To Our Clients and Friends

Memorandum

A Look at the New Tax Law and How It Impacts Your Business and Investments

On December 22, 2017, H. R. 1, the Tax Cuts and Jobs Act (the "Act") was signed into law. The Act significantly revises many aspects of U.S. federal income tax law applicable to businesses conducted in corporate and partnership form, and will also affect the U.S. federal income tax and estate tax treatment of many individuals. Below is a summary of some of the Act's provisions that are expected to have the greatest effect on businesses, investment funds and investors, together with some observations on their potential impact. However, the full impact of these far reaching provisions will, in many cases, only be known as implementing rules and market practices develop. Most of these provisions are immediately applicable, although some were adopted retroactively and some prospectively. Unless otherwise noted, the individual tax reform provisions described below apply only to taxable years beginning after December 31, 2017 and ending before January 1, 2026, while the rest of the provisions apply to all taxable years beginning after December 31, 2017.[1]

INDIVIDUAL TAX REFORM

Income Tax Rates

The Act preserves the number of tax brackets at seven, but generally lowers the tax rates of each bracket. The top tax rate is lowered from 39.6% to 37% and will apply to income in excess of $600,000 for joint filers and $500,000 for single filers. The Act does not change the tax rates applicable to capital gains or qualified dividends.

State and Local Tax ("SALT") and Foreign Tax Deductions

The Act imposes a $10,000 cap on SALT deductions (including deductions for state and local income and property taxes, and foreign income taxes). In addition, foreign real property taxes will no longer be deductible.

Itemized Deductions

Under prior law, high income taxpayers were subject to a limitation on the total amount of itemized deductions they could take in a taxable year. This limitation generally required them to reduce the total amount of deductions that are otherwise allowable by 3% of the amount by which their income exceeded

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

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$300,000 (for joint filers) or $250,000 (for single filers), indexed for inflation. The Act repeals this itemized deduction limitation, making itemized deductions (e.g., charitable deductions) potentially more valuable for high income taxpayers, despite the reduction in the top tax rate (although, as discussed above, SALT deductions are capped and, as discussed immediately below, miscellaneous itemized deductions are suspended).

The Act also suspends all miscellaneous itemized deductions. Thus, investors will no longer be able to deduct investment fees and expenses under the regular income tax. Investors that pay alternative minimum tax (“AMT”) are already subject to this limitation, so the practical impact of this suspension is to impose the historic AMT limitations on the calculation of the regular income tax.

AMT

For many individuals previously subject to AMT, the Act’s limitation on deducting state and local taxes and suspension of miscellaneous itemized deductions, as discussed above, will make it less likely that AMT will apply, and the Act increases the AMT exemption amounts (from $78,750 to $109,400 for joint filers and from $50,600 to $70,300 for single filers, subject to phase out), further decreasing the impact of AMT on many taxpayers.

Mortgage and Home Equity Interest Deductions

The deduction on interest payments with respect to indebtedness (which includes mortgage and home equity lines of credit) incurred to acquire, construct or substantially improve a qualified residence of a taxpayer and secured by such residence (“acquisition indebtedness”) will be limited to $750,000 on debt incurred after December 15, 2017, which is reduced from $1 million under prior law. Interest on home equity indebtedness (generally, any indebtedness secured by a qualified residence other than acquisition indebtedness) is no longer deductible. Note that grandfathering rules apply for pre-existing acquisition indebtedness (generally, acquisition indebtedness incurred on or prior to December 15, 2017), but not pre-existing home equity indebtedness, with special rules for refinancings of pre-existing acquisition indebtedness.

Deduction for Qualified Business Income of Individuals, Trusts and Estates

The Act allows individuals, trusts and estates to deduct 20% of “qualified business income” earned through a partnership, S corporation or sole proprietorship, subject to a number of exceptions and limitations. Qualified business income includes income from most domestic trades or businesses. However, for taxpayers with income above $207,500 (or $415,000 in the case of a joint return), income from a business involving the performance of services in the fields of health, law, accounting, consulting, financial services, brokerage services or any other trade or business where the principal asset of such trade or business is the reputation or skill of its employees or owners (or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests or commodities) is not eligible for the deduction. Therefore, high income taxpayers in these specifically excluded fields will not benefit from this new regime.

