rate under the GOP Bill, if enacted into law, would be a flat 20% beginning in 2018 and for personal services corporations would be subject to a flat 25% corporate tax rate.

GOP Bill, Sections 3101 and 3201. Increased Expensing. Taxpayers would be able to immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. The "original use" with the taxpayer requirement would no longer apply, only "first use" with the taxpayer. Qualified property would not include any property used by a regulated public utility company or any property used in a real property trade or business. The small business expensing limitation would be increased to $5M and the phase-out amount at $20M.

GOP Bill, Section 3202. Small Business Accounting Reform. The current limitations on the use of the cash method at $5M in gross receipts for corporations and partnerships with a corporate partner would be increased to $25M and the requirement that such businesses meet the requirement for all prior years would be repealed. The increased $25M threshold would extend to farm corporations and farm partnership with a corporate partner as well as family farm corporations. The average gross receipts test would be indexed for inflation. This rule would apply even if the business has inventories. In addition, businesses with average gross receipts of $25M or less would be exempt from the UNICAP rules. There would be a parallel increase in allowing businesses to use the completed-contract method instead of the percentage-of-completion method.

GOP Bill, Section 3203. Small Business Exception on Deduction on Deduction of Business Interest. Under current law, business interest is deductible in computing taxable income in the year paid or accrued. Only businesses with average gross receipts of $25M or less would be exempt from the interest limitation rules in the GOP Bill, section 3301 (see below

GOP Bill, Section 3301. Disallowance of Business Interest Deduction. Under the GOP Bill, all business entities would not be allowed to deduct net interest expense in excess of 30% of the business's adjusted taxable income. The net interest expense disallowance would be determined at the tax filing or reporting entity and not at the owner or partner level. Any interest amounts disallowed under section 3301 would be carried forward for five years and would be a tax attribute of the owners. Special rules would apply to allow a pass-through entity's unused interest limitation for the taxpayer year to be used by the pass-through entity's owners. Under section 3204, as discussed, there would be an exemption from these rules for businesses with average gross receipts of $25M or less. The provision would not apply to certain public utilities and real property trades or businesses. Also section 163(j) of the present law would be repealed (so called interest-stripping rules applicable to corporations). The stated rationale for the dramatic change in this area is that for a C corporation, the after-tax effect of debt financing is more favorable, in general, than equity financing due solely to the tax law. Moreover, interest deductions may unreasonably depress the profitability of a business for tax reporting purposes.

GOP Bill, Section 3302. Modification of the Net Operating Loss Deduction. Under the GOP Bill, taxpayers would be required to apply the current AMT rule that an NOL carryover or carryback will only be allowed to the extent of 90% of the taxpayer's taxable income. The provision would generally eliminate all loss carrybacks subject to a special one-year carryback for small businesses and farms in the case of certain casualty and disaster losses.

GOP Bill, Section 3303. Like-Kind Exchanges Only of Real Property. The like-kind exchange rule in section 1031 will continue, but only for exchanges of interest in real property and not to exchanges of tangible personal property that would result in recapture of prior years' expensing.

GOP Bill, Section 3304. Contributions to Capital as Taxable Income. Think about this change for a while and understand that it is only in proposed form. Section 118 and Sections 721 and 351 would be overridden. Gross income of a corporation would include contributions to capital based on the amount of money and fair market value of property contributed exceeds the fair market value of any stock that is issued in the exchange. Similar rules would apply to partnerships. This rule is obviously going to be extremely controversial and it is estimated it will raise $7.4 billion over the 10-year scoring period.

GOP Bill, Section 3311. Self-Created Property as Non-Capital Assets. Under current law, a self-created invention, model, or design, including one that is patented, qualifies as a capital asset. However, self-created copyrights, literary, musical, or artistic works, as well as books or memoranda, are non-capital assets. The bill would make all of such assets non-capital assets and would eliminate the election to treat musical compositions and copyrights in musical works as capital assets. A special rule with respect to transfers of patent rights as generating long-term capital gain is scheduled for repeal.

