Hogan Lovells

U.S. Tax reform in final stretch

Significant differences remain between House and Senate versions of bill but Congress is likely to resolve these and send to the president to be signed into law before Christmas

6 December 2017

This past week, on 1 December, the Senate voted 51-49 to advance its version of U.S. tax reform legislation. This sets the stage for a conference committee process to occur over the next two weeks, in which the Senate and House of Representatives (which passed its own version of tax reform on 16 November) resolve the differences between their respective bills and report a conference bill to be voted on one last time by the full House and Senate. Assuming (as we expect) the final House-Senate agreed legislation passes both the House and Senate, it will be sent to the White House for the President's signature and be signed into law before Christmas.

If you have not been paying attention to the U.S. tax reform process, it is time to pay attention now. This bill will make sweeping and significant changes to the U.S. tax code that will affect any business with operations in the U.S. Although many businesses will see significant tax reductions from the legislation, others will see significant tax increases. The consequences for businesses, even those in the same industry, are very much dependent on the profile of the particular business.

The following outlines some of the highlights of and contrasts between the business tax provisions in the House and Senate bills. We also offer our thoughts concerning the significance of the provisions to business taxpayers (U.S. and non-U.S. based), and our view as to the likely outcome of the conference bill that will ultimately be signed into law.

As this bill enters its last stage of drafting, we are happy to discuss with you our expectations for the outcome of the conference for various provisions of the bill, our thoughts as to provisions that are still 'in play,' i.e., subject to further negotiation and drafting over the next two weeks, how this may affect your business going forward, and how you can start planning now in anticipation of changes to come.

Key Highlights – Business Tax Provisions

U.S. Corporate Tax Rate

— House 20 percent effective for taxable years beginning after 2017.

— Senate 20 percent effective for taxable years beginning after 2018.

Corporate Alternative Minimum Tax

— House – Eliminates Corporate AMT.

— Senate – Keeps Corporate AMT as is.

Pass-through Rate

— House – Maximum 25 percent rate on qualified pass-through business income (not including personal service income, such as financial advisory, law, accounting, engineering). Active owners/employees are generally eligible for the 25 percent rate on 30 percent of such pass-through income.

— Senate – Partners/Interest-holders can deduct 23 percent of qualified business income, (resulting in a 29.65 percent top rate for qualified business pass-through income), but not to exceed 50 percent of W-2 wages. Active business losses for individual owner (married filing jointly) limited to US$500k per year.

Capital Expensing

— House – 100 percent expensing for property placed in service after 27 September 2017 and before 1 January 2023. Reverts to current law, The Modified Accelerated Cost Recovery System (MACRS) for years 2023 and after. Regulated utility property and vehicle dealer floor plan financing property are not eligible for expensing.

— Senate – 100 percent expensing for property placed in service after 27 September 2017 and before 1 January 2023. Phase down – 80 percent expensing in 2023, 60 percent in 2024, 40 percent in 2025, 20 percent in 2026. Regulated utility property and vehicle dealer floor plan financing property are not eligible for expensing.

Interest Expense Deductibility (Domestic Rule)

— House – Net interest expense (that which exceeds interest income) deductible only up to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA). Regulated public utility property debt interest expense and motor vehicle dealer floor plan financing interest expense are excluded from the limitation.

— Senate – Net interest expense (that which exceeds interest income) deductible only up to 30 percent of earnings before interest and taxes (EBIT), which is income after the deductions for depreciation and amortization and hence is a significantly more onerous limit than EBITDA for some industries. Regulated public utility property debt interest expense and motor vehicle dealer floor plan financing interest expense are excluded from the limitation.

Net Operating Losses

— House – Repeals carrybacks. Allows unlimited carryforwards but only to extent of 90 percent of taxable income.

— Senate – Repeals carrybacks. Allows unlimited carryforwards but only to extent of 90 percent of taxable income, reduced to 80 percent after 2022.

Like Kind Exchange (LKE) Deferral

— House – Retains LKE for real property, repealed for personal property.

— Senate – Retains LKE for real property, repealed for personal property.

Carried Interest

— House – Carried Interest must hold for 3 years for long term gain (lower capital gains rate).

— Senate – Carried Interest must hold for 3 years for long term gain (lower capital gains rate).

Real Property – Depreciation

— House – No provision.

— Senate – Reduces depreciation recovery period for real property (commercial and residential rental) to 25 years. Leasehold improvements can be depreciated over 10 years.

Energy Tax Credits

— House – 30 percent (and 10 percent ITC for solar, fuel cell, small wind and other categories harmonized in phase-down schedule and terminated. The renewable electricity Premium Tax Credit (PTC) is modified to repeal the inflation adjustment (restoring the credit to 1.5 cents/Kw) for projects not under construction by 2 November 2017, and phased-down afterward. The section 45J production credit for advanced nuclear facilities is extended and modified.

— Senate – No provision

Life Insurance Tax Provisions

— House – 8 percent surtax on life insurance company income; modifies accounting for life insurance reserves.

— Senate – Extends amortization for policy acquisition expenses; modifies accounting for life insurance reserves.

International Provisions applicable to businesses with income/operations in the U.S. and outside the U.S., inbound and outbound

One-Time Deemed Repatriation Tax for U.S.-based companies with foreign subsidiaries

— House – tax on accumulated earnings and profits (E&P) of controlled foreign corporations (CFCs), 14 percent cash equivalents, 7 percent non-cash equivalents.

