House Ways and Means Committee Releases Comprehensive Tax Reform Bill

Tax and Public Law and Policy, November 3, 2017

Introduction

On November 2, 2017, the House Ways and Means Committee released its much-anticipated plan for reforming the tax code for businesses and individuals in a way that will amount to a net tax cut of $1.5 trillion in the first decade. While the outline of the bill has been public since the so-called Big Six tax writers released their “Unified Framework for Fixing our Broken Tax Code” on September 27, it has been unclear exactly how the rate cuts—for example from a top rate of 35 percent for corporations to a flat rate of 20 percent, including a move to a territorial system—would be paid for.

The release of the 429-page bill, titled the Tax Cuts and Jobs Act of 2017 (H.R. 1), marks the beginning of what Republican leaders hope will be a speedy and successful race to enactment by the end of 2017. The plan makes significant changes to all aspects of the corporate, pass-through, international and individual sections of the tax code.

The Tax Cuts and Jobs Act (TCJA) would lower the corporate rate to 20 percent, effective in 2018 and on a permanent basis. The bill includes a five-year period of full and immediate expensing of qualified property while limiting the deduction for net interest expenses to up to 30 percent of earnings before tax. The limitation on interest deductibility does not include a grandfather for existing debt, but does carve out companies with less than $25 million in gross receipts, regulated public utilities, and real property trades or businesses. The latter two categories would not qualify for full expensing. See page 10 for a description of changes included in TCJA for pass-throughs.

On the international side, the bill would transition the United States to a territorial system of international taxation, partially paid for with a one-time, deemed repatriation tax on deferred income of foreign affiliates with a bifurcated rate of 12 percent for cash and cash equivalents and 5 percent for illiquid assets. The bill also includes a foreign high returns tax (effectively, a global minimum tax on limited income) and an excise tax on certain payments made by a U.S. corporation to a foreign affiliate.

For individuals, TCJA would collapse the seven existing tax brackets into four at 12 percent, 25 percent, 35 percent and 39.6 percent with an expanded zero percent bracket by way of the increase to the standard deduction (doubling it to $12,000 for individuals and $24,000 for married joint filers). The bill would also expand the Child Tax Credit to $1,600 and create a new credit for non-child dependents. It would eliminate the individual Alternative Minimum Tax and deduction for state and local taxes, but maintain a deduction for up to $10,000 in property taxes. The mortgage interest deduction is retained, but capped at $500,000 for new mortgages (which includes mortgages refinanced after November 2) and limited to principal residence.

Starting on page 3 is a chart that outlines the major provisions in TCJA as compared to other recent tax reform proposals. Following the chart is additional in-depth narrative on some of the more significant and novel provisions, including the new limitation on the deductibility of net interest expense, the major international provisions and an explanation of the new pass-through proposal.

Chairman's Mark Revisions

On November 3, Chairman Kevin Brady (R-TX) released an amendment in the nature of a substitute (also referred to as the Chairman's mark) to make two substantive revisions and a number of technical corrections to the original text. Citing a concern that it may not conform to Senate reconciliation rules, the mark removes Section 4502 which would have limited treaty benefits for certain deductible payments. The mark also eliminates an effective date delay provision for the use of chained CPI when indexing the individual income brackets, instead making the alternative inflation method effective for taxable years after 12/31/17.

Timeline

Ways and Means Chairman Kevin Brady (R-TX) officially noticed a mark-up for Monday, November 6, beginning at noon and expected to consume the balance of the week. Mark-up activity is expected to roughly follow this timeline:

- Monday, November 6, at noon: Mark-up begins with opening statements
    - Chairman Brady also plans to offer another amendment with more substantive changes to the underlying bill at the start of the markup
- Tuesday, November 7: Walk-through of the legislation with the Joint Committee on Taxation's Chief of Staff Tom Barthold, followed by an extended Q&A session with committee members
- Wednesday, November 8, and beyond: Amendments considered and final passage, with a built-in deadline of finishing by Thursday, November 9, with Veterans Day observed on Friday, November 10.

While this would require a quick turnaround post-mark-up, House Speaker Paul Ryan (R-WI) has said that he plans to put the bill on the House floor for a vote the week of November 13.