GOP Bill, Section 3313. Repeal of Technical Termination Rule for Partnerships. Under section 708(b) a partnership is terminated where: (i) no part of any business, financial operations, or venture of the partnership continues to be carried on by any of its partners, or (ii) within a 12 month period there is a sale or exchange of 50% or more of the total interests in partnership capital and profits (the "technical termination rule"). Under the GOP Bill, the technical termination rule will be repealed and the partnership will be treated as having continued, therefore eliminating the need for new partnership elections to be required or allowed, as well as the filing of short period returns.

GOP Bill Sections 3401-3406. Overview of Reform of Business Credits. The GOP Bill would change certain business tax and energy tax credit provisions as follows:

a. Clinical testing for certain drugs, etc. The current credit of 50% of qualified clinical testing expenses for certain drugs would be repealed.

b. Employer-provided child care credit. The credit for employer-provided child care would be repealed.

c. Rehabilitation credit. Under current law a taxpayer may claim a credit for expenses to rehabilitate old and/or historic buildings. A 20% credit is allowed for qualified rehabilitation expenditures with respect to a certified historic structure, while a 10% credit is allowed for qualified rehabilitation expenses. The bill would repeal the rehabilitation credit subject to a 24 month phase-out period.

d. Work opportunity tax credit. Repealed.

e. Deduction for certain unused business credits. Under current law, a taxpayer may carry unused business credits back one year and forward 20 years. This provision would be repealed.

f. New markets tax credit. Under current law, a qualifying taxpayer may claim a 5% credit per year for the first 3 years of investments in, and a 6% credit per year for the next four years of investments in a qualified community development entity designed to serve low-income communities and low-income individuals. The bill would provide that no additional new markets tax credits would be allocated after 2017 (passage).

GOP Bill, Section 3801. Nonqualified Deferred Compensation. The government, in particular the IRS, has long struggled with the deferred compensation strategies used by tax advisors to defer income to highly compensated employees. This struggle was present for years before the enactment of section 409A, but section 409A has been with us for some time now and has created an extraordinary amount of complexity and uncertainty. The Majority Staff Summary acknowledges that as to non-qualified deferred compensation, an employee is not required to include such amount in gross income until the year received and similarly the employer is not permitted to claim a corresponding deduction until the year paid. If the qualified deferred compensation is put into a trust protected from the employer's creditors, the compensation is immediately taxable as soon as the deferred compensation is not subject to a substantial risk of forfeiture. There are other special rules with respect to deferred compensation paid by governmental or tax-exempt organizations. Under the GOP Bill, an employee would be taxed on compensation as soon as there is no substantial risk of forfeiture, i.e., the compensation is not subject to the rendering of substantial future services. The current law, including section 409A, would continue to apply to non-qualified deferred compensation arrangements until the last year beginning before 2026. The rationale for the new rule is simplicity.

GOP Bill, Section 3802. Modification of Limitation of Excessive Employee Compensation. Under section 162(m), compensation paid or accrued with respect to a "covered employee" of a publicly traded corporation is limited to $1M a year. The definition of compensation is quite broad. A covered employee is the chief executive officer and the next four highest compensated officers. There are exceptions from this limitation such as performance-based remuneration, including stock options, commissions, and contributions to a qualified retirement plan. Under the GOP Bill, the exceptions to the $1M deduction limitation for commissions and performance-based compensation would be repealed. The definition of "covered employee" would also be revised.

GOP Bill, Section 3803. Excise Tax on Excess Tax-Exempt Organization Executive Compensation. The bill would subject a tax-exempt organization to a 20% excise tax on compensation in excess of $1M paid to any of its five highest paid employees for the tax year. The excise tax would apply to all remuneration paid except for payments to a qualified retirement plan and payments excludable from the executive's gross income.

