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Client Alert

Commentary

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Congressional Tax Reform Proposals: Businesses Will Need to Rethink Key Decisions

Potential legislation would significantly affect businesses across a variety of sectors.

Key Points:

- US House and Senate have each passed comprehensive tax reform legislation.
- Proposals would alter fundamental aspects of US business taxation.
- Both bills include changes to rates, interest expense and net operating loss deductions, full expensing for capital investments, and sweeping international reform among major provisions.

Significant changes to the US tax system are on the horizon. On November 16, 2017, the US House of Representatives passed H.R. 1, the "Tax Cuts and Jobs Act" (the House Bill). On December 2, the US Senate passed its own tax reform proposal (the Senate Bill), which is also titled the "Tax Cuts and Jobs Act" but which differs from the House Bill in certain respects.

This *Client Alert* analyzes key aspects of the House and Senate Bills as they relate to a range of business issues. Specifically, this *Client Alert* discusses how the following proposed changes would affect the structuring and execution of domestic and cross-border transactions:

- New income tax rates for corporations and pass-through entities
- Limits on interest deductibility
- A temporary allowance for expensing the cost of certain capital investments
- Limits on and other changes to the deductibility of net operating losses (NOLs)
- The most significant modifications to the US international tax regime in decades, including a combination of a participation exemption system for foreign profits, coupled with a minimum tax on those profits

This *Client Alert* also summarizes the implications of the House and Senate Bills on the energy and real estate sectors, particularly with respect to master limited partnerships (MLPs), publicly traded partnerships (PTPs), and real estate investment trusts (REITs).

Latham & Watkins has published additional materials analyzing provisions of the House and Senate Bills applicable to private investment funds and asset managers, executive compensation, and renewable energy, and will continue to provide resources, including worthwhile third-party content materials, and insights through the Latham & Watkins US Tax Reform Resource Center.

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I. Business Tax Rates

Both the House and Senate Bills call for reducing the top corporate income tax rate from 35% to 20%. The House Bill, but not the Senate Bill, would also eliminate the corporate alternative minimum tax (AMT). The House Bill would make both of these changes effective for tax years beginning after December 31, 2017. The Senate Bill would make the corporate rate cut effective for tax years beginning after December 31, 2018.

As discussed below, the House and Senate Bills would also reduce the tax rates applicable to many types of income earned by pass-through businesses, although the two Bills achieve a lower rate on business income by drastically different approaches.

II. Interest Deductibility

Both the House and Senate Bills would generally limit net interest deductibility available to corporations and partnerships by introducing two separate, unprecedented, limitations: a general 30% cap on net business interest and a cap on net interest deductible by a US member of an international group. In case of an overlap, whichever cap that would result in greater net interest disallowance would apply. The disallowed net interest could be carried forward indefinitely under the Senate Bill and for five years under the House Bill. If enacted, these limitations will apply for taxable years beginning after December 31, 2017. There is no grandfathering provided for existing debt.

30% Cap on Deductibility of Net Business Interest

Under current law, except for debt between certain related parties or debt guaranteed by certain related parties, the gross amount of business interest expense is generally deductible in computing net taxable income. While some limitations may be imposed on such deductions, those limitations apply based on specific characteristics of debt, and for such debt only. For example, deductions for interest paid on a debt instrument may be limited (1) when the yield on a debt instrument issued by a corporation exceeds a certain threshold (in the case of “applicable high yield discount obligations” under Section 163(i)[1]), (2) the interest is paid to a related party (in the case of “earnings stripping” under 163(j)), or (3) the interest is payable in equity (in the case of “disqualified debt instruments” payable in equity under Section 163(l)).

Both the House and Senate Bills would amend Section 163(j) (which currently limits only related-party interest deductions for thinly capitalized corporations) and impose a general cap on net business interest expense equal to 30% of adjusted taxable income (ATI). In computing ATI for this purpose, any non-business income, gain, loss, and deduction are excluded, and business interest expense, NOLs, and — in the case of the House Bill — depreciation and amortization are added back. By comparison, under the Senate Bill, depreciation and amortization deductions are not added back in computing ATI. Businesses with annual gross receipts of less than US$15 million in the case of the Senate Bill, and with annual gross receipts of less than US$25 million in the case of the House Bill, are exempt. Certain electing real property businesses, farming businesses, and other designated businesses in the case of the Senate Bill (or real estate businesses in general, in the case of the House Bill) are also exempt.

The general 30% cap would apply to partnerships at the entity level. The House Bill, unlike the Senate Bill, would allow the partners of underleveraged partnerships to increase their own ATI for purposes of computing interest deduction from other sources by their share of the partnership’s unused cap. Neither Bill would allow the partnerships to use the partners’ unused caps. As a result, both Bills would require that the excess business interest be used solely against the partnership’s future taxable income, but unlike the House Bill, the Senate Bill would require that any excess business interest be allocated to partners and carried over at the partner level rather than at the partnership level. The Senate Bill also

allows a partner to increase basis in a partner's interest in a partnership upon a disposition for the excess business interest previously incurred.

Limitation on Domestic Entities of International Groups

Under a new Section 163(n), both the House Bill and the Senate Bill would generally limit interest deductible by a US member of an international group to a multiple of an amount that the US member would have incurred if it borrowed in proportion with the rest of the group. The multiplier would be 110% under the House Bill. The multiplier under the Senate Bill would be 130% beginning in 2018 and would phase in by 5% annually to 110% in 2022. The House Bill would apply to a US member of an "international financial reporting group," which group has annual gross receipts exceeding US$100 million and prepares consolidated financials to obtain credit or to provide information to shareholders. It would limit net tax interest expense to the extent the US member's proportionate share of the worldwide book net interest expense exceeds 110% of such US member's proportionate share of the international group's worldwide EBITDA, as shown on the group's consolidated financial statements. By contrast, the Senate Bill would apply to corporate "worldwide affiliated groups" linked by 50% ownership and would limit the US members' net interest expense to the extent their debt exceeds 130% (beginning in 2018 and phasing in by 5% annual increments to 110% in 2022) of the amount of debt computed based on the worldwide affiliated group's debt-equity ratio. For purposes of computing debt-equity ratios of a worldwide affiliated group, total equity of the group would equal the difference between all assets of the group and the total debt of such group, using adjusted basis of tax assets and treating the group as a single corporation, disregarding all intercompany transactions. In computing the assets of a US member, any interest held by the US member in foreign corporations that are members of the same group is ignored.

Observations:

The net interest expense limitation provisions would significantly affect domestic corporations and partnerships. The 30% cap would most likely have an impact on companies primarily relying on interest deductions to reduce their net taxable income or, under the House Bill, companies operating at a loss for extended periods of time. The US member's net interest limit could affect most companies with international affiliates.

- Because these provisions would limit only "net" interest expense (rather than gross interest expense), they would not affect banks that borrow to earn interest income. On the other hand, certain financial services firms might be adversely affected if their earnings consist primarily of dividends and trading gains, which would not offset interest expense incurred to finance them.

- The net interest caps generally would not apply to non-interest business expenses, including embedded interest in derivative instruments or contracts (unless treated as debt, or integrated as part of debt, for US federal income tax purposes), even if such expenses, in whole or in part, represent financing costs and/or time value of money that are akin to interest. This means that leasing or rental expenses as well as periodic payments made under certain swaps, non-equity forward contracts, or other derivative instruments — to the extent they are currently deductible as non-interest expense — presumably would continue to be deductible. As a result, where flexibility exists, corporate taxpayers might consider and reevaluate alternative financing structures that provide maximum deductions instead of simply relying on a traditional bond or bank financing.

- While all interest earned and paid by a corporation is expected to be treated as business interest under the 30% cap, partnerships carrying out a trade or business that also have investment assets would be required to appropriately allocate interest to their trade or business. This may provide planning opportunities for such partnerships. If a partnership is a pure investment partnership with no

trade or business, it is anticipated that none of its deductions would be subject to the 30% cap on business interest at the partnership level.

- Because the definition of ATI under the Senate Bill does not add back depreciation and amortization, if the Senate Bill is adopted, it would significantly reduce the allowable interest deduction for companies with substantial depreciable assets.

- Companies that generate NOLs may be significantly affected, because net interest expense would be entirely disallowed for those years and, if such disallowed expense can only be carried forward for five years as under the House Bill, could expire unused. Treating interest expense carryover as a separate tax attribute is a novel concept and very different from the current treatment under which interest expense merely increases the NOL. Under US GAAP, net interest expense disallowance would generally be treated as a timing item and give rise to a deferred tax asset, which may be subject to valuation allowance.