For taxpayers with income above $207,500 (or $415,000 in the case of a joint return), who are not in a specifically excluded field, the allowable deduction is the *lesser* of (a) 20% of the qualified business income or (b) the greater of either 50% of W-2 wages paid by a pass-through trade or business, or 25% of such W-2 wages plus 2.5% of the unadjusted basis of any tangible depreciable property that is used in the production of qualified business income. Thus, owners of pass-through entities in capital-intensive

industries, such as real estate, if above the $207,500 (or $415,000) income threshold, may not be eligible for the full deduction, but will be permitted to take into account their property basis in determining the amount of the allowable deduction. Phase-in rules apply to taxpayers with income between $157,500 and $207,500 (or between $315,000 and $415,000 in the case of a joint return).

The Act also allows a 20% deduction for a taxpayer's aggregate dividends from a real estate investment trust ("REIT") (excluding capital gain dividends or dividends that would otherwise qualify for capital gains rates), qualified cooperative dividends and qualified publicly traded partnership income (subject to certain exclusions and requirements). This deduction applies without regard to the wage limitation described above.

Limitations on Use of Excess Business Losses

The Act imposes a new limitation on "excess business losses" that prevents individual taxpayers from offsetting more than $250,000 ($500,000 in the case of joint filers) of otherwise allowable net deductions (e.g., depreciation, property taxes and insurance) from trades or businesses against other income not allocable to a trade or business. Excess losses are carried forward as part of the taxpayer's net operating loss ("NOL") carryforwards in subsequent taxable years, and are therefore usable against future income, although subject to the same limitations as NOL carryforwards, as discussed below in the section entitled "NOLs".

Estate, Gift and Generation-Skipping Transfer Taxes

For estates of decedents dying or gifts made after December 31, 2017, and before January 1, 2026, the Act doubles the basic exclusion amount for estate, gift and generation-skipping transfer taxes from $5 million to $10 million, subject to an increase for inflation adjustments (using a new inflation factor). Beginning on January 1, 2026, the doubling sunsets and the exemption reverts to $5 million (adjusted for inflation).

This increase opens a new, limited window for clients to engage in favorable estate planning, enabling them to transfer potentially large amounts to their descendants or other intended beneficiaries during life. For many clients, the doubling of the exemption also may significantly shift the beneficial entitlements under their existing documents in ways that may or may not match their current intent. Accordingly, both to take advantage of the potential tax benefits during the planning window and to ensure their documents effect their current wishes, clients should review and, if necessary, revise their estate plans.

BUSINESS TAX REFORM

Income Tax Rate and AMT

The Act imposes a uniform corporate tax rate of 21% (under prior law, the top corporate tax rate was 35%), which will fundamentally alter the corporate tax landscape (see also our discussion below entitled "Conversions to Corporate Form" for further thoughts on this topic).

The amount that a corporation can claim as a dividends received deduction ("DRD") from another corporation has also been reduced, from 80% to 65% if the corporate payee owns 20% or more of the corporate payor, or from 70% to 50% if the corporate payee owns less than 20% of the corporate payor. The net effect of the reduction in the DRD, taking into account the 21% tax rate, is that the tax a corporation pays on dividends received from another corporation remains generally the same as under prior law.

The Act also repeals the corporate AMT, although some of the provisions of the corporate AMT have been incorporated into the regular income tax, but without the associated ability to claim a credit for the additional regular income tax. Although the corporate AMT is repealed going forward, credit for corporate AMT paid in prior years is nevertheless permitted to offset regular income tax liability for any taxable year (with such credit being at least partially refundable).

Increased Expensing

The Act generally permits taxpayers to immediately expense (rather than depreciate over a period of years) 100% of the cost of certain tangible property that has a depreciable life of 20 years or less and that was acquired and placed into service after September 27, 2017 but before January 1, 2023. Under the Act, in addition to acquisitions of new property, 100% expensing applies to most acquisitions of used property from an unrelated party, eliminating the first user requirement under prior law. The 100% expensing allowance is phased down by 20% per calendar year for qualified property placed into service in taxable years beginning after 2022.

Such expensing will be permitted in the context of an acquisition of assets and may be permitted in a transaction treated as a purchase of assets, such as a purchase of the stock of a corporation with a Section 338 or 336(e) election and, if permitted, would make such election that much more valuable, although it should be noted that such expensing is not available for intangible property (such as goodwill). Such expensing may also be permitted in an acquisition of a partnership interest with a Section 754 election. Additional guidance on these points may clarify the application of 100% expensing in the context of acquisitions.