TAXATION OF U.S. CORPORATIONS WITH RESPECT TO FOREIGN SUBSIDIARIES UNDER H.R. 1, THE TAX CUTS AND JOBS ACT

OVERVIEW

As promised from various talks and presentations leading up to the introduction of H.R. 1, as well as from the recent Republican Unified Framework for Tax Reform, released September 27, 2017, the GOP

Bill introduces major reforms to the international taxation of U.S. businesses, particularly U.S. corporations owning 10% or more of the stock of a foreign corporation. The changes are wide-sweeping and perhaps controversial and mark a paradigm shift in moving the taxation of U.S. corporations from a worldwide income system, with allowance for claiming deemed foreign tax credits on dividends received from such foreign corporations, to a territorial-based, participation exemption system used by many foreign countries.

Observers have long noted the lack of a level playing field for U.S. companies doing business overseas. While this perceived lack of competitiveness has inspired inversions and base erosion strategies, the alleged source of this lock-out of overseas profits is the worldwide system of taxation used in the United States. Proponents for a territorial based system of corporation taxation have long held the view that the United States taxes foreign earned income of U.S. companies in a manner which is inefficient and complex and which results in a competitive disadvantage as compared with companies resident and doing business in other OECD countries. In contrast to a territorial system of taxation, the worldwide system used in the United States allows for the deferral of U.S. tax on much foreign earned income, e.g., non-Subpart F income of a controlled foreign corporation or simply income of a non-controlled foreign based company, which allows for a foreign tax credit as repatriating dividends are made against the high U.S. corporate income tax rate.

More specifically, it is argued, U.S. companies have long been placed in a competitive disadvantage by competing with foreign companies that have been taxed for years at significantly lower rates on their domestic source income, have been subject to a territorial instead of a worldwide tax system of taxation, and have been able to avoid tax on repatriated earnings of foreign source dividends not subject to home country taxation under a participation exemption. For U.S. corporations, the high domestic income tax rate, combined with the benefits of tax deferral or potentially little, if any, foreign taxes paid on foreign source income through ownership of a foreign based subsidiary, perhaps with a management base in a tax, have resulted in trillions of dollars of non-repatriated profits owned or controlled by U.S. companies.

The Tax Cuts and Jobs Act addresses the competitiveness problem by: (i) reducing the U.S. corporate tax rate to a flat 20%; (ii) allowing foreign accumulated earnings and profits to be repatriated in cash or cash equivalent at a 12% rate, with the repatriation of non-cash assets subject to U.S. corporate income tax at a rate of 5%, payable over up to 8 years if the taxpayer so elects; and (iii) establishing a participation exemption system on foreign earnings with respect to 10% or more owned foreign subsidiaries when such earnings are distributed back to the U.S.

NEW PARTICIPATION EXEMPTION SYSTEM

Under the GOP Bill, a new participation exemption system would replace the long-standing dividend-exemption system. Under the participation exemption system, 100% of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the stock of the foreign corporation would be exempt from U.S. tax. No foreign tax credit or deduction would be allowed for any foreign taxes including withholding taxes that are paid or accrued with respect to any exempt dividend. No deduction for expenses properly allocable to an exempt dividend or stock that gives rise to exempt dividends would be taken into account in determining the corporate shareholders' foreign source income.

The rationale for this dramatic change in the taxation of U.S. corporation doing business overseas is to remove or eliminate the "lock-out" effect under current law, which encourages U.S. companies to avoid repatriating their foreign earnings back into the U.S. and thereby avoid U.S. residual taxation on such earnings, especially where the dividends exceed the foreign corporation's accumulated earnings and profits.

To prevent the new participation exemption system from being employed in an exploitative manner, an anti-base erosion feature is contained in the GOP Bill that would subject to income tax 50% of a U.S. parent corporation's foreign "high returns." For this purpose, "high returns" means the excess of the parent's foreign subsidiaries' aggregate net income over the "routine return" on the foreign subsidiaries' aggregate adjusted basis in depreciable tangible property less interest expense. "Routine return" is 7% plus the federal short-term rate. Foreign "high returns" would be allowed up to 80% of relevant foreign tax credits, which could not be carried forward or back. The actual statutory language is complex.