Meanwhile, the Senate Finance Committee is actively working to finish its version of tax reform so that it can start markup this month as well. Finance could drop its conceptual language (the Committee traditionally does not markup legislative text) as early as November 8, with a mark-up planned for the week of November 13. Senate Majority Leader Mitch McConnell (R-KY) told senators that they may be in session the week of Thanksgiving for a possible Senate floor vote on the bill. We will continue to issue updates as more details emerge.

Corporate Tax Changes Comparison

	11/02/17 TCJA[1]	9/17 Big 6 Framework[2]	6/16 GOP Blueprint[3]	12/14 Camp Tax Act[4]
Rates	-Flat 20% rate in 2018 -Permanent -Cost: $1.5 trillion/10 yrs	-Flat rate of 20%	-Flat rate of 20%	-Flat rate of 25%, but phased in over 5 yrs (33%; 31%; 29%; 27%)
AMT	-Repeal corporate AMT	-“Aims to” repeal AMT	-Repeal corporate AMT	-Repeal corporate AMT
Corporate integration (reduce double tax on earnings)	-No mention	-“May consider methods to reduce” double tax on corporate earnings	-50% deduction for dividends and capital gains for individuals; no preferential rate	-40% deduction for dividends and capital gains for individuals; no preferential rate
Expensing (full and immediate write-off of certain capital investments)	-Effective 9/28/17, 100% expensing for certain capital investments, extending it to used property; expires 1/1/23 -Not permitted for regulated public utilities or real property business	-Expensing for “new investments in depreciable assets,” but not structures, for at least 5 yrs; effective 9/28/17 -May give more relief for small businesses	-Expensing for “investments in tangible property (such as equipment and buildings) and intangible assets (such as intellectual property),” but not land	-Permanent Sec. 179 small business up to $250k/yr incl property -Generally lengthen depreciation schedules by repealing MACRS to slow cost recovery
Interest expense deduction	-In ’18, deduction allowed up to 30% of pretax earnings; no grandfather -If average gross receipts $25 mil or less, no limit -Carve out for public utilities and real property business -Plus thin cap rule, world group limit of 110%	-Partially limit (details unspecified) the deduction for net interest expense	-Eliminate deductions for net interest expense (allowed only to the extent of interest income, although can be carried forward) -Special rules provided for financial services companies (banks, insurance, leasing)	-Interest expense limitations apply in the context of anti-base erosion rules -Thin cap rule limits the deduction if debt level of U.S. members is more than 110% of its worldwide group
Research and development (R&D) credit	-No mention	-Retain in some form	-Replace with a more effective and efficient R&D business credit	-Modify and make permanent the Sec. 41 research credit
R&D expensing (Sec. 174)	-No mention	-No mention	-No mention	-Repeal deduction, require 5 yr amortization
Domestic production activities	-Repeal Sec. 199 domestic production deduction effective 2018	-Repeal Sec. 199 deduction	-Repeal Sec. 199 deduction	-Phased repeal of Sec. 199 deduction (down to 6% in yr 1, 3% in yr 2).
NOLs (net operating losses)	-NOLs used only to reduce net taxable income by 90% -Repeal 2-yr carryback -Special 1-yr carryback in case of casualty, disaster -Carryforward + interest	-No mention	-NOLs can be carried forward indefinitely and increased for interest, and can be used only to reduce net taxable income by 90% -No NOL carrybacks	-NOLs used only to reduce net taxable income by 90% -Standard 2-yr carryback remains, but all special carryback rules repealed except casualty, disaster
Inventory accounting and last-in, first-out (LIFO) method	-No mention	-No mention	-Arguably superseded -“Evaluate options for making the treatment of inventory more effective”	-Repeal LIFO method -4-yr recapture for LIFO reserves
New markets tax credit	-Terminate ‘18 and ‘19 allocations; 7-yr phase-out for credits allocated	-No mention	-No mention	-Repeal by omission, since NMTC is set to expire
Historic credit	-Repeal with a transition	-No mention	-No mention	-Repeal rehab tax credit
Low-income housing credit	-No mention	-Retain in some form	-No mention	-Retain the 70% present value credit, repeal 30%

SEE PAGE 6 FOR CHART ON ADDITIONAL BUSINESS DEDUCTIONS AND CREDITS

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International Tax Changes Comparison