Conversions to Corporate Form

Given the significantly lower corporate tax rate, and other beneficial changes to corporate taxation, taxpayers operating businesses through entities taxed as partnerships or S corporations will want to re-evaluate the pros and cons of their entity choices. Under the Act, income earned by a C corporation continues to be subject to two layers of taxation — once when earned by the corporation and again upon a later distribution to the corporation's shareholders. By contrast, income earned by a partnership or an S corporation is taxed only once, at the partner/shareholder level and, there is also now an associated deduction at the partner/shareholder level, as discussed above, which would in many circumstances lower this single level of tax even further (although generally not for entities engaged in excluded activities). Therefore, incorporation of a business previously conducted through partnerships (or LLCs taxed as partnerships) or conversions of S corporations to C corporations will make the most sense for businesses that do not regularly distribute earnings, particularly if they benefit from immediate expensing as discussed above. Finally, sellers of interests in partnerships and, in some cases, shareholders of S corporations, can offer buyers a step-up in the tax basis of the assets of the partnerships/S corporations, which is only available to corporate sellers of C corporation stock which satisfy certain affiliation/consolidation requirements.

Taxpayers will also want to consider the potential impact of future tax law changes on any such conversion. Shareholders of S corporations should also note that, under the Act, an S corporation that revokes its S corporation election and becomes a C corporation takes any tax adjustments attributable to a resulting accounting method change into account ratably over six years (rather than four years, as under prior law) if the revocation occurs during the two-year period following the Act's enactment and the ownership of the corporation on the date of revocation is the same as on the date of the Act's enactment.

Limitations on Interest Deductibility

The Act disallows a deduction for net business interest expense (business interest expense in excess of business interest income) that exceeds 30% of a taxpayer's "adjusted taxable income" — i.e., taxable income before taking account of interest income or expense and before certain deductions (such as depreciation, amortization, depletion and NOLs), although for taxable years beginning on or after January 1, 2022, deductions for depreciation, amortization and depletion are taken into account, thereby lowering a taxpayer's adjusted taxable income. The amount disallowed as a deduction may be carried forward indefinitely.

Note that the Act does not define what constitutes interest for this purpose, although it is likely that original issue discount ("OID") would be included. Items such as debt issuance costs may be excluded, which could result in items that had similar tax consequences prior to the Act having rather different tax consequences going forward.

In the case of partnerships, this limitation generally applies at the partnership level, and a special carryforward rule applies to limit the carryforward of disallowed partnership interest expense. In computing its own limitations, a partner generally must ignore its distributive share of any items of income, gain, deduction, or loss of a partnership in which it is invested when determining the partner's own "adjusted taxable income."

This limitation on the deductibility of interest may have a significant effect on leveraged acquisitions, leveraged recapitalizations and similar transactions. Companies that recently have participated in such transactions may be especially impacted, since the Act does *not* grandfather interest paid on debt which pre-dates the Act.

However, banks and other lenders that earn interest income in excess of interest expense are not expected to be directly affected by this provision. Also, business interest does not include investment interest, and thus this limitation does not apply to such interest.

Finally, this limitation does not apply to interest expense of an electing real property trade or business. However, if such election is made, the depreciation recovery periods of real property become slightly longer, and the immediate expensing of qualified improvement property will not be available.

The Act repeals the interest deduction rules designed to avoid "earnings stripping". Thus, so long as taxpayers satisfy the 30% limitation on net business interest expense under the Act, taxpayers would now appear, for example, to be able to deduct interest paid to a related foreign person even if such interest income is not subject to U.S. tax (although certain taxpayers will be subject to the new base erosion and anti-abuse tax on interest paid to a related foreign person, as discussed further below).

NOLs

The Act eliminates the NOL carryback provisions applicable to corporate taxpayers, except in specific circumstances, but allows an indefinite carryforward of NOLs, each for NOLs arising in taxable years ending after December 31, 2017. For losses arising in taxable years beginning after December 31, 2017, the Act also generally imposes a limitation on the application of an NOL deduction of 80% of the taxpayer's taxable income (which is a more restrictive version of the previous 90% limitation under the corporate AMT that has been eliminated by the Act). Among other exceptions, NOLs of a property and casualty insurance company are subject to special rules.

Carried Interest

The Act contains a provision (the "Carried Interest Provision") that requires a three-year holding period, rather than a one-year holding period, for gains from the sale of property to be eligible for long-term capital gain with respect to a partnership interest received in connection with the performance of services (a "carried interest"). Therefore, gains with respect to a carried interest will be treated as short-term capital gains subject to tax at ordinary income rates unless a three-year holding period is met. Note that the Carried Interest Provision does not apply to a "capital interest," i.e., an interest in a partnership which provides a right to share in partnership capital commensurate with (i) the amount of capital contributed or (ii) the amount that was included as compensation income at the time of grant or vesting of the partnership interest.