Other important provisions contained in the GOP Bill make corresponding changes in the rules applicable to basis in stock of a foreign corporation, the foreign tax credit rules, the treatment of deferred foreign income in transitioning to a participation exemption system of taxation, modifications of the Subpart F rules, and base-erosion rules.

SUMMARY OF IMPORTANT PROPOSED INTERNATIONAL TAX RULES CONTAINED IN H.R. 1.

GOP Bill, Section 4001. Deduction for Foreign-Source Portion of Dividends Received by Domestic Corporations from Certain Ten Percent Owned Foreign Corporations. The Subtitle A to the Bill is the "Establishment of Participation Exemption System for Taxation of Foreign Income." This provision would replace the deemed foreign tax credit approach to worldwide taxation of U.S. corporations by replacing such system with a dividend-exemption system. Under the exemption system, 100% of the foreign-source portion of dividends paid by a foreign corporation (FC) to a U.S. corporate shareholder that owns 10% or more of the FC would be exempt from U.S. taxation. No foreign tax credit (FTC) or deduction would be allowed for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend, and no deductions for expenses properly allocable to an exempt dividend (or stock that gives rise to exempt dividends) would be taken into account for purposes of determining the U.S. corporate shareholder's foreign-source income.

GOP Bill, Section 4002. Application of Participation Exemption to Investments in U.S. Property. Generally, a U.S. corporation owning 10% or more of the stock in a FC is not subject to U.S. tax, as mentioned, on the earnings of the foreign subsidiary until the earnings are distributed to the U.S. parent corporation. The foreign subsidiary's undistributed earnings reinvested in U.S. property are subject to income tax in the U.S. for this purpose. "U.S. property" includes tangible property located in the U.S., intangible property used in the U.S., and equity and debt interests issued by U.S. affiliates. Accordingly, a U.S. corporate shareholder cannot avoid U.S. tax on the distribution of earnings from a foreign subsidiary by reinvesting the foreign earnings in U.S. property.

Under the GOP Bill, the imposition of current U.S. tax on U.S. corporate shareholders with respect to untaxed foreign subsidiary earnings reinvested in United States property would be repealed.

GOP Bill, Section 4003. Limitation on Losses with Respect to Specified Ten Percent Owned Foreign Corporations. Under the participation exemption system for taxation of foreign income, a U.S. parent would reduce the basis of its stock in a foreign subsidiary by the amount of any exempt dividends received by the U.S. parent from its foreign subsidiary - but only for purposes of determining the amount of a loss (but not the amount of any gain) on any sale or exchange of the foreign subsidiary stock by its U.S. parent. Where a U.S. corporation transfers substantially all of the assets of a foreign branch to a foreign subsidiary, the U.S. corporation must include in income the amount of post-2017 (year of enactment) losses realized by the branch.

GOP Bill, Section 4004. Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation. U.S. shareholders owning 10% or more of a FC generally will be required to include in income for the FC's last tax year beginning before 2018 (year of enactment), the shareholder's pro rata share of the net post-1986 historical earnings and profits (E&P) of the FC to the extent such E&P has not been previously subject to U.S. tax as of a stated date. The net E&P is determined by taking into account the U.S. shareholder's proportionate share of any E&P deficits of FCs of the U.S. shareholder or members of the U.S. shareholder's affiliated group. The E&P would be characterized as either E&P that has been retained in the form of cash or cash equivalents, or E&P that has been reinvested in the foreign subsidiary's business *(*e.g., property, plant, and equipment). The portion of the E&P comprising cash or cash equivalents would be taxed at a reduced rate of 12%, while any remaining E&P would be taxed at a reduced rate of 5%. Foreign tax credit carryforwards would be fully available, and FTCs resulting from the deemed repatriation would be available in part to reduce the U.S. tax. At the election of the U.S. shareholder, the tax liability would be payable over a period of up to 8 years, in equal annual installments 12.5% of the total tax liability due. If the U.S. shareholder is an S corporation, the E&P purging-type provision would not apply until the S corporation ceases to be an S corporation, substantially all of the assets of the S corporation are sold or liquidated, the S corporation ceases to exist or conduct business, or stock in the S corporation is transferred.