	11/02/17 TCJA	9/17 Big 6 Framework	6/16 GOP Blueprint	12/14 Camp Tax Act
Move to territorial system	-100% foreign sub (“Fsub”) dividend exemption	-100% exemption for dividends from Fsubs	-100% exemption for dividends from Fsubs	-95% exemption for dividends from Fsubs
Deemed repatriation, one-time transition tax	-Bifurcated (12% cash; 5% remaining earnings) effected by deduction -Due over 8 yrs (in equal installments of 12.5%) -NOLs further reduce deduction; FTCs limited	-Unspecified tax rate on accumulated foreign earnings held in cash or equivalents, lower rate if held in illiquid assets -Due over several years	-Bifurcated 8.75% tax on cash and similar, 3.5% tax on illiquid earnings -Due over 8-yr period	-Bifurcated 8.75% tax on liquid earnings and 3.5% tax on illiquid earnings -Payable 8% each of first 5 yrs (15% in yr 6, 20% in yr 7, 25% in yr 8)
Global minimum tax or inclusion for “foreign high returns” to prevent base erosion, including changes to Subpart F rules	-U.S. parent taxed at 20% on half of the “high returns” of its Fsubs, with high returns defined as: (1) Fsub aggregate net income, minus (2) about 8% of basis in foreign depreciable property, minus (3) a percentage of the number after (2) -FTCs limited to 80%	-Unspecified “rules to protect the U.S. tax base by taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations”	-No actual or quasi-global minimum tax, but prevented base erosion by imposing border adjustments (denying deductions for imports, no tax on exports) -Bulk of the Subpart F rules repealed, with exception of the foreign personal holding co. rules	-15% tax on “FBCII” that is foreign-derived (expansion of Subpart F) -25% tax on “FBCII” that is U.S.-derived (anti-round tripping) -FBCII equals the portion of foreign sub’s income that exceeds 10% of its basis in depreciable tangible property
Other base erosion rules	-Excise tax on deductible payments between U.S. corp and foreign affiliate (unless provided at cost) -Tax is 20% of such payments, unless foreign corp treats as ECI, so deductions allowed -But no FTCs allowed -Applies if $100mil/yr of such payments in group	-Unspecified “rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies”	-The border-adjusted tax (BAT) transforms the tax base to a destination-based consumption tax, half of which acts as an inbound tax, while the other half acts as an outbound exemption	-No mention
Offshore reinsurance	-No mention, but other rules likely impact this	-No mention	-BAT would be harmful if no reinsurance carve-out	-No premium deduction if affiliate not U.S.-taxed

Pass-Through Tax Changes Comparison

	11/02/17 TCJA	9/17 Big 6 Framework	6/16 GOP Blueprint	12/14 Camp Tax Act
Rates	-25% top rate for certain income of pass-throughs -All passive activity income gets 25% rate	-25% top rate for certain income of “small and family-owned businesses”	-25% top rate for “active business income of . . . pass-through entities”	-No special rate for pass-through business income generally
Guardrails to prevent abuse of special rate	-Elect to apply 25% rate to 30% of income or aim to substantiate portion tied to size of partner’s capital investments	-Unspecified measures to stop recharacterization of personal income into business income	-Treat pass-throughs as having paid reasonable comp to certain owners -Details unspecified	-Not applicable
Expensing	-Sec. 179 up from $500k to $5mil to begin 2018	-Additional small business expensing relief possible	-Expensing presumably available to all businesses	-Not applicable
Interest expense deduction	-Limit applies at pship lvl -If average gross receipts $25mil or less, no limit	-Undecided treatment of interest by non-C corps	-Presumably same limitation as for C corps	-Not applicable
Carried interest	-No mention	-No mention	-No mention	-Taxes certain partners’ capital gain as ordinary -Deemed loan of capital /imputed interest model
Cash method	-$5mil raised to $25mil	-No mention	-No mention	-For firms up to $10mil

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Individual Tax Changes Comparison