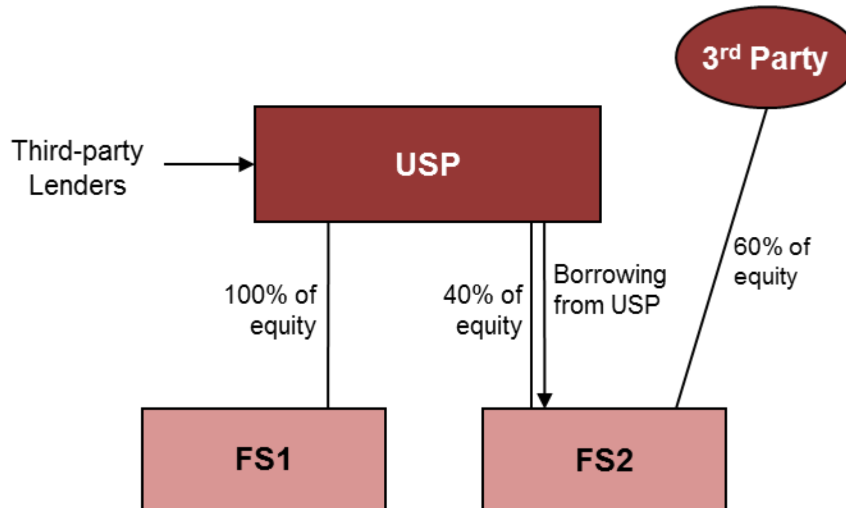
- Even though the proposed limitation on interest deductibility would make a debt financing relatively less attractive compared to an equity financing, the potential cost of the disallowance would be mitigated for corporations due to a significantly reduced corporate tax rate. Furthermore, a debt financing still offers a variety of benefits that an equity financing does not offer. For example, investors with other business interest expense may prefer to invest in debt rather than equity if the debt generates business interest income that would reduce their net interest expense and allow them to use interest deductions that otherwise would be disallowed by the proposed limitations. For issuers, interest payments would still generate deductions, albeit limited under the House and Senate Bills. In addition, it may be easier for interest payments to qualify for full exemption from or reduction in US withholding tax than dividend payments when paid to non-US investors.

- The House Bill's interest limitation for US members of international groups applies to any international group with more than US$100 million in gross receipts that has a US member and prepares consolidated financials (regardless of whether doing so is required) to obtain credit or to provide information to shareholders. As such, the limitation is expected to reach far beyond just publicly traded multinationals or groups that are currently required (for example, for regulatory purposes) to have audited consolidated financial statements. The cap computed based on book EBITDA and book net interest expense may also lead to unexpected results and potential distortion because intercompany borrowings are generally eliminated from consolidated financial statements, but not from the computations of interest expense for tax purposes under the House Bill. Further, ratios based on book EBITDA may be relatively volatile year-to-year based on macroeconomic or geopolitical factors, resulting in swings in the disallowance amounts that have no bearing in the group's leverage or financing structure.

- Under the Senate Bill's limitation for US members of international groups, US headquartered groups that borrow at the parent level may be especially affected. Specifically, the total equity of the US group would generally not include any value of an interest held by the US group in its foreign affiliate. Therefore, the US group would be disallowed a significant portion of the net interest expense that could be viewed as attributable to the operations of foreign affiliates. Such US groups should consider borrowing directly at the foreign affiliates' level. By comparison, the value of minority foreign stock generally would be included as an asset and therefore increase the equity of the US corporation for purposes of debt-equity computation. Hence it appears that the US parent may be able to at least partially benefit from net interest expense incurred to carry stock in specified 10% owned corporations (as long as such ownership is 50% or less) even though such 10% owned corporations may generate

deductible foreign source dividends under the new territorial system. See “International – Participation Exemption for Dividends of Foreign Subsidiaries” below.

Figure 1: Potential Application of New Section 163(n)



- If the Senate Bill version of Section 163(n) is adopted, the equity value of USP would be measured ignoring the equity of FS1 held by USP. The equity/debt of FS2 would not be ignored.
- If the House Bill version of Section 163(n) is adopted, the result would depend on the computation of EBITDA at the level of USP as related to the EBITDA of the worldwide affiliated group.

III. Cost Recovery: Full Expensing

The House and Senate Bills both generally permit full expensing for tangible property (with some real property and other exceptions) acquired and placed in service after September 27, 2017 and before 2023, as opposed to existing law, which permits immediate expensing in limited instances and otherwise requires basis recovery over the property’s statutory useful life. Importantly, under the House Bill — but not the Senate Bill — this favorable rule would apply to used property that is acquired from an unrelated taxpayer. (The Senate Bill would also annually step-down the first year deduction or “bonus” percentage for several years beyond 2022, whereas the House Bill would retain the percentages under current law.)

Observations:

The cost of capital investments will be dramatically reduced as a result of immediate expensing, particularly under the Senate Bill for corporations in 2018 in light of the retained 35% tax rate.

The House Bill — and to a lesser extent the Senate Bill — would likely have a significant effect on the frequency, nature, and pricing of M&A transactions. In particular, under the House Bill purchasers in asset acquisitions (actual or deemed as a result of a stock transaction including a Section 338 or 336(e) election) may now be able to immediately deduct a significant portion of the purchase price. In contrast, sellers would still only pay tax on the amount of gain recognized — and such gain would be subject to a lower corporate tax rate under both the House Bill and, except in 2018, the Senate Bill. Under existing law, corporations are often reluctant to sell assets (including stock of subsidiaries) in light of the immediate corporate tax leakage that often materially exceeds the buyer’s present value of tax savings associated with any asset basis step-up to which the buyer might be entitled, but this calculation would

now be materially different as the tax cost to the seller should be reduced and, under the House Bill, the tax benefits to the buyer would be increased. In sum, there will likely be an increase in corporate M&A activity generally — and potentially asset (actual or deemed) acquisitions in particular — with the particulars dependent on how the House and Senate resolve the differences noted above.

IV. Corporate NOLs

NOL Carrybacks Repealed

Subject to limited exceptions, both Bills repeal the two-year carryback period for NOLs (in the case of the House Bill, for NOLs arising in tax years beginning after December 31, 2017; in the case of the Senate Bill, for NOLs arising in tax years ending after such date).

NOL Carryforwards: Unlimited Duration, Cap on Taxable Income Offset and Annual Adjustment

Both Bills permit NOLs to be carried forward for an unlimited period as opposed to 20 years under current law (with the same effective dates as described in the preceding paragraph). However, with respect to tax years beginning after December 31, 2017, such NOLs — and any existing NOLs — would only be able to offset 90% of taxable income (declining to 80% under the Senate Bill beginning in 2023) (but the Senate Bill would not apply to existing NOLs). Finally, under the House Bill, existing and future NOLs carried forward to tax years beginning after December 31, 2017 would be subject to an annual increase based on an interest rate formula.

Observations:

The repeal of NOL carrybacks could have a significant adverse effect on the most cyclical companies that have periods of both large income and loss generation, as these companies will no longer be able to immediately monetize their tax losses by carrying them back to preceding taxpaying years for refunds. Instead, these companies will only be able to carryforward the NOLs and such NOLs will not be able to zero out taxable income that is generated in the future.

A more immediate impact of the NOL carryback repeal will be with respect to sales of profitable companies — most often between private equity firms — where the transaction often generates a NOL in the short period ending on the closing date because of large transaction deductions arising from cashing out options, refinancing debt, and paying banking and other professional fees. It is common for buyers and sellers today to negotiate the rights to tax refunds arising from such a short period NOL, but under the proposed legislation such refunds would be limited to estimated tax payments made in the short period. This consideration could be especially important with respect to pending transactions as the NOL carryback would still be available if the transaction closes in the current tax year of the target company (except under the Senate Bill for non-calendar year taxpayers whose tax year ends after December 31, 2017). Importantly, the refund amount would be based on the existing 35% tax rate rather than the lower proposed 20% rate (although the Senate Bill would retain the 35% rate in 2018). In the case of the House Bill, only such portion of a NOL that is not attributable to the effect of the full expensing provision described above would be refundable.

The changes in these rules could have significant financial accounting implications as deferred tax assets associated with NOLs (including valuation adjustments) would essentially be recomputed under GAAP in light of the change in corporate tax rates, the unlimited carryforward period, the offset cap, and the annual amount adjustment.

V. Reduced Tax Rates for Pass-Through Entities

Current law generally taxes income earned by both pass-through entities (such as partnerships and S corporations) and sole proprietorships at the rate applicable to their owners, regardless of whether such income is business income. As such, the tax rates applicable to such "pass-through income" for individual owners would otherwise be unaffected by the proposed legislation's reduction in the corporate tax rate from 35% to 20%. However, the House and Senate Bills share the premise that corporate and non-corporate business income should be treated more similarly. Thus, while the House Bill leaves the top individual marginal rate at 39.6% and the Senate Bill reduces it slightly to 38.5%, they each operate to meaningfully reduce the rate applicable to certain types of business income earned by pass-through entities and sole proprietorships, albeit by dramatically different methods.

House Bill

The House Bill sets a maximum rate of 25% on pass-through income that is treated as "qualified business income." Qualified business income (QBI) is defined as the sum of passive business income (PBI) plus the capital percentage (Cap %) multiplied by active business income (ABI). Passive business income and active business income are defined as net business income from a passive business activity and an active business activity, respectively, and a business activity is an activity that involves the conduct of any trade or business. Thus, 100% of passive business income from a given activity qualifies for the 25% rate, whereas only a portion of active business income qualifies for the 25% rate. In formula terms:

QBI = PBI + (Cap %)(ABI)

Net business income is determined separately for each business activity. In order to determine whether a given activity is active or passive, as well as how to group a taxpayer's various activities for this purpose, the House Bill imports the concepts of the passive activity loss rules under current Section 469. Net business income includes any amounts received by the individual taxpayer as wages, director's fees, partnership guaranteed payments and amounts received from a partnership other than in the individual's capacity as a partner (collectively, service-type income) that are properly attributable to a business activity. Net business income does not include certain investment-related items.

Under the House Bill, the capital percentage is in general 30% — and so in general 30% of the income from active business activities is eligible for the 25% rate. Note, however, that to the extent that the portion of net business income represented by service-type income exceeds 100% minus the capital percentage, the capital percentage is reduced. Thus, this limitation would typically be triggered when service-type income exceeds 70% of net business income.