<u>GOP Bill, Section 4101. Repeal of the Section 902 Indirect Foreign Tax Credits; Determination of Section 960 Credit on Current Year Basis</u>. At present, foreign income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until the income is distributed as a dividend is allowed a deduction or credit for the foreign tax paid on the dividend (or a deemed reinvestment in the U.S.) under the deemed payment, gross-up rules under sections 902, 960, and 78. The foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income. Under certain circumstances, the U.S. parent corporation is subject to current U.S. income tax on certain foreign income of its foreign subsidiaries ("subpart F income") even if the income is not repatriated. A U.S. parent corporation generally may claim a credit for foreign taxes paid on the subpart F income. Under the GOP Bill's new participation exemption system, no foreign tax credit or deduction is allowed for foreign taxes (including withholding taxes) paid or accrued with respect to any dividend to which the dividend exemption under section 4001 of the bill would apply. A FTC would be allowed for any subpart F income included in the income of the U.S. shareholder on a current year basis, without regard to pools of foreign earnings kept abroad.

<u>GOP Bill, Section 4102. Source of Income from Sales of Inventory Determined Solely on Basis of Production Activities</u>. For determining the source of income for foreign tax credit purposes, the present law permits up to 50% of the income from the sale of inventory property produced within the U.S. and sold outside the U.S. (or vice versa) to be treated as foreign source income, even though the production activity takes place entirely within the U.S. Under the GOP Bill, income from the sale of inventory produced within and sold outside of the U.S. (or vice versa) would be allocated and apportioned between sources solely on the basis of the production activities as to the inventory.

<u>GOP Bill, Section 4204. Look-Thru Rule for Related Controlled Foreign Corporations Made Permanent</u>. Under present law, a U.S. parent of a foreign subsidiary generally is subject to current U.S. income taxation on dividends, interest, royalties, rents, and other types of passive income earned by the foreign subsidiary, regardless of whether the foreign subsidiary distributes such income to the U.S. parent. However, for tax years of foreign subsidiaries beginning before 2020, and tax years of U.S. shareholders in which or with which such tax years of the foreign subsidiary end, a special "look-through" rule provides that passive income received by one foreign subsidiary from a related foreign subsidiary generally is not includible in the taxable income of the U.S. parent, provided such income was not subject to current U.S. tax or effectively connected with a U.S. trade or business. Under the GOP Bill, the look-through rule would be made permanent as of a stated effective date.

GOP Bill, Sections 4205 and 4206. Modification of Stock Attribution Rules for Determining Status as a Controlled Foreign Corporation (CFC) and Elimination of 30 Day Ownership Provision. A U.S. parent shareholder of a controlled foreign corporation (CFC) is subject to current U.S. income taxation with respect to its pro rata share of the CFC's subpart F income. A foreign subsidiary is a CFC if it 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 GOP Bill, a U.S. corporation would be treated as constructively owning stock held by its foreign shareholder.

Another rule under current law is that the CFC rules apply only if the U.S. parent (shareholder) owns stock in the FC for an uninterrupted period of 30 days or more during the year. Under the GOP 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.

GOP Bill, Section 4301. Current Year Inclusion by U.S. Shareholders with Foreign High Returns. An important base-erosion provision adopted with the participation exemption system is section 4301 of the Bill, which provides that a U.S. parent of one or more foreign subsidiaries would be subject to current U.S. income taxation on 50% of the U.S. parent's foreign high returns. Foreign high returns would be measured as the excess of the U.S. parent's foreign subsidiaries' aggregate net income over 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. Foreign high returns would not include income effectively connected with a U.S. trade or business, subpart F income, insurance, and financing income that meets the requirements for the active finance exemption (AFE) from subpart F income under current law, income from the disposition of commodities produced or extracted by the taxpayer, or certain related-party payments. In similar manner to subpart F income, 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.