	11/02/17 TCJA	9/17 Big 6 Framework	6/16 GOP Blueprint	12/14 Camp Tax Act
Rates	-Reduce 7 brackets to 4 (39.6%, 35%, 25% and 12%); top bracket on $1mil+ joint income	-Reduce 7 brackets to 3 (35%, 25% and 12%) -4th top bracket possible	-Reduce 7 brackets to 3 (33%, 25% and 12%)	-Reduce 7 brackets to 3 (35%, 25% and 10%) -35% is surtax imposed on $450k+ joint income
Standard deduction	-Enhance standard deduction; repeal additional standard deduction and personal exemptions -$12k individuals -$24k married filing joint -Deduction is large enough so that less than 10% of taxpayers will have to itemize	-Consolidate standard deduction, additional standard deduction and personal exemption for self and spouse into one -$24k married filing joint	-Consolidate standard deduction, additional standard deduction and personal exemption for self and spouse into one -$24k married filing joint -Deduction is large enough so that only about 5% of taxpayers will have to itemize	-Consolidate standard deduction, additional standard deduction and personal exemption for self and spouse into one -$22k married filing joint -Deduction is large enough so that only about 5% of taxpayers will have to itemize
Child tax benefits	-Increase child tax credit to $1.6k; first $1k is refundable -For next 5 yrs, new family flexibility and non-child dependents credit ($300) available	-Repeal personal exemption for children -Increase child tax credit -Unspecified amount, but first $1k is refundable	-Consolidate personal exemption for children and child tax credit into one enhanced child and dependent tax credit -$1.5k for each child, with a refundable portion	-Increase child tax credit from $1k to $1.5k and expand to children under age 18 (not 17) -Index credit for inflation -Increase phase-out level to $627,500 joint
Earned income tax credit (EITC)	-Preserve EITC	-Simplify tax benefits that encourage work	-Preserve EITC	-Reduce the max EITC, but rebate payroll tax
AMT	-Repeal individual AMT	-Repeal individual AMT	-Repeal individual AMT	-Repeal individual AMT
Investment income (capital gains, dividends) plus the 3.8% net investment income (NII) tax	-No change to rates -Long-term capital gain and qualified dividend rate stays at 15% (20% for $479k and up) -Preserve NII	-No mention	-Deduct 50% of net capital gains, dividends and interest income (so a top rate of 16.5%) -Keep 3.8% NII tax (assume separate repeal)	-Deduct 40% of net capital gains and dividends (so a top rate of 20%)
Retirement or savings incentives	-No change to pretax contribution limits for traditional 401(k)s -End backdoor Roth maneuver	-Simplify tax benefits that encourage retirement security to "maintain or raise retirement plan participation"	-"Explore the creation of more general savings vehicles" possibly consolidating current tax incentives (401(k) & Roth)	-Cap pretax traditional 401(k)'s to half the max, remainder to after-tax Roth 401(k); expand Roth IRA; end pretax IRA
Higher education tax benefits	-Enhance AOTC and 529s -Prohibits new contributions to Coverdells	-Simplify tax benefits that encourage higher education	-Simplify and consolidated education tax benefits (including 529 plans and AOTC)	-Repeal education loan interest deduction -Consolidate tax benefits -Make permanent AOTC
Estate tax and GST tax	-Double exclusion from $5mil to $10mil; full repeal of both in 2024	-Repeal estate tax and generation-skipping tax	-Repeal estate tax and generation-skipping tax	-No changes
Employer-sponsored health insurance	-No mention	-No mention, but presumably preserved	-Preserve exclusion from taxable income	-Include in taxable income for purposes of surtax ($450k+ for joint)
Mortgage interest deduction	-Preserve, but $500k cap for new mortgages and refinanced mortgages	-Retain tax incentives for home mortgage interest	-Preserve, but larger std deduction limits its value	-Preserve, but gradually reduce the cap for new mortgages to $500k
State and local tax deduction	-Only $10k property kept, no income or sales	-No mention, but presumably repealed	-No mention, but presumably repealed	-Repeal deduction for SALT, property, sales tax
Charitable deduction	-Preserve, with some limitations	-Retain tax incentives for charitable contributions	-Preserve, but larger std deduction limits value	-Preserve, but larger std deduction limits value
Misc. provisions	-Eliminate medical expense deduction, property casualty loss deduction, adoption tax credit			

