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House Republicans release details of tax reform proposal

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The proposal includes significant tax reductions but also eliminates many existing deductions, credits and deferrals, and includes new taxes on multinational corporations.

Republican House Ways and Means Committee Chairman Kevin Brady today released the long-awaited tax reform legislative proposal.

While the proposal includes significant tax reductions, in particular in the U.S. corporate income tax rate and individual income tax rates, it also removes many existing tax deductions, credits and deferrals that make the proposal very much a mixed-bag for businesses operating in the U.S.

The headline business tax proposals are set out below. We will be putting out additional information concerning practical implications of this legislation for different industry sectors.

- A reduction in the top U.S. corporate rate from the existing 35% to 20%.
- Elimination of the corporate AMT effective for tax years beginning after 2017.
- Full business expensing for tangible personal property through 2022.
- A reduction in the top tax rate, to 25%, for a portion (generally 30%) of income of certain
- pass-through business entities. Professional service income from businesses like law firms, accounting firms and medical services is excluded from this reduction.
- Limits on the deductibility of interest expense:

> - A general limit on the deductibility of interest expense to no more than 30% of EBITDA.
> - A second limitation applicable to U.S. corporations in worldwide affiliate groups consolidating for financial reporting purposes: the otherwise deductible interest expense of a U.S. corporate member would be limited to the extent that its share of the group's global interest expense exceeds 110 percent of the U.S. member's share of the group's global earnings before interest, taxes, depreciation and amortization (EBITDA). This provision would apply in addition to the 30% limit above, with the interest expense disallowance being the greater of the amount disallowed under either cap. Disallowed interest expense could be carried forward for 5 years.

- Like-kind exchange deferral, effective after 2017, limited to real property.
- Significant roll-backs of tax benefits for life insurance and other insurance companies, including modifications to the computation of life insurance tax reserves, and greater capitalization required for policy acquisition expenses.
- Repeal of a host of existing tax credits and special deductions, including the domestic production activities deduction, the credit for clinical testing expenses for rare disease drugs, the work opportunity tax credit, the new markets tax credit, and the historic rehabilitation tax credit. Reduction and narrowing of the electricity production credit from wind facilities.
- Termination of private activity bonds.
- Significant reforms in the treatment of foreign income of U.S. corporations, including:

  - **Territorial system –** The taxation of U.S. multinationals' overseas active business income would shift from the current worldwide system to a new territorial system with a 100 percent exemption for dividends from foreign subsidiaries.
  - **Repatriation of existing accumulated earnings of foreign subsidiaries -** A one-time deemed repatriation tax – at rates of 12% for cash equivalents, and 5% for other (hard assets) holdings – would be imposed on the earnings of U.S. corporate foreign subsidiaries accumulated under the old worldwide system. This tax can be paid over 8 years. Foreign tax credit carryforwards would be fully available, and foreign tax credits triggered by the deemed repatriation would be partially available, to offset the deemed repatriation tax.
  - **Look-through rule for payments between foreign subsidiaries would be made permanent.**
  - **Anti-base erosion rule –** The U.S. parent would be taxed, effectively at a rate of 10%, on its foreign subsidiaries' "foreign high returns," defined as the excess of (i) the foreign subsidiaries' aggregate net income over (ii) a 'routine rate of return' of 7% plus the Federal short term rate, on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense. Foreign tax credits otherwise allowable for foreign taxes paid on the foreign high returns would be limited to 80 percent of the foreign taxes paid, could not be cross credited against other foreign source income, and could not be carried back or forward to other taxable years.

- **For Non-U.S. businesses with U.S. subsidiaries: 20% Excise tax on payments by U.S. subsidiaries to their foreign parents –** A special outbound "earnings stripping" rule applies in the case of a foreign multinational group in which one or more U.S. subsidiaries make payments back to the foreign parent or affiliates of at least $100 million annually. Payments (other than interest) to the foreign parent that are (i) deductible, (ii) includible in cost of goods sold, or (iii) includible in the basis of a depreciable or amortizable asset would be subject to a 20 percent excise tax. The only exception would be if the foreign parent elected to treat such payments as effectively connected with a U.S. business. Accordingly,

these outbound payments would effectively be subject to full U.S. tax, eliminating the perceived “earnings stripping” out of the U.S.

Significance for businesses operating in, or with investments in the U.S.

- Full expensing of capital expenditures and a reduction in the U.S. corporate tax rate from the current 35% to 20% will on balance significantly reduce the tax cost of doing business in the U.S. On the other hand, the loss of, or limits imposed on, the deduction for net interest expense will raise the cost of debt in the U.S.
- The ability for U.S.-based corporations to repatriate profits from foreign subsidiaries on a tax free basis (after paying a one-time tax on all accumulated earnings and profits of foreign subsidiaries) should increase the incentive for these companies to repatriate cash and use it to make U.S. investments (or perhaps to pay down debt or pay dividends). The shift to a U.S. territorial system will generally make foreign investments more attractive to U.S. companies.
- The international and base erosion provisions could result in significant tax increases for many multinational companies.
- Loss of many credits and deductions also means that this bill will not be a positive for all businesses. It is very much a mixed-bag.

Process and Outlook

Chairman Brady has announced plans to begin committee markup on this legislation the week of November 6. The Senate is expected to release its own (different) tax reform bill in mid-November.

If, as many expect, U.S. tax reform continues to be a Republican-only effort, the bill can move through Congress via the reconciliation process under the Budget Act of 1974, which would allow Republicans to pass a bill with only 51 votes in the Senate, avoiding risk of a Democrat filibuster, which would otherwise require 60 votes to overcome. Moving a bill through reconciliation, though, makes the process much more complicated. This requires that the Senate comply with the Byrd rule, requiring 60 votes to overcome a point of order if the bill results in any revenue loss after the years included in the Budget Resolution (ie, 11 years after today, and beyond). In addition, given significant cuts in this bill to many cherished tax incentives, and concerns about increasing the already high U.S. debt level, Republicans may have trouble getting sufficient support even within their own caucus. Although Trump, during his campaign, did not express much concern about the U.S. debt, the issue remains a concern among many Republican deficit hawks.

Any business operating in the U.S. has much at stake as U.S. tax reform continues to develop. There is still opportunity to influence the final provisions in this bill, though time to engage is growing shorter. We are happy to answer any questions and assist in evaluating risks and opportunities related to this effort.

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