Taxpayers may make an election to rebut this 30% presumption, and thereby apply a higher capital percentage, by using a formula based on a deemed rate of return and the asset balance for the activity for the year. For certain personal service businesses (*e.g.*, businesses involving the performance of services in the fields of health, law, engineering, architecture, accounting, the performing arts, and financial services), generally the capital percentage is 0% (and hence none of the income from these businesses would qualify for the 25% rate), though these taxpayers may also make an election to demonstrate that their applicable capital percentage is higher, provided that the election results in a capital percentage that is at least 10%.

Senate Bill

The Senate Bill takes a very different approach. Rather than dividing business income into passive and active activities and then determining an appropriate capital percentage, the Senate Bill simply applies a 23% deduction on qualified business income. Under the Senate Bill, qualified business income means

income with respect to a taxpayer's trade or business, but excluding certain personal services businesses similar to those enumerated in the House Bill (though such exclusion does not apply for certain taxpayers at lower levels of income). Qualified business income does not include reasonable compensation paid by an S corporation, any amounts allocated or distributed by a partnership to a partner who is acting other than in his or her capacity as a partner, or any amount that is a guaranteed payment for services rendered to or on behalf of a partnership. Qualified business income also does not include certain investment-related items. If a taxpayer who has qualified business income from a partnership or S corporation also has wages that are properly allocable to qualified business income, then the deduction is limited to 50% of those wages (though such limitation does not apply for certain taxpayers at lower levels of income). The Senate Bill explicitly exempts publicly traded partnerships from this 50% limitation; see "Energy Impact — Master Limited Partnerships and Publicly Traded Partnerships" below. Finally, note that the Senate Bill provision would sunset on December 31, 2025.

Observations:

While both the House and Senate Bills lower the rate on certain types of non-corporate business income, they do so in quite different ways. The Senate Bill appears to be substantially less complex, and hence would seem to be easier to administer, than the House Bill. In both cases, though the top rates on non-corporate business income would be meaningfully lowered (to approximately 35.2% and 25% under the House Bill for active and passive business income, respectively, and 29.6% under the Senate Bill for qualified business income), the rates would remain well above the corporate rate of 20%. Thus, the significant tax rate differential that would exist between corporate business income and non-corporate business income could incentivize certain businesses to consider operating in a corporate form.

Note that under the House Bill, a critical aspect for determining whether income is eligible for the 25% rate is whether such income is active or passive, and such determination is made by reference to the passive activity loss rules of Section 469, with only passive income being eligible for the 25% rate in full. This is particularly noteworthy because those rules were developed to limit the ability of taxpayers to take passive losses, and hence it was generally a worse result for taxpayers for an activity to be treated as passive (and the regulations under Section 469 reflect that). Now, however, for purposes of this new pass-through provision, those same rules will have the opposite impact, since it will generally be a benefit for activities of taxpayers to be treated as passive.

For the potential impact of changes to the taxation of pass-through business income on private investment funds and asset managers, see the Latham & Watkins *Client Alert* "How US Tax Reform Proposals Will Affect Private Investment Funds and Asset Managers."

VI. International

Both the House and Senate Bills would enact the most sweeping international tax reforms in decades, fundamentally altering the framework by which US and non-US headquartered businesses are taxed. These changes fall into five fundamental categories:

1. A participation exemption system for profits derived by US-based multinationals from foreign subsidiaries.

2. A minimum tax on foreign earnings of US-based multinationals with foreign subsidiaries.

3. A base erosion tax on transactions between US and non-US affiliated corporations, in structures involving US and non-US headquartered groups.

4. A one-time tax on the estimated US$2-3 trillion of overseas earnings accumulated by US-based multinationals, payable over eight years, and thus allowing those profits to be repatriated without further US tax.

5. Several other changes across the US international tax regime addressing the source of income, foreign tax credits, deductibility of payments, and other issues.

Participation Exemption for Dividends from Foreign Subsidiaries

Both the House and Senate Bills would enact a long sought after “territorial” regime — subject to the important feature discussed below regarding a minimum tax on foreign earnings — for income earned by foreign subsidiaries of US-parented multinational corporations. Importantly, the exemption of foreign profits would not only apply to controlled foreign corporations[2] (CFCs), but would also apply to earnings of a foreign corporation which is as little as 10% owned by a US corporate shareholder. The House and Senate Bills provide a 100% dividends received deduction (DRD) to a US corporate shareholder for the foreign-source portion of dividends received from a “specified 10-percent owned foreign corporation.” These provisions would be effective for taxable years beginning after December 31, 2017. The key points of the territorial regime are:

- A specified 10% owned foreign corporation is any foreign corporation (other than a passive foreign investment company (PFIC) that is not also a CFC) with respect to which there is at least one domestic corporate shareholder which owns at least 10% of the stock.
- The foreign-source portion of dividends includes only undistributed E&P that is not attributable to US effectively connected income (ECI) or dividends from an 80% owned US corporation, determined on a pooling basis.
- No Foreign Tax Credit (FTC) is allowed for the exempt portion of any dividend and the US recipient’s FTC limitation does not include the exempt portion of such dividend.
- Solely for purposes of determining a loss, the basis of a specified 10% owned foreign corporation must be reduced by the exempt portion of a dividend.
- The House and Senate Bills vary in the requisite holding period in order to claim the DRD, with the House Bill generally imposing a six-month holding period and the Senate Bill generally imposing a one-year holding period.
- Under the Senate Bill, the DRD is not available for any dividend received by a US shareholder from a CFC if the dividend is a “hybrid dividend.” A hybrid dividend is an amount received from a controlled foreign corporation for which a deduction would be allowed under this proposal and for which the specified 10% owned foreign corporation received a deduction from taxes imposed by a foreign country.

Observations:

With the change to a system by which profits of a foreign subsidiary are not taxed on repatriation, the very notion of deferred offshore earnings, a fundamental part of the US international tax system for decades, would no longer exist. Earnings of a foreign subsidiary would be either (1) taxed currently to the US corporate shareholder under a modified Subpart F regime (discussed below), or (2) exempt from US tax when earned, but in each case not subject to US tax upon repatriation, or upon loan or provision of credit support to a related US person.

Participation Exemption on the Sale of a Foreign Subsidiary

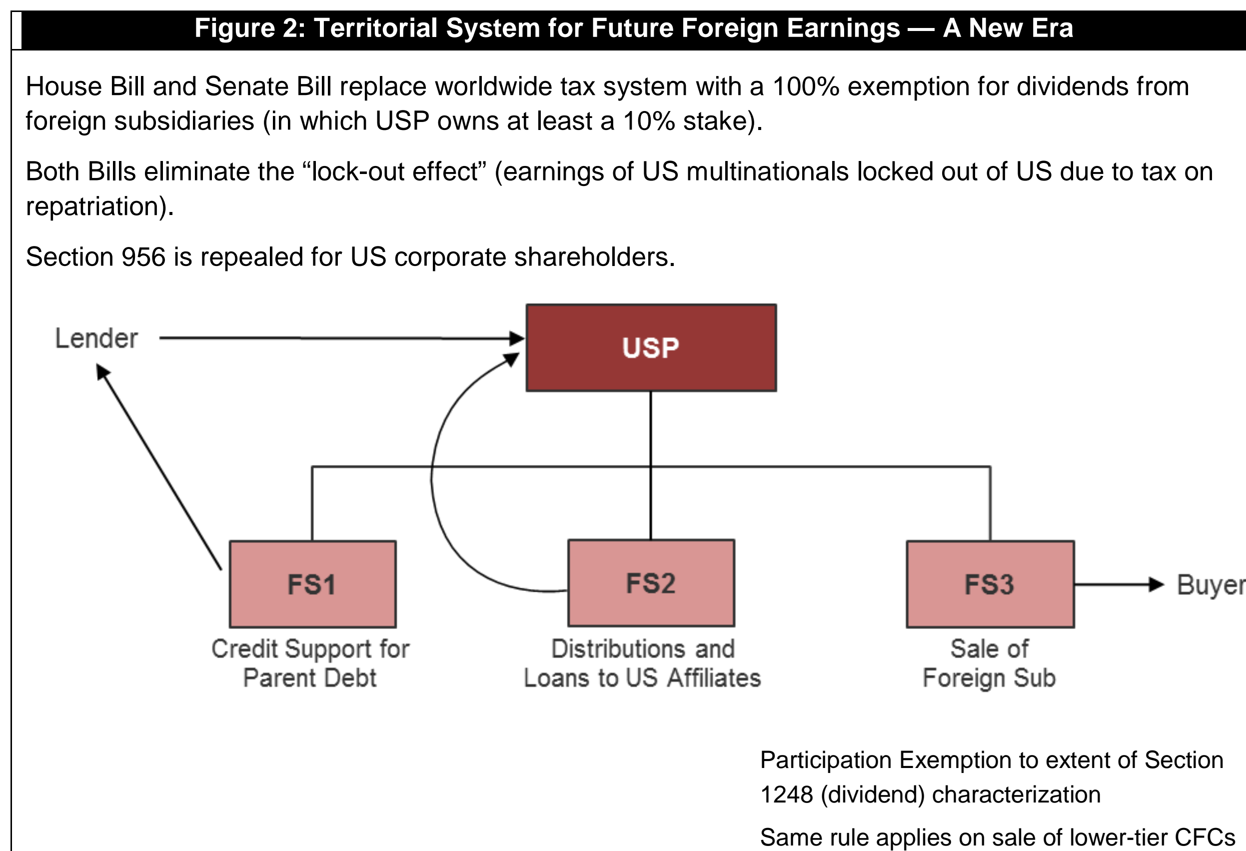
By providing an exemption for dividends from foreign subsidiaries, both the House and Senate Bills provide a mechanism for a complete or partial participation exemption on a US corporation's sale of a foreign subsidiary. To the extent that the gain on the sale of a foreign subsidiary is characterized as a dividend under the rules of Section 1248, such gain would qualify for the exemption described in the prior paragraphs. Section 1248 generally provides that the gain on the sale of CFC stock is treated as a dividend to the extent of the undistributed and untaxed earnings of the CFC.