Other Business Revenue Raisers Scores over 10 yrs in billions (B)			
	New JCT Score	**11/02/17 TCJA**	**12/14 Camp Tax Act**
Orphan drug	+$54.0B	-Repeal Sec. 45C orphan drug credit	-Repeal Sec. 45C orphan drug credit (+$9B)
Insurance	+$39.7B	-10 different insurance tax changes, including changing methodology for computing life insurance tax reserves and capitalizing policy acquisition costs	-Increase interest rate for computing life insurance tax reserves (+$24B) -Capitalize policy acquisition costs (+$12B)
Private activity bonds (PABs)	+$38.9B	-Effective repeal, no federal tax interest exclusion for future issuances of PABs	-Effective repeal, no interest exclusion for future issuances of PABs (+$24B)
Entertainment expenses	+$33.8B	-No deduction allowed for entertainment, transportation; 50% limit on food, drinks	-50% limit on food, drinks; no deduction for entertainment, transportation (+$15B)
Like-kind	+$30.5B	-Keep Sec. 1031 for only real property	-Full repeal of Sec. 1031 (+$41B)
Nonqualified deferred comp	+$16.2B	-Taxes nonqualified deferred compensation as soon as no substantial risk of forfeiture	-Taxes nonqualified deferred compensation when no substantial risk of forfeiture (+9B)
Renewable energy tax breaks	+$13.5B	-Repeal inflation adjustment effective today for Sec. 45 production tax credit -Phase out Sec. 45 production tax credit	-Repeal Sec. 48 investment tax credit -Repeal Sec. 45 production tax credit for renewable electricity effective in 10 yrs
Paid-in capital	+$7.4B	-Contributions of money or property to a corporation or partnership in exchange for an ownership interest are taxable to the extent they are not value-for-value	-Repeal Sec. 118 -Contributions of land and other property by government to corporation in exchange for stock of lesser value taxed (+$9B)
U.S. territories	+$0.8B	-Extend Puerto Rico rum excise tax benefit	-No major Puerto Rico tax changes
Nonprofit tax changes	+$0.2B	-Repeal federal tax exemption for interest on state and local bonds used to finance construction of certain sports stadiums	-Repeal tax exemption for professional sports leagues, such as the NFL (+0.1B) -Impose excise tax on investment income of private colleges and universities (+$2B)
Real estate investment trusts (REITs)	Not specified	-Would get special treatment under the new pass-through rate; maximum 25% rate on certain REIT dividends	-End REIT spinoffs and tax built-in gain for C-corp-to-REIT conversions (enacted) (+$6B)
Advertising cost recovery	-----	-No mention	-Require 50% advertising costs to be amortized (+$169B)
Bank excise tax	-----	-No mention	-Impose new excise tax on systemically important financial institutions (+$86B)
Publicly traded partnerships	-----	-No mention	-Only PTPs not taxed as corps are mining, natural resources; no financial PTPs (+$4B)
Financial products	-----	-No mention	-Mark-to-market for derivatives (+$16B)

Major Changes to Corporate Taxation

Interest Expense Deductibility

One of the more contentious business payfors in the tax reform bill is the new limitations on the deductibility of net interest expense, which are effective for tax years beginning in 2018. Businesses that take on a lot of debt to make large purchases of capital assets may appreciate the new expensing rules that allow them to immediately and fully deduct the cost of such purchases over the next five years. However, the bill also limits the ability of businesses to deduct their net interest expense (Sec. 3301 of TCJA; scored to raise $172 billion over 10 years). The change is effective for tax years starting in 2018, and there is no grandfathering of existing debt.

In part to reduce the tax code's bias in favor of debt financing and in part to come up with revenue to fund a corporate rate reduction, TCJA puts limits on the amount of interest expense that a business—no matter if it is taxed as a C corporation or a pass-through—can deduct. After netting interest expense against interest income, the remainder can be deducted to only the extent that it falls at or below 30 percent of a business's "taxable income computed without regard to business interest expense, business interest income, net operating losses, and depreciation, amortization, and depletion." (Note that there is a separate interest expense limitation that TCJA would apply in the context of a worldwide group to address earnings stripping concerns. It is calculated by reference to EBITDA, which is earnings before interest, taxes, depreciation and amortization. Current law Section 163(j) is repealed and replaced.)

