To Our Clients and Friends

Memorandum

Tax Cuts and Jobs Act Passed by the House

On November 16, 2017, the U.S. House of Representatives passed H. R. 1, the Tax Cuts and Jobs Act (the "Act"). On the same day, the U.S. Senate Committee on Finance approved its tax reform plan, which is expected to be considered by the full Senate in the coming weeks. Although the Senate Finance Committee has not released legislative text, a summary of its plan makes clear that it differs from the Act in a number of significant respects. Below is a summary of some of the Act's provisions that, if enacted, would have the greatest effects on businesses, investment funds, investors, and executives.

Business Tax Reforms

Corporate Tax Rate Changes

The Act generally would reduce the corporate tax rate from 35% to 20% beginning in 2018. The corporate dividends received deduction would be reduced to preserve the current law effective tax rates on a corporation's dividend income. The corporate alternative minimum tax would be repealed.

Maximum 25% Tax Rate for Business Income of Individuals

The Act would generally reduce to 25% the maximum tax rate applicable to certain ordinary income earned by individuals (including through partnerships and S corporations). Income qualifying for the 25% rate generally would include:

- 100% of income from passive business activities (e.g., activities of a business in which the individual does not materially participate); and
- 30% of income from active business activities, except that:
  - a higher percentage may qualify for the 25% tax rate to the extent more than 30% of the active income of the business is attributable to a return on invested capital (rather than a return on labor).

Active business income earned from certain personal services businesses (e.g., health, law, consulting, financial services, brokerage services, and similar businesses, including many investment partnerships) would generally be ineligible for the reduced 25% tax rate.

Carried Interest

The Act would apply a special rule to any partnership profits interest (commonly referred to as "carried interest") held by a taxpayer in connection with the performance of services in a business involving the raising of capital for investment in (or development of) specified assets, including securities, commodities,

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and real estate held for rental or investment. The special rule would increase the long-term capital gain holding period from one year to three years for gains realized with respect to the profits interest, whether from a disposition thereof (in which case the three-year holding period requirement would apply to the interest itself) or from an allocation by the partnership of gain from the sale of property (in which case the three-year holding period requirement would apply to such property). The rule would be effective for taxable years beginning after December 31, 2017.

Limitations on Interest Deductibility

Net business interest expense (business interest expense in excess of business interest income) of any U.S. business (other than certain small businesses) generally would be available to offset only 30% of the business's adjusted taxable income (defined similarly to EBITDA). Excess business interest expense may be carried forward for up to 5 years. The current interest "earnings stripping" rules would be repealed.

- This proposed limitation on the deductibility of interest may have a significant effect on leveraged acquisitions, leveraged recapitalizations, and similar transactions.
- Banks and other lending businesses that earn interest income in excess of interest expense are not expected to be directly affected by this proposal.
- Real estate businesses and certain regulated public utilities would not be subject to this limitation.

Immediate Expensing

The Act generally would permit taxpayers to expense (rather than to depreciate over a period of years) 100% of the cost of certain qualified tangible property acquired and placed into service after September 27, 2017 and before January 1, 2023. Under the Act, expensing would include acquisitions of used property from an unrelated party, in addition to acquisitions of new property.

- Real estate and property used in a trade or business by certain regulated public utilities are not eligible for immediate expensing.

Limitations on the Use of Net Operating Loss Deductions

Under the Act, a corporation's net operating losses ("NOLs") arising in taxable years beginning after 2017 generally could not be carried back, but could be carried forward without limitation, and carried forward amounts would increase by an interest factor. In addition, the deduction for carryforwards and carrybacks would be limited to 90% of the taxpayer's taxable income determined without regard to the NOL deduction. This limitation would apply to tax years beginning after 2017 (including carryforwards of existing NOLs).

Like-Kind Exchanges Limited to Real Property

The Act would limit the rule allowing deferral of gain on like-kind exchanges to exchanges of U.S. real property. Thus, for example, taxpayers would no longer be able to defer gain on exchanges of intangible property. This provision generally would be effective for transfers after 2017, but a transition rule would allow transactions partially completed to receive tax deferred treatment.

State Sovereign Investors

The Act provides that all entities exempt from tax under section 501(a), including certain state government-sponsored entities, like pension plans, 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). The Act does not address the Constitutional theory for the exemption from federal tax for state sovereign entities.

International Tax Reforms

Territorial Corporate Tax System

The Act introduces a corporate "participation exemption," moving the United States from a worldwide to a territorial tax system. As a result of the participation exemption, the earnings of foreign subsidiaries of U.S. corporations generally would no longer be subject to U.S. tax upon repatriation to the United States (subject to a new anti-base erosion tax on certain foreign subsidiary earnings that exceed a specified return on the subsidiary's depreciable tangible property). This exemption generally would apply to post-2017 dividends paid by a foreign corporation (other than certain passive foreign investment companies) to a U.S corporation that owns at least 10% of such foreign corporation's voting power for a minimum of 6 months. Similarly, foreign subsidiary earnings would no longer be included in the income of a U.S. parent corporation as a result of an investment in U.S. property by the foreign subsidiary (such as a pledge of the stock of the foreign subsidiary as collateral for a borrowing of the U.S. parent). As part of the transition to a territorial tax system, accumulated foreign earnings (determined as of November 2, 2017 or, if higher, December 31, 2017) would be deemed repatriated and taxed at 14% (to the extent represented by cash or cash equivalents) or 7% (to the extent represented by fixed assets). The U.S. shareholder may elect to include these amounts in income ratably over 8 years. The deemed repatriation rule applies to a broader class of U.S. shareholders than the participation exemption, and thus the income inclusion rules could result in surprising consequences.

