November 13, 2017

HWH Tax Alert

2017 TAX REFORM: SENATE PROPOSAL AND AMENDMENTS TO HOUSE BILL

On November 9, 2017, Senate Finance Committee Chair Orrin Hatch (R-UT) released his mark (the "Senate proposal") of H.R. 1, the Tax Cuts and Jobs Act, for consideration by the full Senate Finance Committee ("SFC") beginning on November 13, 2017. On the same day, the House Committee on Ways and Means approved a modified version of the original House bill. The following material highlights certain important differences between the Senate proposal and the House bill, as amended. For more information about the original House bill, see our previously released Highlights of the 2017 House Tax Reform Bill.

Because the Senate proposal did not include legislative text, some of its provisions will be clarified further as the SFC takes action on the bill in the coming week. We will continue to monitor progress on these proposals and intend to provide further information as significant events occur. In the meantime, please reach out to any member of our tax department (contact information below) if you have questions about, or would otherwise like to discuss, how the proposed changes may affect you or your business.

BUSINESS TAXATION

Delayed reduction of corporate tax rate to 20%. Like the House bill, the Senate proposal would provide for a flat 20% corporate income tax rate. However, under the Senate proposal, the reduced rate would not be effective until after 2018.

Special 17.4% deduction for pass-through income. In lieu of the reduced 25% tax rate applicable to certain pass-through and other "qualified" business income under the House bill, the Senate proposal provides for a 17.4% deduction of business income from pass-through entities. As a result, the Senate proposal reduces the maximum marginal rate of tax on most pass-through income to 31.8% and avoids the complexity of the active/passive distinction contained in the House proposal. In addition, unlike the House bill, the Senate proposal would benefit taxpayers regardless of their marginal tax rate. Note that the 17.4% deduction would be phased out with respect to personal services income above $150,000 for married taxpayers filing jointly.

Adoption of territorial taxation. Like the House bill, the Senate proposal (1) adopts a territorial tax system under which U.S. corporations will receive a 100% deduction for dividends of foreign source income from 10% (or more) owned foreign subsidiaries, and (2) imposes a one-time tax on the post-1986 undistributed (and not previously taxed) earnings of 10%-owned foreign subsidiaries in connection with transitioning to the new system. The Senate proposal imposes such tax at a rate of 10% for earnings held in cash (and equivalents) and 5% for reinvested earnings, as compared to 12% for cash and 5% for reinvested earnings under the original House bill and 14% for cash and 7% for reinvested earnings under the amended House bill.

New tax on foreign intangibles income. Under the Senate proposal, U.S. corporations would be subject to current taxation on certain "global intangible low-taxed income" ("GILTI") of their foreign subsidiaries, with foreign tax credits available with respect to such income reduced by 20% and subject to other limitations. In particular, current taxation would apply to the amount by which the foreign corporation's active foreign source income exceeds a 10% return on the adjusted tax basis of its active foreign tangible assets. In addition, U.S. corporations would be entitled to deduct 37.5% of the lesser of their taxable income or certain foreign income attributable to intangibles, generally resulting in an effective tax rate on GILTI of 12.5%.

Excise tax payments to foreign affiliates. Under the amended House bill (but not the Senate proposal), domestic corporations would pay a 20% tax on certain cross-border transactions with related parties unless the foreign counterparties elect to treat such payments as income that is effectively connected with the conduct of a U.S. trade or business.

Enhanced deductibility for capital investments. The Senate proposal provides for a smaller increase than the House bill in the Code section 179 expense limitation, increasing it from $500,000 to $1,000,000 of the cost of qualifying property placed in service during the taxable year, and reducing such maximum expense by the excess of the amount of qualifying property placed in service during a taxable year over $2,500,000.

Reduced dividends received deduction. Unlike the original House bill, each of the Senate proposal and the amended House bill provide that the dividends received deduction applicable to dividends from domestic corporations that are not wholly-owned would be reduced to 65% for 20%-owned corporations and 50% for corporations that are less than 20% owned (in contrast to dividends received deductions of 80% and 70%, respectively, under current law).

Nonqualified deferred compensation. Unlike the amended House bill (which would retain current law applicable to nonqualified deferred compensation), the Senate proposal would treat vesting, rather than payment, of nonqualified deferred compensation as a taxable event.

Net operating loss (NOL) deduction. While both the House bill and Senate proposal would limit deductibility of NOLs to 90% of taxable income, and each generally would eliminate NOL carrybacks and allow carryforwards indefinitely, the Senate proposal would not provide an interest factor to preserve the value of NOLs deducted in the future.

Timing of income inclusion prompted by financial statement recognition. The Senate proposal would require income recognition for tax purposes no later than the year in which it is accounted for on GAAP or similar financial statements. The intended reach of this provision is uncertain given that the Senate proposal did not include legislative text.

TAXATION OF INDIVIDUALS

Changes to individual tax brackets and rates. Unlike the House bill, which would reduce the number of tax brackets for individuals to four (12%, 25%, 35%, and 39.6%), the Senate proposal would modify the current seven brackets, adjusting only the highest marginal rate from 39.6% to 38.5% (applicable to income above $1 million for joint filers).

State and local tax deductions. The Senate proposal would repeal the itemized deduction for state and local taxes completely (other than such taxes incurred in a business or income-producing activity), without the exception contained in the House bill for deducting property taxes of up to $10,000 per year.

Mortgage interest deduction. In contrast to limitations on deductibility of mortgage interest under the House bill (i.e., deductibility limited to interest on only $500,000 of acquisition indebtedness and only if attributable to a principal residence), the Senate proposal would continue the current mortgage interest deduction for interest on acquisition debt. However, similar to the House bill, the deduction for interest on home equity indebtedness would be eliminated under the Senate proposal.

Retention of certain deductions and other tax benefits. The amended House bill restores the adoption tax credit that was repealed by the original House bill. The Senate proposal similarly would retain the adoption tax credit, as well as certain other benefits that would be eliminated under the House bill, including the alimony deduction, the deduction for medical expenses, and the exclusion from income for certain dependent care programs.

Reduction, but no repeal, of the estate tax. Like the House bill, the Senate proposal would double the basic exemption amount for the estate tax. However, the Senate proposal does not provide for eventual repeal of the estate tax in future years.

Treatment of "carried interest." While the amended House bill imposes holding period limitations with respect to applying preferential rates to gains attributable to carried interest, the Senate proposal would not affect the taxation of carried interest.

Contacts

If you have questions regarding the subject matter of this HWH Tax Alert, please feel free to contact Ken Harris (312-662-4620, kharris@hwhlegal.com), Andrea Despotes (312-662-4627, adespotes@hwhlegal.com), Bob Bedore (312-662-4625, rbedore@hwhlegal.com), or Matt Koenders (312-662-4626, mkoenders@hwhlegal.com) directly.

Information

A summary of the Senate proposal prepared by the Joint Committee on Taxation is available here. A summary of amendments to the original House bill are available here.