Thus, upon the sale of a CFC, an exemption from gain would be available to the extent that the gain is treated as a dividend, as such dividends qualify for the exemption system described above.

To the extent that the gain on the sale would be treated as capital gain, it would not qualify for the participation exemption and thus (in the case of a US seller) would be taxable gain or (in the case of a CFC selling a lower-tier CFC) would continue to be treated as Subpart F income.

Observations:

Presumably, as divestitures of foreign subsidiaries are negotiated, buyers and sellers will consider Section 338 elections on the part of a buyer, thus converting what otherwise would be capital gain into ordinary dividend income in the hands of the seller. The deemed sale gain from any such election may be subject to the minimum tax discussed below.



Modified Subpart F/CFC Regime — Includes Minimum Tax

For over 50 years, US shareholders of a CFC have been taxed currently (1) on certain "Subpart F income" (such as passive income or foreign base company sales or services income), and (2) on non-Subpart F earnings in the case of investments in certain US property, such as a loan (or credit support) by a CFC to a US shareholder or other related US person.

There are three key points with regard to the CFC rules under both the House and Senate Bills:

- As a general matter, the Subpart F/CFC rules remain. For example, US shareholders will continue to currently include foreign personal holding company income, foreign base company sales income, and foreign base company services income.
- Section 956, which requires current inclusion of non-Subpart F earnings in the case of an investment in US property such as a loan or credit support, would be eliminated for US corporate shareholders as unnecessary, given that earnings would either be taxed currently or exempt, but in either case no longer deferred.
- The concept of Subpart F income is expanded, as both the House and Senate Bills use the mechanism of an income inclusion similar to current Subpart F to target perceived income shifting and high returns on foreign operations which are not otherwise subject to US tax. In short, Subpart F's approach to an inclusion of a pro rata share of income by a US shareholder would be expanded to impose a "minimum tax" on foreign earnings of US-parented groups.

In addition, the House and Senate Bills modify stock attribution rules for determining status as a CFC so that stock owned by a foreign person is attributed to a US person for purposes of determining whether a foreign corporation is a CFC, and they eliminate the requirement that the foreign corporation be controlled for 30 days before Subpart F inclusions apply. These provisions would be effective for taxable years beginning after December 31, 2017.

House Bill — Minimum Tax on Foreign Earnings of US-Based Multinationals

The House bill imposes a tax on US shareholders of a CFC, on a current basis and essentially at a 10% rate, on certain income earned by CFCs. This new tax is imposed by requiring a US shareholder to include in income its share of 50% of the "foreign high return amount" earned by the foreign corporation. This regime would be effective for taxable years beginning after December 31, 2017. Key provisions of the tax are:

- Foreign high return amount would generally equal the aggregate net income of the CFCs[3] reduced by a percentage (7% plus the Federal short-term rate) of the CFCs' aggregate basis in associated tangible depreciable business property to the extent, if any, that it exceeds the CFCs' aggregate interest expense. As a formula, this would be expressed as:

  FHRA = Net CFC Tested Income – [[(7% + AFR) x QBAI] – Interest Expense]

- Foreign tax credits, in a separate basket, would be available for 80% of the foreign taxes imposed on the income included as foreign high return amount.

Senate Bill — Minimum Tax on Foreign Earnings of US-Based Multinationals

Under the Senate Bill, a US shareholder of a CFC must include in income for a taxable year its share of the CFC's global intangible low-taxed income (GILTI). Key provisions of the tax are:

- GILTI would generally equal the aggregate net income of the CFCs[4] reduced by 10% of the CFCs' aggregate basis in associated tangible depreciable business property

- Foreign tax credits, in a separate basket, would be available for 80% of the foreign taxes imposed on the income included as global intangible low-taxed income.

Importantly, the new tax benefits available for certain foreign-derived intangible income (described below) would be available for the amount of GILTI, essentially providing for a deduction equal to 50% of GILTI, to be reduced after 2025. This regime would be effective for taxable years beginning after December 31, 2017.

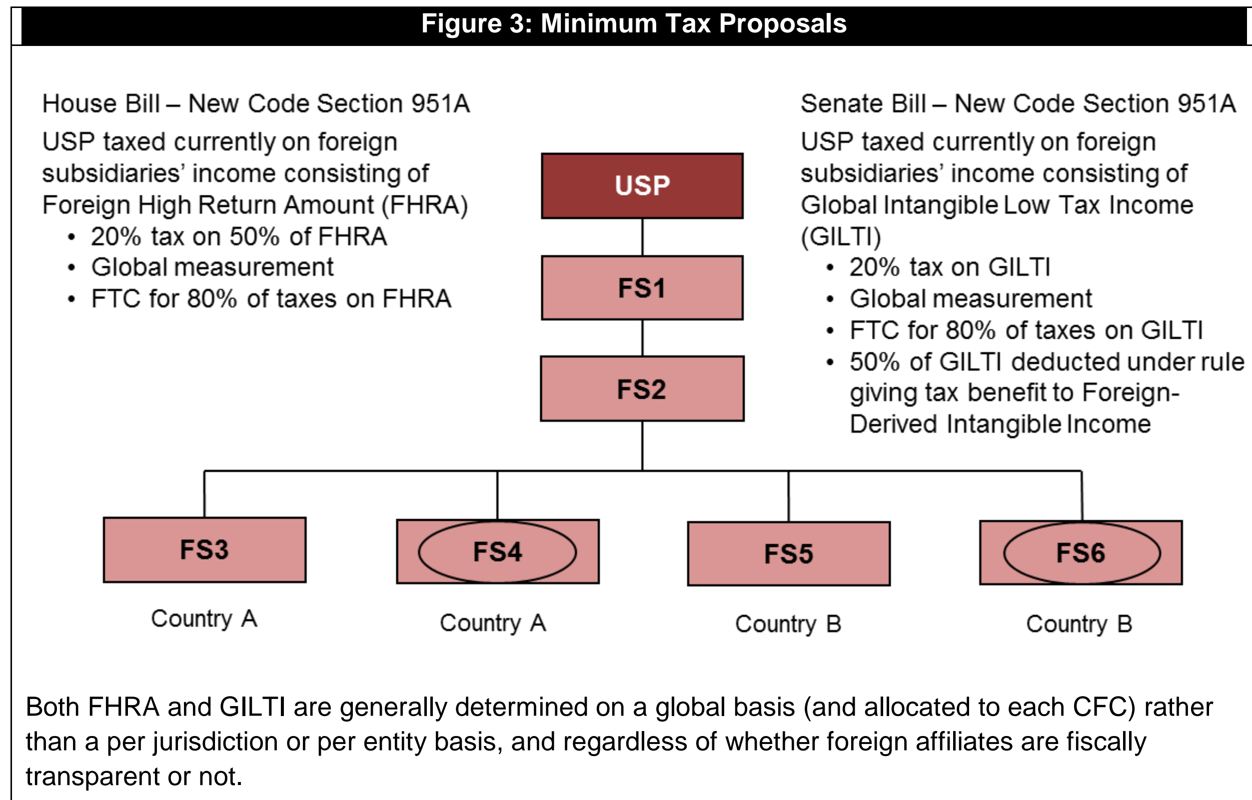
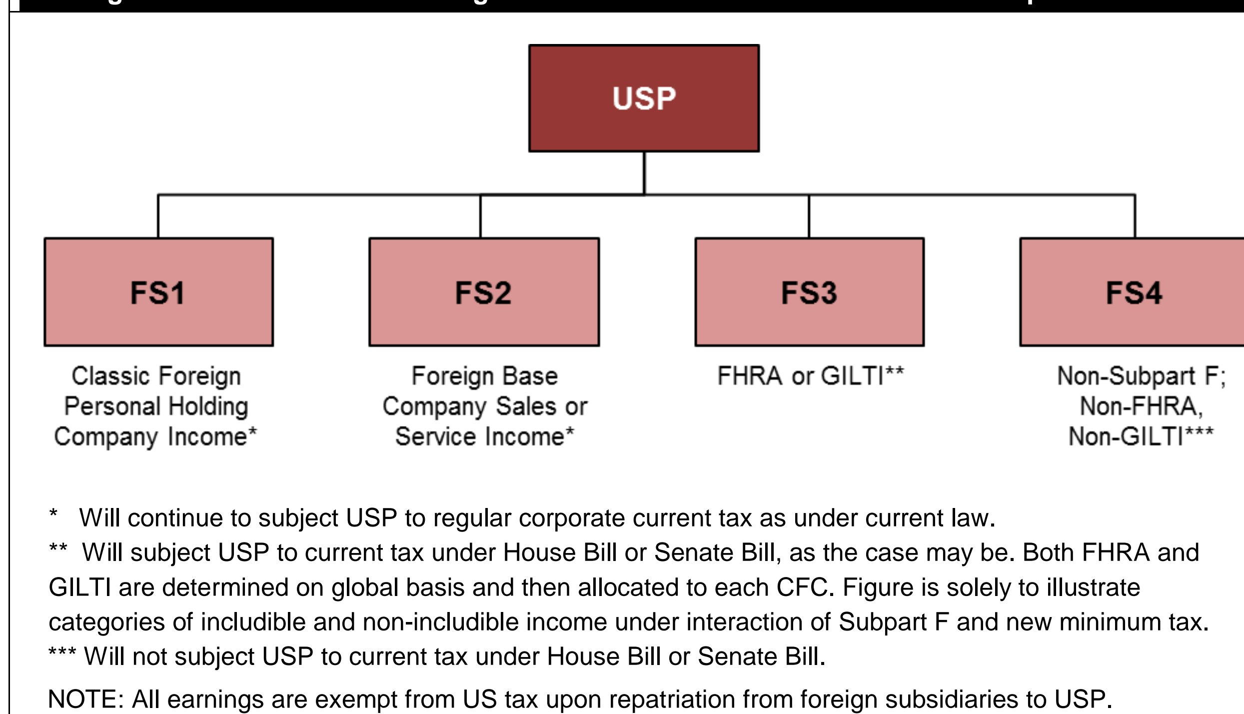


Figure 3: Minimum Tax Proposals

Both FHRA and GILTI are generally determined on a global basis (and allocated to each CFC) rather than a per jurisdiction or per entity basis, and regardless of whether foreign affiliates are fiscally transparent or not.