The Carried Interest Provision does not change current law with respect to whose holding period is relevant. Therefore, if a carried interest recipient acquires a carried interest with respect to a partnership that has held an asset for four years, such carried interest recipient will be allocated long-term capital gain from the disposition of that asset regardless of how long the carried interest recipient has held its partnership interest. However, if a carried interest recipient disposes of the partnership interest less than three years after receipt, any gain with respect to such disposition will be short-term capital gain regardless of how long the partnership has held its underlying assets.

The Carried Interest Provision applies only to partnerships that invest in securities, real estate and related assets on behalf of third-party investors, and a carried interest held by a corporation is exempt from the foregoing treatment.

The Carried Interest Provision is unlikely to significantly change current taxation with respect to carried interests in typical cases (i.e., for private equity funds that hold assets for more than three years and for hedge funds that generally hold assets for less than one year), though this provision may have a meaningful impact for some sponsors that do not fit this mold.

Tax Accounting Changes Affect Year of Recognition of Revenue

The Act requires that accrual method taxpayers recognize items of income subject to the "all events" test for income recognition at a point no later than when such income is included as revenue in a specified financial statement (such as a 10-K). Certain exceptions apply, including with respect to income received in connection with mortgage servicing contracts and for taxpayers using special methods of accounting (other than methods of accounting for, among other things, OID and market discount). Thus, companies that are subject to this new rule and hold OID or market discount instruments may be required to recognize income sooner than otherwise required under the OID and market discount rules.

The new provision generally is not intended to require the recognition of income in situations where a realization event for U.S. federal income tax purposes has not yet occurred. Thus, gain or loss recognition is not required from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for U.S. federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment. Therefore, the new rule should not require a typical private equity fund to recognize income for tax purposes solely because an asset is marked above cost for financial accounting purposes. Nor is such revenue recognition intended to require the recharacterization of a transaction from sale to lease, or vice versa, to conform to how the transaction is reported in a specified financial statement. Thus, book accounting and tax accounting will continue to reflect differences in accounting methodologies.

Solely in the case of income from a debt instrument with OID, the effective date of such changes is delayed until tax years beginning after December 31, 2018.

Gain on the Transfer of an Interest in a Partnership Engaged in a U.S. Trade or Business

The Act amends Section 864(c) to provide that a non-U.S. person's gain from the direct or indirect disposition of a partnership interest will be treated as effectively connected income ("ECI") subject to U.S. tax to the extent that the non-U.S. person would have had ECI had the partnership sold all of its assets at fair market value as of the date of the sale. This amendment effectively codifies the Internal Revenue Service's ("IRS's") long-held view (as set forth in Rev. Rul. 91-32) that a non-U.S. person's gain on the sale of an interest in a partnership that is engaged in a U.S. trade or business (an "ECI Partnership") is ECI if such non-U.S. person would have ECI if the partnership were to sell its underlying assets, a position rejected by the Tax Court in 2017 in the *Grecian Magnesite* case.[2] This rule has limited retroactive effect, applying to all dispositions occurring on or after November 27, 2017.

This rule references both direct and indirect dispositions, but its application in the context of tiers of partnerships that ultimately own ECI assets is not entirely clear. Treasury Regulations issued pursuant to the regulatory authority given to the U.S. Treasury Department may provide guidance on this and other issues, including application to various non-recognition transactions.

In order to ensure that the government receives the substantive tax liability due from the non-U.S. person, the Act amends Section 1446 to require the transferee to withhold 10% of the amount realized by the transferor in the disposition, unless the transferor certifies that it is a U.S. person. Note that the withholding obligation is 10% of the entire amount realized for the partnership interest (which includes the transferor's share of the partnership's liabilities), not just the portion attributable to the U.S. trade or business of the partnership, and, in cases where the withholding exceeds the substantive tax due, the transferor (or the transferee) may decide to petition the IRS to allow a reduced amount of withholding (which the new rules authorize the IRS to do) or, alternatively, may seek to claim a refund. This withholding regime is similar to the withholding requirement imposed on transferees of U.S. real property interests from non-U.S. persons under the FIRPTA rules, but (at least until Treasury Regulations are issued) there are several differences.

Notably, the new rules provide that if the transferee fails to withhold the correct amount, the partnership that is the subject of the transfer is required to deduct and withhold from future distributions to the transferee the amount that the transferee failed to withhold. How this might apply in the context of distributions (as opposed to sales of partnership interests), or in certain cases involving tiered partnership structures, is not clear.

These withholding rules apply to all dispositions occurring after December 31, 2017.

Note that these rules also apply to master limited partnerships and other publicly traded partnerships, but guidance from the IRS[3] has suspended the application of the withholding provisions (but not the underlying tax obligations) until further guidance is issued.

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[2] Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (July 13, 2017).

[3] Notice 2018-08.