GOP Bill, Section 4302. Limitation on Deduction of Interest by Domestic Corporations Which Are Members of an International Financial Reporting Group. While reducing the corporate tax rate under the GOP Bill may reduce the influence of debt, the GOP Bill still provides rules to discourage excessive debt. This provision is designed to prevent multinational companies from generating excessive interest deductions in the United States on debt that is issued to foreign affiliates or that is incurred to produce exempt foreign income in a dividend-exemption system.

Under section 4302, the deductible net interest expense of a U.S. corporation that is a member of an international financial reporting group is limited to the extent the U.S. corporation's share of the group's global net interest expense exceeds 110% of the U.S. corporation's share of the group's global earnings before interest, taxes, depreciation, and amortization (EBITDA). This limitation would apply in addition to the general rules for disallowance of certain interest· expense under section 3301 of the Bill. Taxpayers would be disallowed interest deductions pursuant to whichever provision denies a greater amount of interest deductions. Any disallowed interest expense would be carried forward for up to five tax years, with carryforwards exhausted on a first in, first out basis. For this purpose, an "international financial reporting group" is a group of entities that includes at least one foreign corporation engaged in a trade or business in the United States or at least one domestic corporation and one foreign corporation, prepares consolidated financial statements, and has annual global gross receipts of more than $100M.

GOP Bill, Section 4303. Excise Tax on Certain Payments From Domestic Corporations To Related Foreign Corporations; Election to Treat Such Payments As Effectively Connected Income. Under present law, multinational enterprises, and particularly foreign-parented multinational enterprises, can erode the U.S. tax base by shifting profits to foreign affiliates, based on risk shifting, asset deployment, and functions taking place outside of the United States. The foreign profits of such foreign affiliates generally will avoid U.S. income tax, thus giving foreign companies a significant tax advantage over U.S. companies for sales to U.S. customers and provides significant tax incentives for U.S. companies to either invert or be acquired by foreign companies. Current law therefore affords significant opportunities to multinational companies to erode the U.S. tax base through deductible related-party payments, although these payments frequently relate to globalized supply chains.

Under the GOP Bill, payments (other than interest) by a U.S. corporation to a related FC that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset would be subject to a 20% excise tax, unless the related FC elected to treat the payments as income effectively connected with the conduct of a U.S. trade or business. Consequently, the foreign corporation's net profits (or gross receipts if no election is made) with respect to those payments would be subject to full U.S. tax, eliminating the potential U.S. tax benefit otherwise desired, i.e., reduction in U.S. taxable income.

Exceptions would apply for intercompany services which a U.S. company elects to pay for at cost (i.e., no markup) and certain commodities transactions. To determine the net taxable income that is to be deemed ECI, the foreign corporation's deductions attributable to these payments would be determined by reference to the profit margins reported on the group's consolidated financial statements for the relevant product line. No credit would be allowed for foreign taxes paid with respect to the profits subject to U.S. tax. Further, in the event no election is made, no deduction would be allowed for the U.S. corporation's excise tax liability. The provision would apply only to international financial reporting groups with payments from U.S. corporations to their foreign affiliates totaling at least $100 million annually.

<u>GOP Bill, Section 4502. Limitation on Treaty Benefits for Certain Deductible Payments With Respect to Fixed and Determinable, Annual or Periodical (FDAP) Income.</u> Under the GOP Bill, if a payment of FDAP income is deductible in the United States and the payment is made by an entity that is controlled by a foreign parent to another entity in a tax treaty jurisdiction that is controlled by the same foreign parent, then the statutory 30% withholding tax on such income would not be reduced by any treaty, unless the withholding tax would be reduced by a treaty if the payment were made directly to the foreign parent.

The introduction of H.R. 1 on November 2 was an important first step in the long effort to reform U.S. tax law to enhance business competitiveness and improve the economic outlook for individual taxpayers. A close reading of its provisions reveals a host of issues yet to be plumbed. Differences between Republicans and the Democrats, high-tax states and lower-tax states, business interests, and House and Senate bills on these issues are bound to put the enactment of tax reform legislation on a challenging forward path, with many twists and turns ahead.