— Senate – tax on accumulated E&P of CFCs, 14.5 percent cash equivalents, 7.5 percent non-cash equivalents.

Territorial U.S. System

— House – Territorial system, 100 percent dividends received deduction (DRD) (i.e. no tax on repatriation of foreign income) with exceptions (base erosion measures).

— Senate – Territorial system, 100 percent DRD (i.e. no tax on repatriation of foreign income) with exceptions (base erosion measures).

U.S. CFC “Intangible Income” Taxable

— House – 10 percent tax on “foreign high return” income, i.e. aggregate net CFC income above a “routine” rate of return of 7 percent plus federal short term bond rate applied against CFC depreciable tangible property.

— Senate – 10 percent tax on Global Intangible Low-Taxed Income (GILTI), i.e. aggregate net CFC income that exceeds a 10% return on CFC depreciable tangible property. (10 percent tax increases to 12.5 percent after 2025.) Offsetting deduction allowed for foreign-derived intangible income earned from U.S. intellectual property assets.

Base Erosion Excise / Anti-abuse Tax for U.S. Payments to Non-U.S. Related Party

— House – 20 percent excise tax on payments to a related non-U.S. corporation by a U.S. corporation that are allowed as a U.S. deduction or included as cost of goods sold, inventory or as a depreciable/amortizable asset. (Exception for certain financial transactions. 80 percent of foreign tax credits allowed.) Excise tax does not apply if the taxpayer treats such payments as Effectively Connected Income (ECI).

— Senate – "BEAT" tax, an alternative minimum tax on U.S. corporate taxpayers with annual gross receipts exceeding $500 million, equal to 10 percent (increasing to 12.5 percent after 2025) of (modified) taxable income, without allowing deductions for normally deductible U.S. payments to a foreign related party though still allowing deductions for such payments if they are for cost-of-goods-sold—and not allowing general business tax credits.

Interest Expense Deductibility (Global Rule) for "Excessive U.S. Indebtedness"

— House – U.S. member of multinational group deduction for interest expense limited (as a share of global interest expense) to no more than 110 percent of the U.S. member's share of EBITDA as it relates to Global EBITDA. Taxpayer can deduct only the lesser of this global interest limit or the domestic interest limit.

— Senate – U.S. member of multinational group deduction for interest expense limited (as a share of global interest expense) to no more than a specified percentage of the U.S. member's debt/equity ratio as it relates to Global debt/equity. "Equity" is calculated as tax basis minus debt. The specified percentage is 130 percent for 2018, 125 percent for 2019, 120 percent for 2020, 115 percent for 2021, and 110 percent for 2022 and thereafter. The taxpayer can deduct only the lesser of allowable interest expense as determined under this global interest limit or the domestic interest limit.

Hogan Lovells Comments

The Conference to resolve differences between the House and Senate is expected to formally commence late this week, but discussions at the House Ways and Means and Senate Finance staff level already have begun. Barring any surprises (which are always possible) we expect the conference to be resolved by 15 December or early in the week of 18 December, at which point we expect the House and Senate to both vote to pass the conference bill, to be sent to the President to be signed into law. This will be the most significant U.S. tax reform legislation in more than 30 years. The following presents our predictions as to the likely outcome of the conference, and thoughts with respect to how this will impact businesses with operations/investments in the U.S., whether U.S. or foreign based.

— Many businesses, in particular multinational businesses, will find that the benefits of the lower U.S. tax rate and other items such as full capital expensing will not offset the tax increases associated with provisions like the base erosion taxes, including e.g. limitations on the deductibility of interest expense. The net impact of this bill on any particular business will depend very much on the particular characteristics of the business and its (domestic and/or global) operations, and could be very different even for businesses in the same industries.

— There remains a good deal of work to be done by congressional members and staff in the conference committee over the next 10 days to two weeks. This is particular true with respect to the international provisions and the reduction in the pass-through business rates, where the House and Senate approaches are considerably different.

— Although the last hour amendment to the Senate bill restoring the corporate alternative minimum tax (AMT) (at the current rate) has caused considerable consternation in the business community, we do not expect the Senate position to prevail on this provision. Either the Senate will recede to the House, which repeals the corporate (and individual) AMT, or else the conference bill will reduce the corporate AMT rate significantly.

— The provision for a lower pass-through business income tax rate continues to give tax-writers trouble and could create significant potential for tax structuring benefits.

What it means for you

— If you haven't been following U.S. tax reform, it is time to take a hard look at how these changes will affect your business. This bill includes major changes that will create winners and losers.

— As the conference committee finalizes this legislation, we expect, in addition to decisions relating to the "big picture" provisions, some changes allowing transition relief to those negatively affected, and special exceptions to mitigate harm to certain industries or sectors.

— We also expect that there will be at minimum a technical corrections bill that will move through Congress in 2018, to fix and modify provisions in this bill that do not turn out as intended. This means that those affected taxpayers who did not speak up or examine the tax bill on this round may have an opportunity to influence fixes in a bill next year.

We would advise businesses to engage now to ensure that they fully understand the consequences of this bill for their tax situation.

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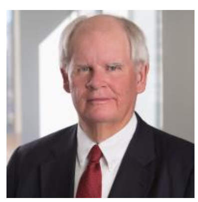

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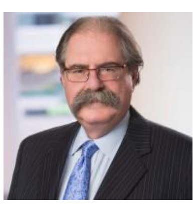

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