Given these complexities and uncertainties, the application of these rules may significantly affect market practices associated with limited partner/member transfers, particularly until further guidance is issued.

Modification to Certain Partnership Rules

Even if a partnership has not made an election under Section 754 (i.e., an election to adjust the tax basis in its property upon either a transfer of or a distribution with respect to a partnership interest), the law prior to the Act required an adjustment of the tax basis in partnership property in the context of a transfer of, or a distribution with respect to, a partnership interest if the aggregate tax basis of all partnership property exceeds its fair market value by more than $250,000 ("a substantial built in loss"). Prior law, however, did not take into account special allocations of losses or losses allocable under Section 704(c). The Act expands the definition of a substantial built in loss in the context of transfers of partnership interests (but not distributions) to include situations where the transferee partner would be allocated a net loss of more than $250,000 if all the partnership assets were sold for their fair market value immediately after such transfer (even if there is no overall built in loss in the partnership's property). This provision will have specific import in partnerships which utilize "tracking" economics where a buyer is buying an interest in assets with a built in loss, even if the partnership as a whole does not have a substantial built in loss.

The Act also repeals the Section 708 "technical termination" rules for partnerships (i.e., the rule that provided that a partnership terminates if 50% or more of interests in the partnership's capital and profits were sold or exchanged within twelve months).

Like-Kind Exchanges

The Act limits the rule allowing deferral of gain on "like-kind" exchanges to exchanges of real property. Thus, for example, taxpayers are no longer able to defer gain on exchanges of intangible property. This provision is effective for transfers after 2017, but a transition rule allows transactions partially completed prior to January 1, 2018 to continue to receive tax deferred treatment.

EXEMPT ORGANIZATIONS REFORM

The Act modifies the prior law (which allowed tax-exempt entities to aggregate all unrelated business taxable income ("UBTI")) by requiring that UBTI, and deductions taken in the production of such UBTI, be calculated separately for each source of income. This will prevent tax-exempt entities from offsetting UBTI with unrelated UBTI loss and, in many cases, will mean that UBTI losses from businesses that never produce a profit will go unutilized. Additionally, under the Act, NOL carryforwards are allowed only with respect to the UBTI source from which such NOLs were generated. However, this NOL tracing rule is not applicable to NOLs generated in taxable years beginning prior to January 1, 2018, so such NOLs can be utilized without the tracing requirement. As a result of this change in law, tax-exempt entities may be more inclined to use blocker corporations to block UBTI, as a blocker generally will be permitted to aggregate income.

It should be noted that the House bill version of the Act included a provision that all entities exempt from tax under Section 501(a), including certain state government-sponsored entities, would be subject to tax on any UBTI, notwithstanding qualification under another exemption in the Code (e.g., the provision applicable to government-sponsored entities). This provision was *not* adopted.

INTERNATIONAL TAX REFORM

The Act makes a number of very significant and complex changes in the area of international taxation, with some very favorable results for certain taxpayers, especially certain corporate taxpayers, and some adverse results for other taxpayers. The Act's signature international provision is to adopt a corporate "participation exemption," effectively moving the United States from a worldwide tax system to a territorial tax system for corporate taxpayers. However, because the Act did not repeal the pre-existing international tax regimes (e.g., the controlled foreign corporation ("CFC") and passive foreign investment company ("PFIC") regimes), for either corporate taxpayers or individual taxpayers, and in some cases expanded their reach, individual taxpayers and, to a lesser extent, corporate taxpayers remain subject to a worldwide system. Below is a brief summary of these provisions.

Imposition of a Participation Exemption System

The Act adopts a corporate "participation exemption," which generally exempts the foreign earnings of foreign subsidiaries of U.S. corporations (other than regulated investment companies ("RICs") or REITs) from U.S. tax upon repatriation to the United States. This exemption generally applies to dividends paid by a foreign corporation (other than certain PFICs) after December 31, 2017 to a corporate "United States shareholder" (as discussed below) for a minimum of one year in a specified two-year interval beginning on the date that is one year prior to the ex-dividend date. This exemption is not available for "hybrid dividends" — that is, an amount received from a CFC for which a deduction under this exemption would be allowed and for which such CFC received a deduction (or other tax benefit) with respect to any income taxes imposed by a foreign country. Additionally, foreign tax credits or deductions are disallowed for any taxes paid or accrued with respect to any portion of a distribution treated as a dividend that qualifies for this deduction. Furthermore, the United States shareholder's basis in the stock of the foreign subsidiary generally is reduced by the amount of any such deduction, solely for purposes of determining a loss for distributions made after December 31, 2017.

