House Republicans Propose Tax Reform Legislation – Will This Become Law?

It's here! House Republicans have released the legislative text of the most serious effort to reform the US Tax Code since 1986. Republican tax-writers have come a long way from the "Blueprint" and the "Unified Framework" – they have officially broken ground on sweeping tax reform legislation titled the Tax Cuts and Jobs Act (the Bill). Although they have made significant progress, Congress still has more work to do to pass a bill by their proclaimed end-of-year target. On the other side of the Capitol, the Senate does not plan merely to rubber-stamp the House proposal. In fact, Senate Republicans intend to release their own plan next week and begin a markup during the week of November 13. With that, the content of a final bill remains uncertain at best. Although the substance of the final bill remains a work in progress, one aspect of this process is certain: there is a political imperative for Republican lawmakers to secure a "win" before next year's midterm elections. Below, we highlight key aspects of the proposed legislation, starting with a brief overview of some domestic provisions, followed by more detailed points applicable to multinationals.

Domestic Provisions

Included in the Bill are several important domestic changes, the most significant of which are:

- Corporate tax rate has been reduced to 20% on a permanent basis beginning in 2018
- Rate of tax for owners of certain pass-through entities will be 25%
- Immediate expensing for qualified property placed in service after September 27, 2017 for five years
- Net interest expense deduction capped at 30% of adjusted taxable income with some exceptions
- Elimination of most investment credits, but Research and Experimentation credit and Low-Income Housing Tax Credit remain
- NOL carryover may only be used to offset 90% of a taxpayer's taxable income and generally no carryback allowed
- Corporate AMT has been eliminated
- Significant changes to the taxation of insurance companies and the non-profit sector

Non-US Earnings

Territorial Tax System

The Bill includes significant changes to the taxation of business income earned outside the US. Under our current system, US tax on earnings from active foreign business can be deferred until those earnings are repatriated, subject to several exceptions. This is called a "deferral system" because the inherent assumption in the system is that all foreign earnings will eventually come back to the US and be taxed. This Bill proposes a change from this "global" system of taxation to a "territorial" system in which non-US business income generally is not taxed in the US.

Participation Exemption

This new territorial system is achieved primarily through a dividend exemption approach. US corporate shareholders that own 10% or more of a foreign corporation will receive a 100% exemption on the foreign-sourced portion of dividends received from the foreign corporation. This provision is intended to put US multinationals on more of an equal footing with foreign competitors when doing business outside the US and eliminate the tendency to "lock up" foreign earnings, something that is encouraged under the current deferral system. This territorial approach brings along with it several other changes, including:

- Elimination of the US foreign tax credit with respect to exempt dividends
- Elimination of the deemed dividend US companies endure when their foreign subsidiaries make certain investments in US property
- Denial of a "double benefit" if foreign subsidiary stock is sold at a loss by reducing the US parent's basis in the stock for purposes of calculating loss

The exemption would apply to dividends received after 2017 and the companion changes generally take effect starting in 2018.

One-Time Tax on Existing Foreign Earnings

As part of the transition to the new territorial system, the Bill would deem a repatriation of a proportionate share of all previously deferred (i.e., "locked up") foreign earnings from 10% or greater foreign subsidiaries. The deemed repatriation will not include any previously taxed earnings and will be net of foreign subsidiary earnings deficits. All earnings held in cash or cash equivalents will be taxed at a 12% tax rate and all other such assets will be taxed at a 5% rates. The deemed repatriation generally occurs in 2018 and the resulting tax can be paid in installments over eight years.

Global Minimum Tax on "High Return" Foreign Income

In order to head off inappropriate US tax base erosion that could result from the foreign dividend exemption of the new territorial system, the Bill will implement what is effectively a new 10% minimum tax on "high return" foreign earnings of multinational businesses.

This works by subjecting the US parent of one or more foreign subsidiaries to current tax on 50% foreign subsidiaries aggregate high return income (effectively resulting in a 10% tax rate assuming the US corporate rate is 20%). The aggregate approach means that the computations are not made on a country-by-country or entity-by-entity basis. For this purpose, high return income is the excess of the foreign subsidiaries' aggregate net income over a so-called routine return on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property reduced for interest expense. The routine return for this purpose is 7%, plus the federal short-term rate (slightly above 1% at present). High return income would not include income effectively connected with a US trade or business, subpart F income, certain foreign insurance and financing income, and certain foreign commodities income.

