STROOCK
SPECIAL BULLETIN

The Senate Tax Reform Bill: Benefits for Some and Burdens for Others

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On December 2, 2017, in the early hours of Saturday morning, the U.S. Senate passed its version of the comprehensive tax reform bill (the "Senate bill"). The Senate version of the bill differs significantly from the previous Senate proposal introduced by the Senate Finance Committee,[1] and from the version that the House of Representatives passed on November 16, 2017.[2] As a general matter, the Senate bill takes the approach of making permanent changes to the corporate tax rate, but almost all of the individual tax changes in the Senate bill will sunset after 2025. The House bill, on the other hand, takes the approach of making most changes permanent, but at the expense of more drastic (and more controversial) changes in the area of individual taxation.

Given the significant differences between the House and the Senate versions of the bill, the conference committee is expected to begin its work on resolving these differences. Once the conference committee has reached an agreement, both the House and Senate will vote to pass the same version of the final bill, which will then be submitted for the President's signature.

This **Stroock Special Bulletin** discusses certain significant provisions in the Senate bill, and how they compare with corresponding provisions in the version previously passed by the House.

Pass-Through Taxation

The Senate bill allows individuals to deduct 23% (up from the 17.4% in the previous Senate proposal) of "domestic qualified business income" from partnerships, S corporations, and sole proprietorships (the "Pass-through deduction"). For an individual in the top marginal tax bracket of 38.5%, this deduction would yield an effective federal tax rate of approximately 29.6% on pass-through business income. As described below, however, an individual in the top marginal tax bracket may not fully benefit from this deduction. The House bill, on the other hand, took a completely different approach by capping the highest marginal tax rate from certain business income at 25%. It remains uncertain which

[1] *See* "Tax Reform: Now it's the Senate's Turn," *Stroock Special Bulletin*, November 10, 2017, available at http://www.stroock.com/siteFiles/Publications/OverviewSenateTaxLegislation.pdf.

[2] For a discussion of the proposed bill that preceded the final version, *see* "Overview of the Proposed 'Tax Cuts and Jobs Act' and How it Differs from Current Law," *Stroock Special Bulletin*, November 6, 2017, available at http://www.stroock.com/siteFiles/Publications/OverviewTaxCutJobsAct.pdf.

approach will prevail during the reconciliation process.

The Senate also added a provision that income from publicly traded partnerships (that are not treated as corporations) is eligible for the Pass-through deduction. This provision would benefit energy and real estate ventures formed as master limited partnerships.

The Pass-through deduction in the Senate bill is subject to several significant limitations, namely limitations based on "personal service" income, W-2 wages, and passive income.

Limitation on Income From "Personal Service" Businesses

The first limitation is imposed on income from "personal service" businesses, which include businesses that perform services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, or dealing with securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. Many, if not most, pass-through businesses will fall into this category. Additionally, the trade or business of performing services as an employee is specifically excluded.

The Pass-through deduction for owners of these personal service businesses is phased out when the owner's taxable income (from all sources and not just from the personal service business) exceeds $250,000 for single taxpayers ($500,000 for married taxpayers who file jointly) and is completely eliminated when the taxable income reaches $300,000 for single taxpayers ($600,000 for married taxpayers who file jointly).

Additionally, owners who personally perform services for pass-through businesses are subject to additional limitations because qualified business income does not include (A) reasonable compensation, (B) any guaranteed payments for services, or (C) any payments for services to partners not acting in their capacity as partners (to the extent described in future regulations).

One can expect that these limitations will create additional incentives to try to reclassify employees as self-employed independent contractors, to reclassify guaranteed payments as profits interests, and to minimize the reasonable compensation payments.