Excise Tax on Payments to Foreign Affiliates

Certain payments by U.S. companies to related foreign affiliates that are deductible or includible by the payor in costs of goods sold, inventory, or depreciable basis would be subject to a 20% excise tax unless the foreign recipient elects to report the payment as effectively connected income (or "ECI") that is subject to U.S. tax. If such an ECI election is made, a foreign tax credit limited to 80% of the foreign taxes paid would be allowed. The excise tax would apply only to large international groups (with average aggregate intercompany payments exceeding $100 million over a three-year period).

Interest Expense Limitation Affecting International Groups

The Act limits the net interest expense available to a U.S. corporation that is a member of an international group in certain circumstances, based on the EBITDA contributed by the U.S. corporation to the group. This limitation would apply only to large international groups (with average annual gross receipts exceeding $100 million over a three-year period). This limitation applies in addition to the limitation on the deductibility of net interest expense described above.

Executive Compensation Reforms

Expansion of Section 162(m)

The Act would greatly expand the reach of the $1 million compensation deduction limitation under section 162(m) for public companies by eliminating section 162(m)'s commission and performance-based compensation exceptions. The Act would also expand section 162(m)'s coverage to include companies that do not have publicly traded stock but do have public debt. Finally, the Act would expand coverage to individuals who at any time were the company's CEO, CFO, or one of the three most highly compensated employees, regardless of whether they remain at such level or position. These changes to section 162(m) would take effect for tax years beginning after December 31, 2017.

Limited Ability to Defer Income Tax on Receipt of Certain Qualified Stock

The Act would provide a limited ability for certain employees of privately held corporations to defer income tax on the receipt of "qualified stock" received in connection with the exercise of stock options or settlement of restricted stock units for up to five years after the right to the stock vests by making an election similar to a section 83(b) election. The exemption is of limited utility, however, as (i) it may be used only in tax years in which the corporation has made more than *de minimis* option and/or restricted stock unit grants to at least 80% of its US employees, and (ii) it is inapplicable to current and former CEOs and CFOs of the corporation, as well as persons who have been, within the preceding 10 taxable years, either one of the top four most highly compensated officers or a one percent shareholder of the corporation.

Deferred Compensation

The overhaul of the existing deferred compensation regime that was included in the original draft of the Act was not included in the version of the Act passed by the House.

Individual Tax Reforms

The Act would reduce the number of tax brackets and preserve the top tax rate of 39.6% for individuals, which would apply to income in excess of $500,000 for single filers and $1,000,000 for joint filers. The Act does not change the maximum tax rate applicable to long-term capital gains of individuals.

Various itemized deductions would be limited or eliminated. Deductions for state and local taxes would be eliminated, other than a deduction for up to $10,000 of state and local property taxes. The mortgage interest deduction would be limited to $500,000 on debt incurred after November 2, 2017 to acquire a principal residence.

The individual alternative minimum tax would be repealed.

From 2018 through 2024, the basic exclusion amount for the estate, gift, and generation-skipping transfer taxes would be $10 million ($20 million in the case of married couples), in each case subject to inflation adjustments. Starting in 2025, the estate and generation-skipping transfer taxes would be repealed and the maximum gift tax rate would be lowered from 40% to 35%.

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Authors:

Alan S. Kaden

David Shapiro

Robert Cassanos

Jeffrey Ross

Daniel J. Paulos

Shane Hoffmann

Reid Thompson

Ryan Conley

Joshua Gelfand

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:

Contacts:

Tax

Michael J. Alter	+1.202.639.7094	michael.alter@friedfrank.com
Robert Cassanos	+1.212.859.8278	robert.cassanos@friedfrank.com
Michelle B. Gold	+1.202.639.7243	michelle.gold@friedfrank.com
Alan S. Kaden	+1.202.639.7073	alan.kaden@friedfrank.com
Daniel J. Paulos	+1.212.859.8650	daniel.paulos@friedfrank.com
Christopher Roman	+1.212.859.8985	christopher.roman@friedfrank.com
Kenneth Rosenfeld	+1.212.859.8034	kenneth.rosenfeld@friedfrank.com
David I. Shapiro	+1.212.859.8039	david.shapiro@friedfrank.com
Eli Weiss	+1.212.859.8855	eli.weiss@friedfrank.com
Richard A. Wolfe	+1.212.859.8922	richard.wolfe@friedfrank.com

Executive Compensation & ERISA

Amy L. Blackman	+1.212.859.8620	amy.blackman@friedfrank.com
Donald P. Carleen	+1.212.859.8202	donald.carleen@friedfrank.com
Adam Kaminsky	+1.202.639.7420	adam.kaminsky@friedfrank.com
Jeffrey Ross	+1.212.859.8678	jeffrey.ross@friedfrank.com