Figure 4: Minimum Tax — Categories of Income/Interaction with Other Subpart F Rules



* Will continue to subject USP to regular corporate current tax as under current law.
** Will subject USP to current tax under House Bill or Senate Bill, as the case may be. Both FHRA and GILTI are determined on global basis and then allocated to each CFC. Figure is solely to illustrate categories of includible and non-includible income under interaction of Subpart F and new minimum tax.
*** Will not subject USP to current tax under House Bill or Senate Bill.

NOTE: All earnings are exempt from US tax upon repatriation from foreign subsidiaries to USP.

Targeting US Base Erosion: New Taxes If a US Affiliate Engages in Transactions with a Non-US Affiliate in a Multinational Group

Both the House and Senate Bills attempt to limit tax benefits of transactions between US and non-US affiliates in a multinational group which are perceived to artificially reduce the US tax base through transfer pricing and other arrangements, so-called “base erosion.” Importantly, both the House and Senate Bills target base erosion with rules that apply to both US-parented and non-US parented structures.

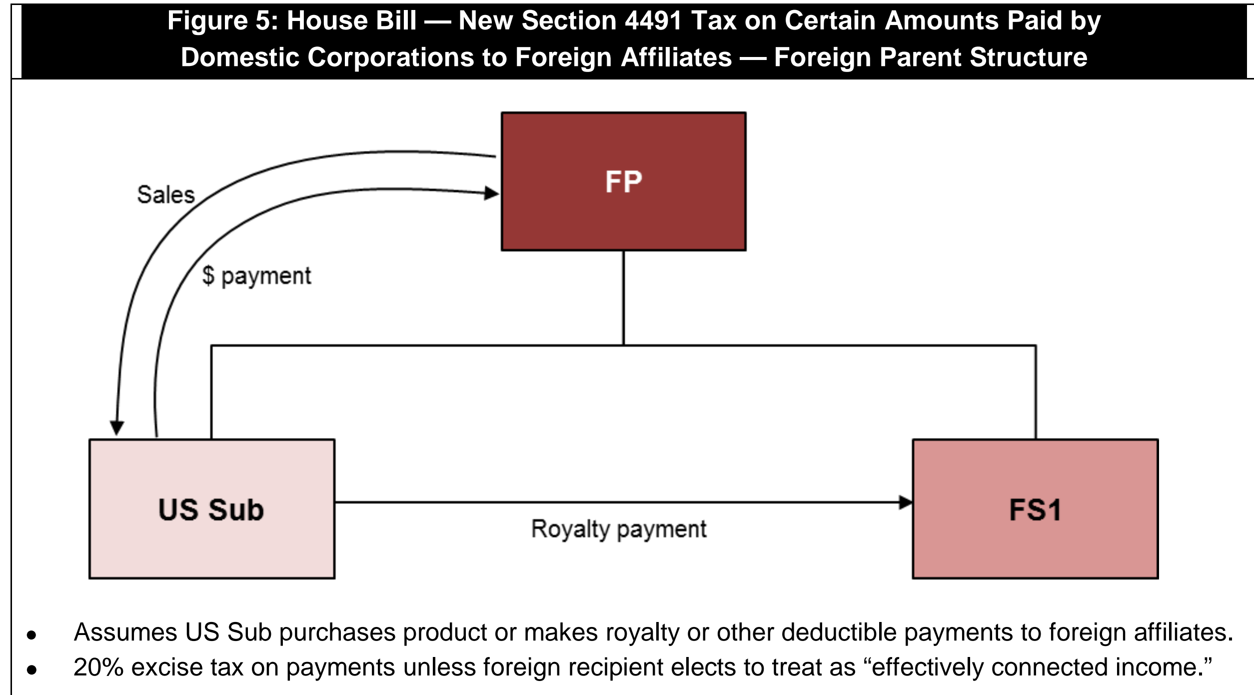
House Bill — Excise Tax on Transactions Between US and Non-US Affiliates

The House Bill would impose a new excise tax on US corporations with respect to certain “specified amounts” paid or incurred by the US corporation (or a foreign corporation’s US branch) to a related foreign corporation that is part of a group of entities that prepare consolidated financial statements. The excise tax is not imposed if the payment constitutes income effectively connected to a US trade or business (ECI) of the foreign recipient. The specified amount subject to the excise tax generally would include amounts that are deductible by the US affiliate making the payment, or includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset. Specified amounts would not include interest payments.

The House Bill would permit a foreign corporation receiving the payment to elect to treat the specified amount as ECI as an alternative to having the excise tax imposed on the related US corporation making the payment. If ECI is elected, the foreign corporation’s net taxable income attributable to this specified amount would be subject to full US tax at the new 20% corporate tax rate plus the branch profits tax, which is imposed at 30% of the after-tax earnings, bringing the tax to in excess of 44% (subject to possible treaty reduction).

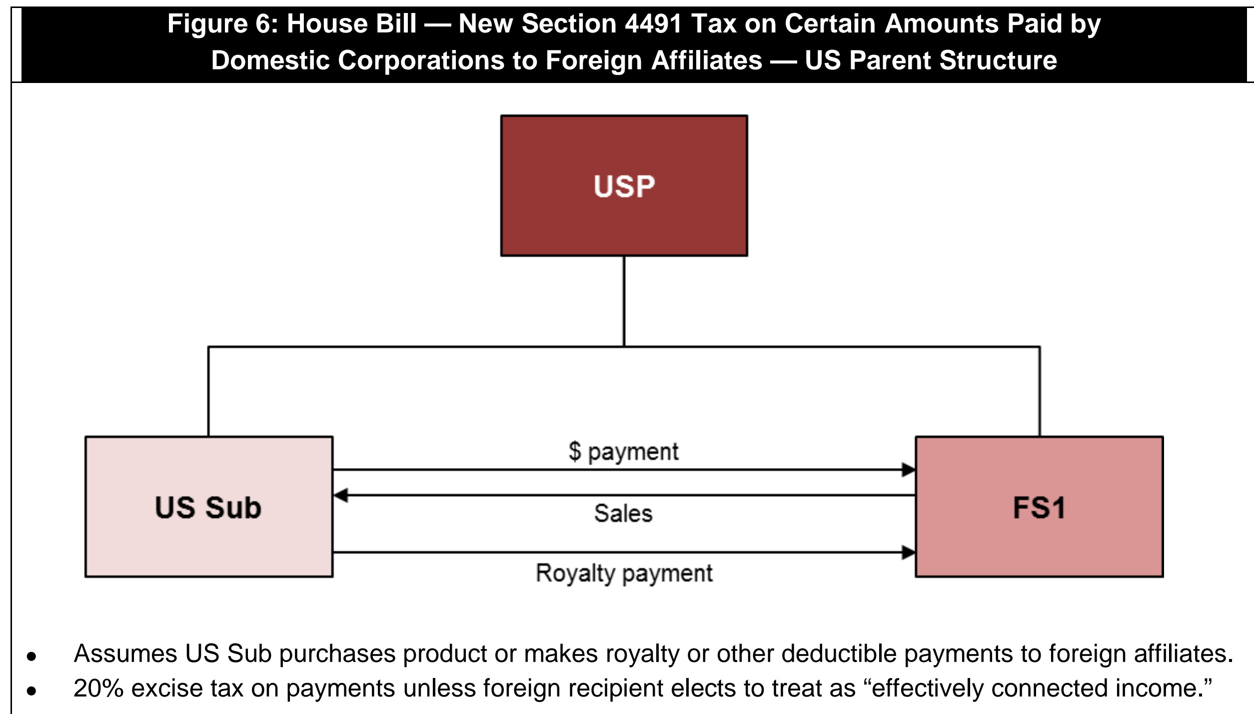
If the foreign corporation makes the ECI election, rather than looking to the actual expenses incurred by the foreign corporation to determine this net taxable income amount, the foreign corporation would reduce the specified amount by a deemed deduction determined by reference to the profit margin of the relevant product of the international group. These provisions would be effective for amounts paid or incurred after December 31, 2018. A foreign tax credit may be available.

Figure 5: House Bill — New Section 4491 Tax on Certain Amounts Paid by Domestic Corporations to Foreign Affiliates — Foreign Parent Structure



- Assumes US Sub purchases product or makes royalty or other deductible payments to foreign affiliates.
- 20% excise tax on payments unless foreign recipient elects to treat as “effectively connected income.”