Limitation Based on the W-2 wages of a Qualified Trade or Business

The second limitation is based on the W-2 wages of a qualified trade or business. In general, the 23% deduction with respect to income from a qualified trade or business cannot exceed 50% of the W-2 wages paid with respect to that trade or business. Thus, if a business does not pay wages, then the owners of such business will not get any Pass-through deductions (unless their income is below the threshold described below). Additionally, only wages paid and properly allocable to a qualified trade or business are counted.[3]

The limitation based on W-2 wages does not apply to owners with taxable income (from all sources and not just from the business) that does not exceed $250,000 for single taxpayers ($500,000 for married taxpayers who file jointly). This limitation in phased in for taxpayers with incomes between $250,000 and $300,000 for single taxpayers (between $500,000 and $600,000 for married taxpayers who file jointly), and the limitation applies fully for taxpayers with incomes exceeding $300,000 for single taxpayers ($600,000 for married taxpayers who file jointly).

As a result of this limitation, high-net-worth owners of real estate investment partnerships are unlikely to benefit from the Pass-through deduction if the real estate investment

[3] What is "properly allocable" is not defined in the Senate bill. We can expect significant uncertainty with respect to which wages are properly allocable to qualified business income.

partnerships have no or few direct employees because they are managed and operated by third-party property managers. It is possible that in future legislation or regulations this limitation based on W-2 wages will be relaxed to take into account the commercial reality that wages are often paid by an independent management company.

Certain Types of Income Specifically Excluded From Being Treated as Qualified Business Income

Certain types of income are specifically excluded from being treated as qualified business income. Capital gains or losses, dividends, interest (unless properly allocable to a trade or business), and certain other types of income are all excluded.

Interestingly, qualified dividends from real estate investment trusts (REITs) are eligible for the Pass-through deduction and are not subject to many of these limitations. For example, dividends from a REIT with no W-2 wages will still be eligible for the Pass-through deduction regardless of the income of the taxpayer, and there is no limitation on deductibility of state and local income taxes by the REIT. One can expect that this treatment may create an additional incentive for some real estate investment businesses to reorganize as REITs.

Finally, it should be noted that there are other provisions in the Senate bill that will impact owners of pass-through businesses. Elimination of the deduction for state and local income taxes will affect all business owners (even those residing in low tax states) whose businesses pay state and local income taxes.

The Senate bill also states that the Pass-through deduction "shall not apply to any trust or estate." Presumably, this means that non-grantor trusts cannot take this deduction, but owners of grantor trusts can still take the Pass-through deduction. However, due to the brevity of this exclusion language, lack of legislative history, and lack of regulations, we can expect some uncertainty with respect to Pass-through deductions by trusts and estates.

Corporate Taxation – 20% in 2019

The Senate bill mirrors the House bill in reducing the top marginal corporate rate from 35% to 20%. Unlike the House bill, which would implement the lower tax rate for tax years beginning after 2017, the Senate bill would delay this change until 2019. However, the corporate tax rate remains a debatable provision for the final reconciled bill and recent commentary coming out of the White House, signaling the possibility of a 22% corporate tax rate, might be an indication of some flexibility in the corporate tax rate for the final version of the bill.

The Alternative Minimum Tax ("AMT")

The Senate bill leaves intact the AMT for corporations. Interestingly, since the AMT rate would continue to be 20% and this is the same as the 20% corporate tax rate proposed by the Senate bill, corporations would almost always be subject to the AMT because of the broader base to which the AMT applies if the Senate bill were enacted in its current form.

For individuals, the Senate bill leaves the AMT, but increases the exemption amount for years 2018 through 2025. In 2017, the AMT exemption amount was $54,300 and it began to phase out at $120,700 for single taxpayers ($84,500 for married taxpayers filing jointly for whom the exemption began to phase out at $160,900). Under the Senate bill, if enacted, the AMT exemption in 2018 will be $70,300 and it will begin to phase out at $156,300 for single taxpayers ($109,400 for married taxpayers filing jointly for whom the exemption begins to phase out at $208,400).

The AMT exemptions and phase out thresholds will adjust annually for inflation (using the chained CPI-U index), but in 2026 they will revert to the current level, as adjusted for inflation between 2017 and 2026.