Of note: The limitation is applied on a taxpayer-by-taxpayer basis, so, while U.S. entities that file the same consolidated return can net all of their interest income against all of their interest expense and apply the cap to the consolidated group's adjusted taxable income, the limitation is not calculated on a worldwide group basis. Any net interest expense that cannot be used in the current year can be carried forward for up to five years.

There are a few carveouts. Because public utilities are effectively required by regulators to pass any tax increase directly on to consumers in the form of higher energy bills, those companies (electricity, water, sewer, gas, steam) are excluded from the limitation. In addition, real property trades or businesses (defined in Section 469(c)(7)(C)), which presumably would include REITs, would be exempt. However, the most significant carve-out is for small businesses (defined as businesses with average gross receipts of $25 million or less).

Major Changes to International Taxation

Deemed Repatriation Tax

As part of a transition to a territorial system, tax writers plan to impose a one-time mandatory repatriation tax on the post-1986, previously untaxed earnings of certain foreign corporations (Sec. 4004 of TCJA; scored to raise $223.1 billion over 10 years). This tax is generally levied in tax year 2017 whether or not the earnings are repatriated. Not only is it designed to get at the foreign earnings of U.S. multinationals that have been accumulating in their controlled foreign corporations (CFC) under the tax policy of deferral (many U.S. multinationals took the position that they were indefinitely reinvesting the funds in their foreign subsidiaries), but it will also hit U.S. corporations and partnerships that happen to own at least 10 percent of a foreign corporation that has accumulated earnings that have not been taxed in the United States.

The repatriation tax will be imposed using a bifurcated rate structure that works out to an effective rate of 12 percent on cash and similar items (such as net accounts receivable and actively traded personal property) and 5 percent on earnings that essentially have been reinvested in tangible property (and are therefore illiquid). But, in reality, the 12 percent and 5 percent rates are effected by way of a deduction mechanism. The untaxed, accumulated foreign earnings will show up on the U.S. multinational's (or shareholder's) tax return as what amounts to a deemed Subpart F income inclusion. Then, the company will be allowed to deduct 65.7 percent of the income inclusion for liquid earnings or 85.7 percent of the income inclusion for illiquid earnings, and the remainder is taxed at the current top corporate income tax rate of 35 percent. (For example: $100 inclusion minus a $65.70 deduction equals $34.30 times 35 percent equals $12—12 percent of the original income inclusion for the cash position earnings.)

Figuring out what the original income inclusion will be is even trickier. It all starts with the foreign corporation's post-1986 earnings and profits (E&P). This amount is not readily known, but it generally

requires an E&P study to figure it out. However, a common proxy for accumulated E&P is the balance sheet line referred to as "retained earnings." Tax writers take a snapshot approach to this number—they want whichever is greater: the E&P as of November 2, 2017 or the E&P as of December 31, 2017. Any dividends that the foreign corporation paid out during the 2017 tax year will have to be added back in. The income inclusion is the U.S. multinational's (or shareholder's) pro rata share of the foreign corporation's E&P, with adjustments for previously taxed or effectively connected income and other items.

As for what portion of the income inclusion is effectively taxed at 12 percent versus 5 percent, tax writers propose the average of the accumulated cash and similar items held by the foreign corporation over the last three years. The pro rata portion of that is taxed at 12 percent. The rest of the E&P (assuming it has more E&P than cash; note that this is a proxy for the noncash portion) is taxed at 5 percent. The U.S. taxpayer can use NOLs and other usual adjustments to reduce the amount of tax that it owes on the deemed income inclusion, but any foreign tax credits (FTCs) associated with the inclusion will be limited to the same extent as the deduction percentage. (For example: If $10 of FTCs come over with a $100 inclusion associated with noncash earnings, then the available FTCs will be reduced by 85.7 percent, meaning that $1.43 in FTCs can be used to reduce the tax owed; $100 inclusion minus $85.70 deduction equals $14.30 times 35 percent equals $5 minus $1.43 in FTCs equals $3.57.)

Once the U.S. taxpayer has figured out how much tax it owes, TCJA will give it eight years, without interest, to pay the tax (but it generally must start paying in tax year 2017, and the eight payments are in equal installments).