This exemption also applies to gain from the sale of stock in certain foreign corporations and gain from the sale by a CFC of stock in another foreign corporation (in each case, for sales after December 31, 2017), to the extent either is treated as a dividend for this purpose under the Code, but only so long as the stock that was sold has been held for at least a year.

Deemed Repatriation

As part of the transition to a territorial tax system, the Act requires that the accumulated foreign earnings (determined as of November 2, 2017 or December 31, 2017, whichever is greater) are deemed repatriated on December 31, 2017 and generally taxed at 15.5% (to the extent represented by cash or cash equivalents) or 8% (to the extent represented by all other assets). (The application of these rates to individuals raises additional complexities.) The United States shareholder may elect to include these amounts in income ratably over eight years, and if the United States shareholder pays the installment amounts timely, no interest will be imposed. The deemed repatriation rule applies to a broader class of United States shareholders than the participation exemption, and thus the income inclusion rules could result in surprising consequences. A special exemption applies for REITs.

For purposes of the deemed repatriation rule, the Act's expansion of the United States shareholder definition to include shareholders that own 10% of the vote or value is *not* taken into account (however, the modification to the downward attribution rule *is* taken into account) (see our discussion below under "CFC Related Provisions").

It should be noted that, because the deemed repatriation tax will give rise to incremental tax basis, any adverse timing results may, depending on the facts, be offset by permanent tax savings in the context of a subsequent sale (at a higher tax rate).

CFC Related Provisions

As noted above, the Act maintains the requirement that United States shareholders of a CFC include in income each year, as ordinary income, their shares of certain types of the CFC's undistributed foreign income, as well as the earnings that the CFC is treated as investing in "United States property" under Section 956 (which applies, for example, when a CFC provides credit support for U.S. debt), regardless of whether the CFC makes any distributions.

The complete retention of Section 956 is a surprising result. It means that a CFC's foreign earnings that could be distributed without U.S. tax under the newly-enacted participation exemption are subject to U.S. tax at regular rates if the foreign earnings are retained by the CFC and become subject to Section 956 (including if the CFC provides credit support for U.S. debt). It is even more surprising since both the House bill and the Senate amendment had eliminated this provision.

In light of the Act's retention of Section 956, it is likely that loan agreements and other debt instruments will continue to contain meaningful limitations on CFC pledges and guarantees with respect to U.S. debt. However, because corporate borrowers will now be able to repatriate their foreign earnings more tax efficiently (under the newly-enacted participation exemption discussed above), unless the applicable foreign jurisdictions impose a withholding tax on such dividends, market practices in this area may evolve.

Additionally, the Act makes several significant modifications to the rules requiring United States shareholders of CFCs to include certain categories of passive income in their income on a current basis (i.e., the "Subpart F" provisions), including the following:

- The definition of a "United States shareholder," which is relevant for determining whether a foreign corporation is a CFC and for determining whether the Subpart F provisions apply to such shareholder, is expanded to include any U.S. person owning 10% of a foreign corporation's shares by vote or value (rather than solely by vote, as under prior law). As a result, voting power "cutbacks" and similar restrictions in governing documents that prevent a shareholder from being able to exercise more than 9.9% of the vote of a foreign corporation will no longer be effective in preventing the shareholder from becoming a United States shareholder or the foreign corporation from becoming a CFC.

- The constructive ownership rules used in determining whether a foreign corporation is a CFC are expanded, so that stock owned by a foreign person generally may be attributed downward to a U.S. entity that is owned by the foreign person. This change is intended to combat CFC "de-control" and similar transactions, although it will have broader implications, including for multinational corporate groups and certain investment funds. For example, if a foreign parent corporation wholly owns a foreign subsidiary and a U.S. subsidiary in parallel (as so-called brother-sister subsidiaries), the foreign subsidiary may be treated as a CFC as a result of the downward attribution of the stock of the foreign subsidiary to the U.S. subsidiary. In this case, a U.S. person that owns a 10% or greater interest in the foreign parent corporation could be subject to Subpart F consequences with respect to the foreign subsidiary, although we understand, and the legislative history indicates, that the downward attribution rule may be applied more narrowly. This particular change has a retroactive effective date and applies beginning with the last taxable

year of foreign corporations before January 1, 2018 (and taxable years of United States shareholders in which or with which such taxable years of foreign corporations end).

- The requirement under prior law that a foreign corporation must be a CFC for an uninterrupted period of at least 30 days in a taxable year before the Subpart F inclusion rules apply is eliminated so that the Subpart F rules will apply if the foreign corporation is a CFC at any time during the taxable year.

These modifications may push more foreign corporations into the CFC regime and may cause more taxpayers to be treated as United States shareholders.