Property Tax Deductions, State and Local Tax Deductions, and Mortgage Deductions

The Senate bill, just as the House bill, would eliminate the state and local income tax or sales tax deduction for individual taxpayers.[4]

Under both the Senate and the House bills, the real property tax deduction would remain in place but would be capped at $10,000. Real property taxes related to businesses or investments would still be deductible.

The Senate bill leaves in place the current mortgage interest deduction for mortgages up to $1,000,000, while the House bill would limit it to mortgages up to $500,000 (with currently outstanding mortgages being grandfathered). The Senate bill and the House bill both repeal the home equity interest deduction.

International Taxation

Participation Exemption and Repatriation Tax for Existing E&P

The Senate bill shifts the U.S. corporate tax system closer to a territorial system. Like the House bill, the Senate bill provides a participation exemption for foreign-sourced dividends paid by a foreign shareholder to a 10% U.S. shareholder. The Senate bill, however, denies this deduction to hybrid dividends (dividends that are deductible in the country of the paying company) and imposes a longer holding period of at least 365 days.

In order to transition to the "participation exemption" system of taxation, the Senate bill, like the House bill, provides for a one-time tax on all unrepatriated and previously untaxed earnings and profits of foreign subsidiary corporations at the rate of approximately 14.5% for cash and other liquid assets (14% in the House bill) and approximately 7.5% for reinvested earnings (7% in the House bill). The tax on unrepatriated income is payable over eight years.

Foreign Tax Credits

Both the House bill and the Senate bill repeal the indirect foreign tax credit and source income from the sale of inventory based on where production of the inventory occurs. Each bill modifies the foreign tax credit baskets in different ways.

Modifications of CFC and Subpart F Provisions

The Senate bill, for the most part, follows the House bill in modifications to Subpart F provisions but has some significant differences.

Notwithstanding the general territoriality rule, the Senate bill would tax a U.S. shareholder's share of a controlled foreign corporation's ("CFC") "global intangible low-taxed income," or "GILTI," at a 10% rate (which could increase to 12.5% for tax years beginning after December 31, 2025). GILTI is active income in excess of an implied return of 10% of the CFC's adjusted bases in tangible depreciable property used to generate the active income. The House bill has a similar concept but applies to income in excess of the short-term federal rate plus 7%, multiplied by the same base amount. In both bills, tax credits are available for 80% of foreign taxes paid.

Under the Senate bill (but not the House bill) a special 12.5% rate (which could increase to 15.625% in tax years beginning after December 31, 2025) would apply to the intangible income of a U.S. corporation derived in connection with foreign sales or foreign use (effectively a "patent box"). The Senate bill also contains a provision that exempts a CFC from recognizing gain on the distribution of intangible property to a U.S. shareholder that is a corporation if made by the CFC before the last day of the third tax year of the CFC beginning after December 31, 2017.

[4] Although earlier reports suggested that Congress intended to preserve state and local income tax deductions related to businesses and investments, the final version of the House and the Senate bills appear to deny all state and local income tax deductions to individuals.

The Senate bill also makes a very slight, but very important change to the definition of "U.S. Shareholder" for purposes of the application of Subpart F provisions. Under the bill, "U.S. Shareholder" is a person who owns at least 10% of the value of the foreign corporation, as opposed to the previous rule that required at least 10% of the vote. Many existing corporate structures would have to be reexamined and modified if this change is enacted.

Base Erosion

The House and the Senate bills both attempt to address the issue of base erosion, but they do so in different ways. Both bills take a swipe at deductibility of related party interest payments.

The Senate bill does not include the provision in the House bill that imposes an excise tax on domestic corporations making payments to foreign affiliates. However, the Senate bill has a provision intended to reach a similar result — the "base erosion minimum tax." For purposes of this minimum tax, taxpayers are required to (i) calculate 10% of their taxable income after adding back deductions for deductible payments to foreign affiliates and a portion of any net operating loss carryforwards and (ii) calculate the taxpayer's tax liability unreduced by any tax credits claimed by the taxpayer (other than the R&D credit). If (i) is greater than (ii), the taxpayer must pay the difference as a tax. The base erosion minimum tax applies to domestic corporations that have annual gross receipts in excess of $500 million (for the three prior tax years) and that have a "base erosion percentage" of 4% or higher for the taxable year.