Figure 6: House Bill — New Section 4491 Tax on Certain Amounts Paid by Domestic Corporations to Foreign Affiliates — US Parent Structure



- Assumes US Sub purchases product or makes royalty or other deductible payments to foreign affiliates.
- 20% excise tax on payments unless foreign recipient elects to treat as “effectively connected income.”

Senate Bill — Base Erosion Anti-Abuse Tax

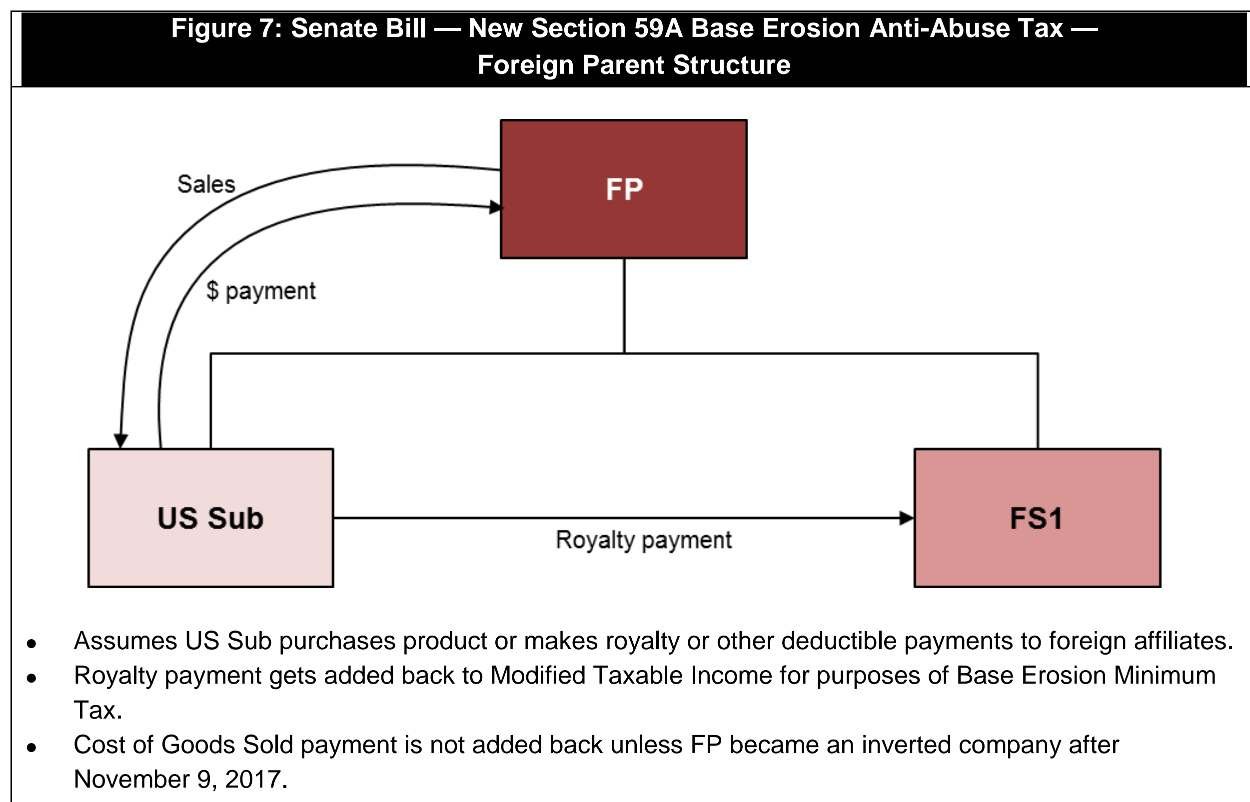
The Senate Bill would create a new base erosion minimum tax, which would apply to US corporations that have made related party deductible payments totaling 4% or more of such corporation's total deductions for the year. The corporation must determine its “modified taxable income” by adding back to its adjusted taxable income for the year all deductible payments made to a foreign affiliate for the year.

The excess of 10% of the corporation's modified taxable income over its regular tax liability for the year (as adjusted for certain credits) would be the base erosion minimum tax amount that is owed. The rate is 11% for banks and securities dealers. The 10% rate is increased to 12.5% (13.5% for banks and securities dealers) in tax years beginning after 2025.

A number of special rules apply for certain derivative payments made by financial institutions.

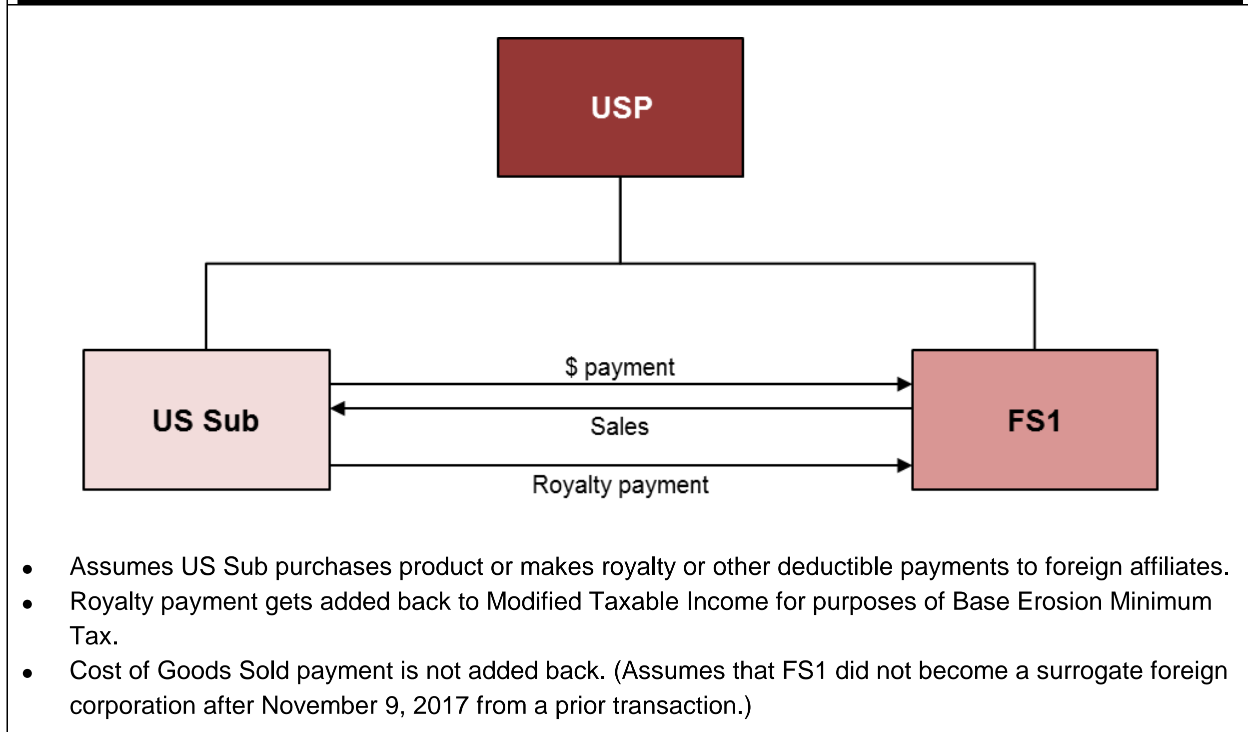
The payments which must be added back generally include those payments to a related foreign person and with respect to which a deduction is allowable (including interest), or with respect to the purchase of depreciable property. The amount of the add back is reduced to the extent the payment to the foreign person is subject to US withholding tax or is a payment for services eligible for the service cost method of Section 482. Cost of goods sold payments are added back only in the case of payments to a foreign corporation which becomes a surrogate foreign corporation (an inversion) after November 9, 2017. These provisions would be effective for payments paid or accrued in taxable years beginning after December 31, 2017.

Figure 7: Senate Bill — New Section 59A Base Erosion Anti-Abuse Tax — Foreign Parent Structure



- Assumes US Sub purchases product or makes royalty or other deductible payments to foreign affiliates.
- Royalty payment gets added back to Modified Taxable Income for purposes of Base Erosion Minimum Tax.
- Cost of Goods Sold payment is not added back unless FP became an inverted company after November 9, 2017.

Figure 8: Senate Bill — New Section 59A Base Erosion Anti-Abuse Tax — US Parent Structure



- Assumes US Sub purchases product or makes royalty or other deductible payments to foreign affiliates.
- Royalty payment gets added back to Modified Taxable Income for purposes of Base Erosion Minimum Tax.
- Cost of Goods Sold payment is not added back. (Assumes that FS1 did not become a surrogate foreign corporation after November 9, 2017 from a prior transaction.)

Taxation of Foreign-Derived Intangible Income

The Senate Bill would include an incentive for US companies to sell goods and provide services to foreign customers. Under the Senate Bill, income from the sale of goods and services abroad (but not the receipt of royalties) would be effectively taxed at only 12.5%. This concept of foreign-derived intangible income is based on a series of complex definitions, and generally includes the excess returns over 10% of aggregate basis in associated tangible depreciable business property. Also, as noted above, this provision allows a deduction equal to 50% of GILTI. This provision would apply to taxable years beginning after December 31, 2017. The tax benefits for foreign derived intangible income (and GILTI) under this section would be reduced in tax years beginning after 2025.

Mandatory Deemed Repatriation for Current Offshore Earnings

US-based multinationals have an estimated US$2-3 trillion of earnings accumulated in foreign subsidiaries. Those earnings have not been subject to US tax but, if repatriated under current law, would be subject to the statutory 35% corporate tax rate less any allowable FTC. Partially in recognition of this "lock-out effect," in 2005, Congress allowed a voluntary repatriation at a rate of 5.25%, which prompted US-based multinationals to repatriate an estimated US$350 billion of overseas earnings.