New Tax on Global Intangible Low-Taxed Income

The Act requires United States shareholders of CFCs to include in their income on a current basis their pro rata share of the "global intangible low-taxed income" or "GILTI" of such CFCs. GILTI is calculated by subtracting from the net income of the CFC an amount that is intended to represent a 10% "routine" return on the CFC's tangible depreciable property (measured using the tax basis, rather than fair market value, of such property).

U.S.-parented groups (and other corporate United States shareholders) are allowed a deduction equal to 50% of the GILTI included in such corporation's income for the relevant tax year, and an 80% foreign tax credit with respect to its share of certain foreign taxes paid by the CFC. As a result of these provisions, and taking into account the 21% U.S. corporate tax rate, GILTI (of a U.S. corporation) on which no foreign tax is paid are subject to U.S. tax at a rate of 10.5%, and GILTI that is subject to foreign tax at a rate of at least 13.125% are not subject to any residual U.S. tax. The 50% deduction for GILTI is temporary, and for tax years beginning after December 31, 2025, drops to 37.5%, resulting in a U.S. federal income tax rate of 13.125% on GILTI for those years.

Significantly, United States shareholders that are not corporations are not eligible for the 50% GILTI deduction or 80% foreign tax credit described above. Thus, for example, the effective tax rate on GILTI for an investor in a private equity fund formed as a U.S. partnership could be as high as 37%. In certain cases, an individual United States shareholder may be able to mitigate this harsh result by making an election to be subject to tax on GILTI at the 21% corporate tax rate and obtain the 80% foreign tax credit described above. It does not appear, however, that such individual United States shareholders would be entitled to claim the 50% GILTI deduction that is available to United States shareholders that are actually corporations. Moreover, this election does not appear to be available to a United States shareholder that is a partnership, or to an individual partner who does not qualify as a United States shareholder (i.e., who does not own directly or indirectly 10% or more of the CFC by vote or value). Because these rules generally apply only to United States shareholders, widely held funds organized as offshore partnerships generally will avoid these results.

The calculation of GILTI is complex and will likely incentivize transactions that increase the tax basis of depreciable property held by CFCs, such as structuring offshore acquisitions as asset purchases (or equity purchases that are treated as asset purchases for U.S. tax purposes) or structures that avoid the application of the CFC rules. This may also further incentivize investment funds targeted to U.S. investors to organize themselves outside of the United States.

Foreign-derived Intangible Income

The Act implements a new tax regime that provides a lower 13.125% U.S. federal income tax rate (rather than the new standard 21% rate) on "foreign-derived intangible income" for domestic C corporations (other than RICs and REITs). The special tax rate is effected by granting a 37.5% deduction for a C corporation's foreign-derived intangible income. Foreign-derived intangible income is, generally, a portion of a C corporation's income in excess of a threshold return derived from services performed for persons not located in the United States and from sales or licensure of property to non-U.S. persons for consumption outside the United States. The Act thereby attempts to reduce incentives for corporate taxpayers to move intangible property outside of the United States for use in their foreign operations or for licensure to foreign customers. The 37.5% deduction is temporary, and for tax years beginning after December 31, 2025, drops to 21.875%, resulting in a U.S. federal income tax rate of 16.406% (rather than the standard 21% rate) on foreign-derived intangible income for those years.

Base Erosion Anti-abuse Tax ("BEAT")

The Act imposes an additional minimum tax on certain large corporations (measured by revenue) that reduce their U.S. tax base by making sizable deductible payments, such as interest payments, to foreign affiliates. In addition to multinational groups, private equity fund managers that use levered blockers in their structures will need to be mindful of this new provision as levered blockers can be subject to this new tax under the right set of facts.

In order to be subject to this new tax, a taxpayer must (1) be a corporation (other than a RIC, a REIT or an S corporation), (2) have $1.5 billion of gross receipts over the three prior taxable years and (3) have a "base erosion percentage" (as defined below) for the taxable year of 3% or higher (2% in the case of a group that includes a bank or registered securities dealer) (an "applicable taxpayer").

Corporations which are members of the same controlled group of corporations[4] are treated as one person for purposes of determining whether the second and third conditions in the previous paragraph are met, although there is uncertainty among tax practitioners as to exactly how this aggregation rule is to be applied, and a view that this rule may be modified by a technical correction.

In the case of a foreign person, the gross receipts of which are taken into account for purposes of testing whether the second condition is met, only gross receipts which are taken into account in determining ECI are taken into account.

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[4] Very generally speaking, corporations are members of the same controlled group if they share 50% or more common ownership by either vote or value. Additionally, a foreign corporation can be part of the controlled group of corporations, even if it does not have ECI.