Insurance Provisions

The House bill originally had special rules relating to the computation of life insurance reserves for tax purposes, the apportionment of the dividends received deduction ("DRD") between the life insurance companies and their policyholders, and the amortization of specified policy acquisition expenses (the so-called DAC tax). It was thought that these special rules were scored incorrectly, so the final bill as passed by the House replaced the special rules with an 8% surtax on life insurance companies. The Senate bill reinstated the original House provisions, but with more moderate changes — the life reserves generally would be 92.87% of the statutory reserves (with a special rule for the interest rate used to discount them) and the difference for old contracts between the new reserve and the old reserve would be taken into income (or deducted) ratably over 8 years; the portion of the DRD allocated to life companies would be 70% of the total; and the DAC tax would be increased by lengthening the amortization period from 10 to 15 years and by increasing the amount subject to amortization from 1.75% of annuity premiums to 2.1% and from 7.7% to 9.24% in the case of life contracts (with a different rate for group life contracts).

Taxation of Energy Projects

The Senate bill differs significantly from the House bill in that it does not directly change any tax credits or other incentives for the energy industry. It does not include provisions in the House bill (i) eliminating the inflation adjustment for new wind projects that qualify for the production tax credit (the "PTC") which reduces the credit from 2.4 cents per kilowatt-hour of electricity produced to a base amount of 1.5 cents per kilowatt-hour, (ii) revoking IRS guidance with respect to when construction is deemed to commence for purposes of determining a project's eligibility for the PTC, and (iii) setting an expiration of 2027 for the 10% investment tax credit for solar energy.

However, the Senate bill makes subtle changes that will indirectly and significantly affect the energy industry. The "base erosion minimum tax" described above will adversely affect the renewable energy industry. For taxpayers such as large multinational banks, which historically have claimed a significant amount of the renewable energy tax credits, the inability to use tax credits to offset the tax liability under the base erosion minimum tax will make the tax credits significantly less valuable. In effect, this could operate as a 100% clawback of

the tax savings associated with the investment and production tax credits.

While the House bill repeals the corporate AMT, the Senate bill retains the corporate AMT with a 20 percent rate. As discussed above, under the Senate bill, corporations would almost always be subject to the AMT which would limit the value of tax credits. In the renewable energy context, this would mean that a corporation could only apply the PTC offset to its tax liability for the first four years after a project is placed in service even though, in the absence of the AMT, the PTC is available for 10 years after a project is placed in service. It is expected that if the corporate AMT is retained in the reconciliation process, its rate would be proportionately reduced so that fewer corporations would be subject to it.

In both the House and Senate bills, owners of master limited partnerships ("MLPs") will benefit from reduced tax rates with respect to their share of the MLP's income. The House bill lowers the pass-through rate to 25%, while the Senate bill effectively lowers the highest marginal tax rate to 29.65% by reducing the highest marginal personal tax rate to 38.5% and providing for a 23% Pass-through deduction. However, as described above, the Senate bill limits the Pass-through deduction to 50 percent of an investor's share of the partnership's W-2 wages. Since most MLPs do not have direct employees, their individual investors would not be able to take advantage of the Pass-through deduction. An amendment introduced by Sen. John Cornyn, R-Texas, would exempt oil and gas MLPs from that wage limitation, ensuring that their passive investors gain the full benefit of the reduced pass-through tax rate.

Conclusion

Stroock tax attorneys have been closely monitoring the developments of the various tax reform plans. Once the tax reform bill is finalized and signed by the President, we will be able to assess its impact on various existing business structures. It is clear that if and when any tax legislation is enacted into law, individual and business tax planning will be significantly affected. We are available to discuss any questions you may have regarding this proposed tax reform (and any subsequent developments) and its effect on your tax planning.

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