As part of the transition to a territorial tax regime, both the House and Senate Bill would impose a ***mandatory*** tax on a US shareholder's pro rata share of its foreign subsidiaries' undistributed E&P. The House Bill would measure the earnings as of November 2, 2017 or December 31, 2017, whichever is higher. The Senate Bill would measure the earnings as of November 9, 2017 or December 31, 2017, whichever is higher. A US shareholder (or affiliated group) could reduce the amount of undistributed E&P subject to the tax by E&P deficits of other foreign subsidiaries.

The House Bill and the Senate Bill would impose the repatriation tax at two different rates:

- House Bill: 14% on E&P to the extent of foreign cash and other liquid assets, and 7% on all residual E&P. The cash positon would be determined based on an average of the prior two years and the date of introduction (November 2, 2017).

- Senate Bill: 14.5% on E&P to the extent of foreign cash and other liquid assets, and 7.5% on all residual E&P. The cash positon would be determined based on the average of the prior two years, or at the end of the tax year of inclusion, whichever is greater.

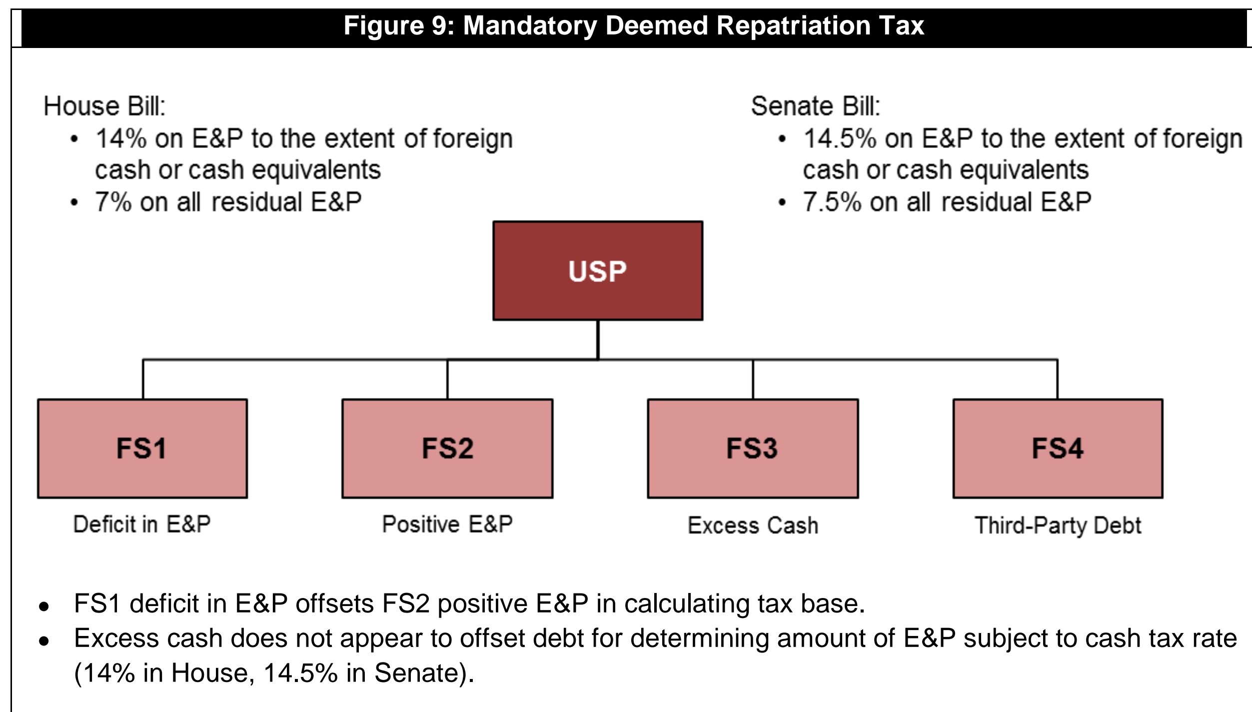
Foreign tax credits would be partially available to offset the repatriation tax, generally to the extent of that portion of earnings subject to the tax.

Both the House and Senate Bills would permit a US shareholder to elect to pay the liability imposed under the tax over a period of up to eight years, with slightly differing payment schedules.

Once taxed, these earnings could then be repatriated without US tax, as distributions would be treated as previously taxed income.

Both the House and Senate Bills would accelerate the tax upon certain events, while the Senate Bill includes a particularly harsh anti-inversion provision which would require the US corporation to pay the full 35% rate on the deferred foreign earnings (less the taxes it already paid), if the US corporation inverts within 10 years after enactment, or otherwise becomes an "expatriated entity." No FTCs would be available in the case of a US corporation becoming subject to this anti-inversion rule.

Figure 9: Mandatory Deemed Repatriation Tax



Other Important International Tax Changes

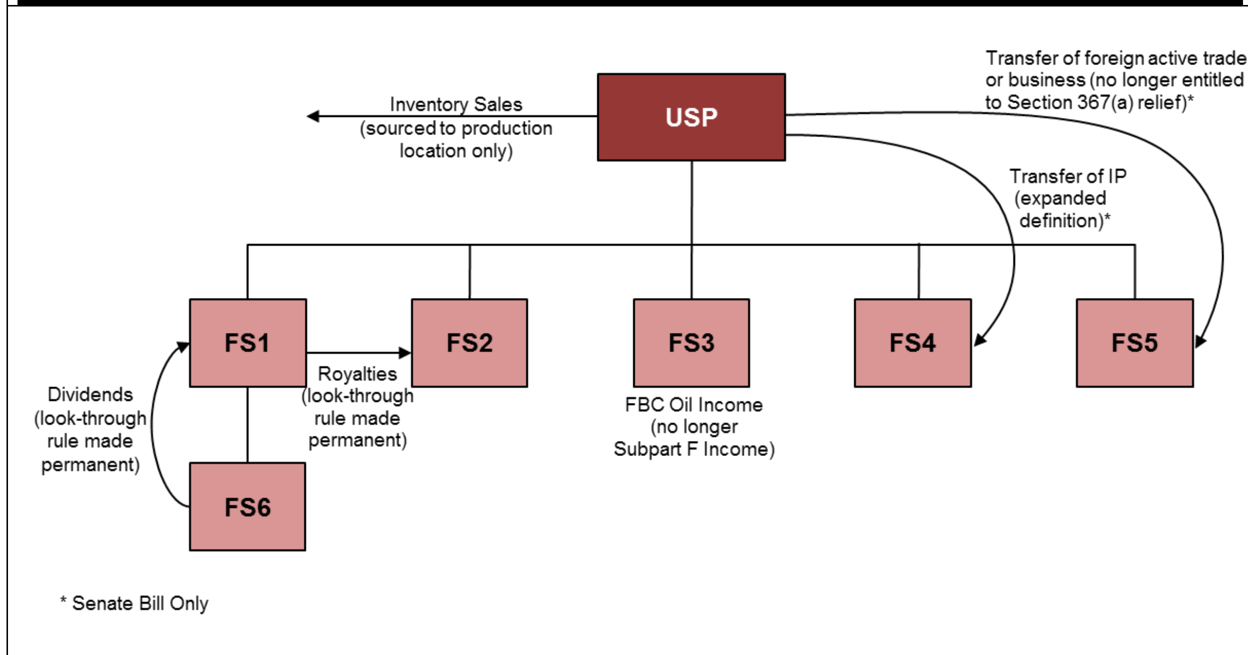
House and Senate Bills

- Section 902 would be repealed. Because, as noted, the concept of deferred foreign earnings would no longer exist, FTCs would only be available under Section 960 to the extent foreign taxes are imposed on Subpart F income that is included in a US shareholder's gross income.
- The look-through rule of Section 954(c)(6), allowing payments between CFCs to avoid Subpart F characterization, would become permanent.
- The source of income from sales of inventory would be determined solely on the basis of production activities.
- Foreign base company oil related income would be eliminated as a category of foreign base company income.

Senate Bill

- Under the Senate Bill, for purposes of determining the value of intangibles in transfer pricing situations, workforce in place, goodwill (both foreign and domestic), and going concern value are intangible property. The Senate Bill also addresses the authority of the IRS to specify the method to be used to determine the value of intangible property, both with respect to outbound restructurings of US operations and to intercompany pricing allocations.
- The Senate Bill denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. For example, any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.
- Any individual shareholder who receives a dividend from a corporation which is a surrogate foreign corporation as defined in Section 7874(a)(2)(B), other than a foreign corporation which is treated as a domestic corporation under Section 7874(b), is not entitled to the lower rates on qualified dividends.
- Under the Senate Bill, certain intangible property owned by foreign subsidiaries can be distributed to US corporate shareholders without US tax during the three years immediately following enactment.
- The active trade or business exception, which allows the transfer to a foreign corporation of certain foreign businesses without a toll charge would be repealed.
- The Senate Bill makes certain changes with respect to pre-2018 unused overall domestic losses.

Figure 10: Brief Illustration of Several Other Changes



VII. Energy Impact

The general business provisions provided by the House Bill and the Senate Bill (*e.g.*, interest deductibility, full expensing, and the changes to the international tax system) are not expected to uniquely affect MLPs, PTPs, their unitholders, or the broader energy industry. For example, see "Interest Deductibility" and "Cost Recovery: Full Expensing," above, for a more detailed discussion of changes proposed by the House and Senate Bills to these more general business activities.