Global Minimum Tax (aka Foreign High Returns Tax)

Although tax writers are loath to call it that, the global minimum tax has arrived (Sec. 4301 of TCJA; scored to raise $77.1 billion over 10 years). Designed as an anti-base erosion measure necessitated by the move to a territorial system, its predecessors were targeted at taxing certain highly mobile foreign income at an effective rate of 10 percent. The foreign high returns tax is similar in that it taxes currently in the United States (which under TCJA, would have a corporate rate of 20 percent) half of something called "foreign high returns." The tax due can be reduced for FTCs (although they will be limited to 80 percent of the foreign taxes paid).

In predecessor versions, the minimum tax was framed in terms of taxing intellectual property (IP). When a product that utilizes patented technology is sold somewhere in the world, a portion of the proceeds are allocated to the IP. If that IP is owned or licensed by a foreign sub of a U.S. parent corporation, a minimum tax would tax those proceeds.

But tax writers quickly came to realize that it was not going to be that simple. Because the Internal Revenue Service and U.S. multinationals are constantly fighting over what is an appropriate portion of proceeds to allocate to IP, lawmakers have decided to tax something that is easier to measure than a foreign sub's intangible income.

Under this proposal, the foreign high returns tax is determined on a worldwide basis (not sub-by-sub). It has been suggested that the foreign high returns tax ensures that the average tax paid on a U.S. multinational's foreign operations will be about 12.5 percent (20 percent of 50 is 10 percent; plus some extra to account for the 80 percent FTC limitation).

Upon reading the text of the bill, it gets a bit more complicated. The tax is levied on the U.S. parent corporation's net income across all of its foreign subs (X) minus about 8 percent of its adjusted basis in

its foreign depreciable property (such as buildings and equipment in its foreign subs) (Y)—where X minus Y equals Z—and, finally, minus the following percentage of Z: Z divided by X.

If we have not yet lost you, this example should help: U.S. parent has one foreign sub. Foreign sub has a basis in its depreciable property of $300, and its income is $50 (X=$50); 8 percent of $300 is $24 (Y=$24), $50 minus $24 is $26 (X minus Y=$26), so Z equals $26. The percentage of Z divided by X ($26/$50) is 52 percent; 52 percent of Z, which is $26, equals $13.52; $26 minus $13.52 equals $12.48. So, the foreign high returns tax in this case is $12.48. U.S. parent will include half of that amount ($6.24) in its current income taxed at 20 percent, resulting in a U.S. tax due of $1.25.

Although tax writers have changed the name, replaced an adjusted gross foreign sub income construct with a net CFC “tested income” construct, tweaked the rate of return and altered the tax mechanism/rate, this proposal is not significantly different from the global minimum tax provision that was put out by former House Ways and Means Committee Chairman Dave Camp in 2014 (see Camp’s H.R. 1, Section 4211 “Foreign intangible income subject to taxation at reduced rate”). The numbers used in the example above are similar to those used in an example provided by the Joint Committee on Taxation in its technical explanation of the provision. Applying the example numbers to Camp’s minimum tax, which was imposed at a rate of 10 percent on foreign base company intangible income, would have resulted in U.S. tax due of $1.20.

To step back a bit more, this tax was originally designed to reduce the incentive for U.S. multinationals to locate their IP in low-tax jurisdictions where they lack a substantial, “real” business footprint. But, the way it is calculated, the more office buildings you own outside the United States, the better. Paying out large amounts in a foreign jurisdiction for employees, contract manufacturing services or financial services will not help. IP-heavy firms are extremely sensitive to these pressures and have been trying to change this proposal since it was first floated by Camp. The Committee has already prepared a response to the charge that this change “penalizes America’s global businesses,” firmly asserting that TCJA “does not impose taxes on routine foreign operations.”

New Excise Tax on Certain Related Party Payments

While the general outlines of the proposals described above were either largely previewed by Camp or in the “A Better Way” tax reform blueprint from June 2016, the excise tax on certain related-party payments is brand new (Sec. 4303 of TCJA; scored to raise $154.5 billion over 10 years). Designed as an additional base erosion measure to get at transfer pricing abuses and post-inversion planning techniques, the new excise tax attempts to level the playing field between U.S. multinationals and foreign multinationals. The Committee states that this tax “applies equally to foreign and U.S. companies.” As long as there is a U.S. company somewhere in the chain making a payment (that it then deducts) to a foreign company somewhere else in the chain, this tax could apply.