A US parent is taxed on foreign high return income each year regardless of whether the income was actually repatriated to the US and a partial (80%) foreign tax credit will be allowed. This means that there will be a residual US tax on high return income unless a 12.5% or greater foreign tax is actually paid on the income. The foreign tax credit will have no carry-forward or carry-back for this purpose.

The high return income tax is effective generally after 2017.

Other International Provisions

The Bill includes several other changes to US international tax, including:

- Changes to the source of income with respect to inventory produced in the US
- Elimination of current taxation of certain foreign oil-related income and historic shipping income
- The controlled foreign corporation "look through" rule in 954(c)(6) is made permanent
- Changes to other controlled foreign corporation rules

Investment Into the US

The Bill contains provisions that appear principally intended to implement the undertaking in the September "Unified Framework" to combat erosion of the US tax base through provisions that are also intended to level the playing field between US-based multinational businesses and foreign-based multinational businesses operating in the US.

Interest Payments

The Bill provides for the disallowance of deductions for related party interest payments by a US corporation that is a member of an "international financial reporting group" and has annual global gross receipts of more than $100 million. Under the provision, interest deductions by the US corporation would be disallowed to the extent the US corporation's share of the group's global net interest expense exceeds 110% of the US corporation's share of the group's global earnings computed on an EBITDA basis (i.e., the US corporation can have 10% more leverage than the global group). This provision, which would be effective for taxable years beginning after 2017, would be applied in tandem with the Bill's general limitation on interest deductibility described above. The deduction would be disallowed pursuant to whichever of the two provisions results in the largest disallowance. Any disallowed interest could be carried forward for five years and applied on a FIFO basis. For this purpose, an "international financial reporting group" means a group that prepares consolidated financial statements and includes either at least one foreign corporation engaged in a trade or business in the US or at least one domestic corporation and one foreign corporation.

Other Payments

Subject to certain limited exceptions, the Bill imposes a 20% "excise tax" on deductible or other tax-benefitted payments (other than interest) made by a US corporation to a foreign corporation that is a member of the same "international financial reporting group." In order to avoid this tax on the gross payment, the payee foreign corporation can instead elect to treat those payments as taxable income that is effectively connected with a US trade or business. If such an election were made, those payments would be subject to US tax and, if no election were made, no deduction would be allowed for the excise tax paid by the US corporation. The provision would be effective for taxable years beginning after 2018 and would be applicable with respect to those international financial reporting groups with payments from US affiliates to their foreign affiliates of at least $100 million annually.

Treaty Benefits

Notably, a revised draft of the Bill removed the limitation on treaty benefits for certain deductible payments described below. In the original draft, the Bill addressed the situation where a foreign-controlled US entity makes a deductible payment that is classified as "fixed or determinable, annual or periodical" (e.g., dividends, interest, rents, etc.) to another entity that is controlled by the same foreign parent and located in a jurisdiction that has a tax treaty with the US under which the 30% statutory withholding rate on the payment is reduced or eliminated. Under the provision, which would have been effective for taxable years beginning after the date the Bill is enacted, the 30% withholding rate would not be reduced by any treaty unless it would have been reduced had the payment been made directly by the US payor to the foreign parent.

Where Do We Go From Here?

With a tight timeline and intra-party fissures already emerging, Republicans have difficult weeks ahead of them. As for timing, the House Committee on Ways and Means plans to begin its markup of the legislation November 6 and report it to the House floor by November 10. As previously mentioned, Senate Republicans intend to release their plan next week and begin a markup in the Finance Committee during the week of November 13. Though he did not mention the Senate, President Trump recently said that he expects the House to pass legislation by Thanksgiving and for a bill to reach the Oval Office by Christmas. That said, prospects for differences between House and Senate bills suggest a conference committee may write the final legislation, which could impact both the timing and substance of a final bill. And if that ambitious timeline did not make things hard enough, key factions of the Republican Party have already come out against the Bill. As the details of the plan become known, there already appears to be evidence of a schism among traditional GOP establishment groups (i.e., the Club for Growth, homebuilders, realtors and even Republican members from high-taxed states have all expressed concerns or outright opposition to the Bill). Although there is still a long way to go, Republicans are building momentum with each passing day, thereby increasing the chances of delivering the most comprehensive tax reform bill in a generation.

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