Master Limited Partnerships and Publicly Traded Partnerships

Based on the current form of the House and Senate Bills, MLPs and PTPs will continue to enjoy their tax-advantaged status under the Code. Neither proposal seeks to eliminate or curtail, in any way, the "qualifying income exception" provided by Section 7704 that allows certain MLPs and PTPs to be classified as partnerships for US federal income tax purposes. As such, income earned by an MLP or PTP will continue to be passed through to its owners without being subject to an entity-level US federal income tax.

As discussed in more detail above at "Reduced Tax Rates for Pass-Through Entities," the House Bill lowers the maximum US federal income tax rate applicable to QBI from pass-through entities for passive owners to 25% from the current maximum applicable rate of 39.6%. By contrast, the Senate Bill seeks to apply a lower US federal income tax rate to income earned in pass-through entities by providing taxpayers a deduction equal to 23% of their qualified business income, which deduction will result in a maximum applicable US federal income tax rate of 29.6%. This deduction, however, is subject to a Form W-2 wage limitation that is similar in design and scope to the wage limitation applicable to the deduction offered to taxpayers for certain manufacturing activities under Section 199. The Senate Bill, however, exempts PTPs from the application of the Form W-2 wage limitation.

Observations:

The beneficial rate afforded to pass-through entities under the House Bill should generally be available to all passive unitholders of MLPs and PTPs. Active individual owners of MLPs and PTPs should generally enjoy this lower rate on 30% of the income earned from their actively managed MLPs and PTPs with the remaining 70% of such earned income being taxed at their respective individual rates. As a result of this framework, under the House Bill, income earned from MLPs and PTPs will continue to be subject to lower US federal income tax rates than income earned from corporations. This rate differential is similar to the rate differential that exists between pass-through income and corporate income provided by current law.

With respect to the Senate Bill, it is important to note that MLPs and PTPs are exempt from the application of the Form W-2 wage limitation. As such, all unitholders of MLPs and PTPs should enjoy the beneficial deduction offered by the Senate Bill. When combined with the reduced US federal income tax rate offered to corporations under the Senate Bill, this framework appears to maintain the rate differential that exists between pass-through income and corporate income under current law.

Oil & Gas Taxation

The broader oil and gas industry fares well under both the House and Senate Bills, and most provisions specific to the taxation of natural resources remain unchanged. Historically, the oil and gas industry has faced the potential elimination of several important benefits — namely, the deduction for intangible drilling costs (IDCs), the availability of percentage depletion, the exception to passive loss treatment for certain working interests and favorable geological and geophysical recovery periods. All of those benefits remain untouched under both the House and Senate Bills. Both the House and Senate Bills would restrict like-kind exchange transactions to those involving “real property,” as described below under “REITs – Like-Kind Exchanges.”

The House Bill would repeal business credits available for enhanced oil recovery under Section 43 and credits relating to production from marginal wells under Section 45I. Neither credit was addressed in the Senate Bill.

The Senate Bill proposes opening the Arctic National Wildlife Refuge (ANWR) to oil and gas exploration activities, including drilling activities, by authorizing at least two ANWR area lease sales during the next 10-year period. The House Bill does not address opening ANWR to such activities.

Observations:

Though like-kind exchange transactions may be restricted to those involving “real property,” operating and non-operating interests in oil and gas reserves have typically qualified as real property for these purposes and are expected to continue to do so under both the House and Senate Bills. Thus, this transaction should remain a viable planning tool for the oil and gas sector.

Though the House Bill would repeal certain business credits, in particular with respect to credits relating to production from marginal wells, it is expected that the impact of this repeal will be minimal, as the availability of such credits is reduced when oil prices are above a minimum floor.

The repeal of the AMT in the House Bill should generally be favorably received by the oil and gas industry. Due to the capital-intensive nature of oil and gas exploration companies, many such companies have historically been AMT taxpayers. The House Bill also provides that existing AMT credit would be refundable, which, coupled with the repeal of the AMT, should free up significant capital for additional growth.

VIII. REITs

While the proposals in the House Bill and Senate Bill will have an effect on REITs, they generally do not seek to change the overall taxation of REITs or their shareholders. Subject to a few exceptions that are intended to be helpful to REITs or the real estate industry generally (some of which are described below), neither the House Bill nor the Senate Bill specifically addresses REITs. A brief summary of certain of the House Bill and Senate Bill proposals, as they relate to REITs, follows.

Dividends

In general, under the House Bill and the Senate Bill, dividends paid by REITs (other than capital gain dividends, which will be subject to tax as capital gains to the same extent as provided under current law) are subject to tax at the same rate as a partner's allocable share of income earned by a pass-through entity as described in "Reduced Tax Rates for Pass-Through Entities" above. Accordingly, to the extent a REIT shareholder receives dividends attributable to rental income received by the REIT, the shareholder generally will pay tax on the dividend at the same rate that would apply to a partner's allocable share of rental income earned by a partnership. If dividend income relates to other types of income derived by the REIT, such as interest, the dividends would also be taxed at the pass-through rate, which may be lower than the rate applicable to such income if it were earned directly.

Interest Deductibility and Expensing

As described above under "Interest Deductibility," the House Bill and the Senate Bill limit the ability of corporations and partnerships to deduct net interest expense. Each of the bills provides special rules for interest paid in connection with a "real property trade or business" (generally, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business), which should include most equity REITs. In general, these provisions may be of less significance to mortgage REITs to the extent that they do not have net interest expense.

Under the House Bill, net interest expense remains fully deductible for entities engaged in a real property trade or business. However, the immediate expensing provided under the House Bill, described above under "Cost Recovery: Full Expensing," does not apply to property used in a real property trade or business (*e.g.*, buildings or other structures). Under the Senate Bill, a taxpayer may elect out of the new rules limiting the deductibility of interest provided that it uses a 40-year cost recovery period for nonresidential real property, a 30-year cost recovery period for residential real property and a 20-year recovery period for "qualified leasehold improvement property." Absent this election, the cost recovery period under the Senate Bill is reduced to 25 years for residential and nonresidential real property and to 10 years for qualified tenant improvements.

These provisions generally apply to property placed in service after December 31, 2017.

Like-Kind Exchanges

Under current law, Section 1031 generally allows a taxpayer to exchange property used in a trade or business or held for investment for "like-kind" property without currently recognizing gain or loss. Both the House Bill and Senate Bill would amend Section 1031 to permit exchanges of real property only. While this proposal is generally favorable for REITs and other real estate owners relative to taxpayers that own non-real estate assets, to the extent a REIT owns a material amount of personal property associated with its real property, the like-kind exchange provisions would be less beneficial than under current law.

The amended provisions generally would apply to exchanges completed after December 31, 2017, unless the property is disposed of or received in the exchange on or before such date.

International Provisions

In order to qualify as a REIT, among other conditions, a REIT must satisfy two gross income tests on an annual basis. In addition, a REIT must distribute at least 90% of its taxable income, without regard to the deduction for dividends paid and excluding net capital gains, and it must pay tax at regular corporate rates to the extent that it annually distributes less than 100% of its taxable income.

As discussed above under “Mandatory Deemed Repatriation for Current Offshore Earnings,” both the House and Senate Bills contain provisions that would impose a mandatory tax on a US shareholder’s pro rata share of its foreign subsidiaries’ undistributed E&P. Under the Senate Bill, such income would be excluded for purposes of the REIT gross income tests. In addition, this proposal allows REITs to elect to meet the distribution requirement with respect to such income over an eight-year period. The House Bill does not contain similar provisions. If legislation were finalized without provisions similar to the ones included in the Senate Bill, it could be more difficult for REITs to meet the income and distribution tests for the year any such amounts are repatriated and included in income.

In addition, under the House Bill, a REIT’s share of a CFC’s foreign high return amount, described above in “International – House Bill – Minimum Tax on Foreign Earnings of US-Based Multinationals,” would be treated as qualifying income for purposes of the REIT gross income tests.

Observations:

One of the most helpful legislative proposals related to REITs is the treatment of REITs as pass-through entities for purposes of determining the tax rate applicable to dividends paid to REIT shareholders. This change goes a long way to preserve the tax advantages associated with investment in a REIT as compared to a “regular” C corporation, and continues to tax shareholders of a REIT in a manner similar to investors in pass-through entities, consistent with the Congressional purpose that resulted in the creation of the REIT vehicle. However, the other provisions generally described above may have significant consequences for certain REITs, depending on their particular circumstances.

IX. Looking Ahead

Unless the House votes to approve the Senate Bill in its entirety, a conference committee composed of members from the House and the Senate will now meet to reconcile differences between the House and Senate Bills. The conference report that emerges from this committee will then be voted on by the House and Senate. In the Senate, a simple majority vote is needed for passage as a result of special budget reconciliation rules. Provided the conference report passes both the House and the Senate, it will proceed to the President for his signature.

Latham will continue to carefully monitor tax reform developments and provide resources, including worthwhile third-party content materials, and insights through the Latham & Watkins US Tax Reform Resource Center.

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Endnotes

[1] All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated.

[2] Generally more than 50% owned by vote or value by 10% US shareholders.

[3] Without regard to ECI, Subpart F income, certain commodities income, and income that qualifies for specified exceptions to Subpart F (for example, Section 954(c)(6), which is the CFC "look through" rule).

[4] Similar, though not identical, to the House Bill, the income in this inclusion category is calculated without regard to ECI, Subpart F income, and income that qualifies for specified exceptions to Subpart F (for example, under Section 954(c)(4)).