The new excise tax is relevant only to groups that have at least $100 million in outbound (from the U.S. corporation to the foreign affiliate) related-party payments each year. Such otherwise deductible payments (including cost sharing payments, royalty payments, service agreement payments, etc.) will now be subject to a 20 percent excise tax, unless the related foreign corporation elects to treat the amount as effectively connected income (ECI). If ECI treatment is elected, applicable deductions can be used to reduce the amount of tax due. Payments for intercompany services where there is no markup (the payment reflects the actual cost) are exempted from the tax.

In its section-by-section summary, the Committee acknowledges that, “although these payments frequently relate to globalized supply chains and other legitimate business operations, the tax benefit achieved by reducing U.S. taxable income without a corresponding increase in U.S. taxable income

elsewhere in the multinational group results in a distorted computation of the overall U.S. tax liability of multinational companies." It is tax writers' hope that this excise tax will help bring jobs back to the United States.

Major Changes to Pass-Through Taxation

Guardrail: New Pass-Through Formula

Another innovative proposal is the introduction of a special 25 percent rate on the business income of pass-through entities. Under current law, if a business is taxed as a partnership, for example, any items of income that it earns are passed through to the individual owners of the business (the partners), who then pay tax on that income at their individual rates. But, Sec. 1004 of TCJA (scored to cost $448 billion over 10 years) would give pass-through business owners the opportunity to subject their business income to a much lower 25 percent tax rate. Moreover, if the partner's interest in the pass-through business is purely passive (tested under the material participation rules of Section 469), their full distributive share of the business income will benefit from the 25 percent rate.

The big question with this proposal has always been how to determine the portion that benefits from the lower rate. Officials indicated early on that professional services firms, including law and accounting firms, would largely not be eligible for the special rate, which is the case in TCJA. They also insisted that guardrails would be put in place to ensure that individuals would not be able to recharacterize wage income as business income to save taxes.

In an unrelated proposal in the Camp bill, tax writers floated the idea of a 70/30 split, and TCJA embraces that concept. Business owners have the opportunity to elect to treat 70 percent of their distributive share as what amounts to compensation for services, taxed at the individual's ordinary income tax rate, and 30 percent as a return on capital investment. Alternatively, business owners can choose to prove that they should get a capital share higher than 30 percent by demonstrating the size of the partner's capital investments.

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[1] Four primary documents associated with the reform plan were released November 2. They are (1) the draft legislative text of the bill (available at https://waysandmeansforms.house.gov/uploadedfiles/bill_text.pdf); (2) a section-by-section summary of the major provisions of the bill, produced by Ways and Means (available at https://waysandmeansforms.house.gov/uploadedfiles/tax_cuts_and_jobs_act_section_by_section.pdf); (3) a shorter descriptive summary of the bill produced by Ways and Means (available at https://static1.squarespace.com/static/598e0867be42d6f782347394/t/59fb4a0b27ef2d9f3f9a0a12/1509640715893/WM_TCJA_PolicyOnePagers%5B7%5D.pdf); (4) and a preliminary revenue table (the so-called score) produced by the Joint Committee on Taxation (available at https://www.jct.gov/publications.html?func=download&id=5026&chk=5026&no_html=1).

[2] For the text of the "Unified Framework for Fixing our Broken Tax Code" released by the Big Six on September 27, 2017, see https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf.

[3] For the text of the "A Better Way" tax reform blueprint released June 24, 2016, by House Republican leadership, see http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

[4] For the text of the Tax Reform Act of 2014, introduced December 10, 2014, by former House Ways and Means Committee Chairman Dave Camp as H.R. 1, see https://www.congress.gov/113/bills/hr1/BILLS-113hr1ih.pdf. For the House Ways and Means Committee's section-by-section summary on the discussion draft of the bill released February 2014, see https://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_by_Section_Summary_FINAL_022614.pdf. For the Joint Committee on Taxation's technical explanation dated September 2014, see https://www.jct.gov/publications.html?func=startdown&id=4674.

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