The new tax is equal to the excess of

- 10%[5] of the "modified taxable income" of the taxpayer for the taxable year over
- an amount equal to the "regular tax liability" of the taxpayer for the taxable year reduced (but not below zero) by the income tax credits allowed against such regular tax liability (other than the R&D credit and certain other credits).[6]

To determine its modified taxable income, an applicable taxpayer adds back to its taxable income for the year (1) certain base eroding payments and (2) the "base erosion percentage" of any allowable NOL deduction for the taxable year.

Generally speaking, and subject to certain exceptions (particularly, for "qualified derivative payments" and certain goods and services), a base eroding payment means an amount paid or accrued by a taxpayer to a foreign "related party" of the taxpayer and with respect to which a deduction is received. A base eroding payment also includes any (1) amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of depreciable or amortizable property, (2) any premium or other consideration paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer for certain reinsurance payments and (3) certain amounts that are paid or accrued by the taxpayer to a related corporation that has undergone an inversion after November 9, 2017.

Any payment on which there is FDAP withholding generally is not treated as a base eroding payment.[7]

The base erosion percentage means, for any taxable year, the percentage determined by dividing the aggregate amount of base eroding payments of the taxpayer for the taxable year by the aggregate amount of the deductions allowable to the taxpayer for the taxable year (including the base erosion tax benefits included in the numerator) and by making certain adjustments.

A related party means (1) any 25% owner of the taxpayer, (2) any person related to the taxpayer or any 25% owner of the taxpayer and (3) any other person related to the taxpayer through common control.

Note that a taxpayer can be subject to both the limits on interest deductibility discussed earlier (in the section entitled "Limitations on Interest Deductibility") and the BEAT. To the extent an applicable taxpayer has paid interest to both (1) foreign related parties and (2) non-foreign related parties (i.e., parties that are either not foreign or not related), the Act has an anti-taxpayer ordering rule which essentially maximizes the amount of payments to the foreign related parties that are treated as base eroding payments.

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[5] 5% for taxable years beginning in 2018 and 12.5% for taxable years beginning after 2025. In the case of a taxpayer that is a member of an affiliated group that includes a bank or a registered securities dealer, the rates are 6% instead of 5%, 11% instead of 10% and 13.5% instead of 12.5%.

[6] For taxable years beginning after 2025, the regular tax liability is reduced (but not below zero) by all income tax credits.

[7] The Act, as enacted, does not provide a similar exemption for a payment that is ECI to the foreign recipient, although there is legislative history to the contrary, and we understand that this may be fixed in a technical correction.

Deduction Limitation for Interest and Royalties Paid or Accrued Pursuant to Hybrid Transactions or by or to Hybrid Entities

The Act introduces a new provision which denies deductions for interest and royalty payments made to certain related parties where such amounts are paid or accrued pursuant to a "hybrid transaction" or by or to a "hybrid entity" in a context where the related party (1) is not required to include such amount in income under the tax laws of its country of tax residence or (2) is allowed a deduction with respect to such amount under the tax laws of its country of tax residence. For purposes of this provision, (i) a "hybrid transaction" is any transaction or instrument for which payments are treated as interest or royalties for U.S. federal income tax purposes, but are not treated as such under foreign tax laws and (ii) a "hybrid entity" is an entity treated as fiscally transparent for U.S. federal income tax purposes but not treated as such under the tax laws of the entity's country of tax residence, or vice-versa. This provision is intended, similar to measures adopted by the OECD, to address hybrid mismatch arrangements that give rise to either (A) a deduction with no income inclusion or (B) a double deduction. The Act also authorizes the issuance of Treasury Regulations to carry out the purposes of the provision in various contexts, including as to conduit arrangements and branches.

Miscellaneous Additional International Tax Provisions

The Act repeals the active trade or business exception to tax on foreign-bound transfers pursuant to Section 367 for transfers after December 31, 2017. The Act also repeals a provision permitting U.S. corporations to claim foreign tax credits with respect to dividends received from foreign corporations in which such U.S. corporations own 10% or more of the voting stock.

The Act establishes a tax in situations where a domestic corporation transfers substantially all the assets of a foreign branch to a 10%-owned foreign corporation for transfers after December 31, 2017.

EXECUTIVE COMPENSATION TAX REFORM

The Act overhauls Section 162(m), greatly expanding the scope of the deduction limitation under Section 162(m) for executive compensation in excess of $1 million. Please see our earlier memorandum for further discussion, Tax Cuts and Jobs Act Results in Major Overhaul to Section 162(m).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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