Simpson Thacher

Memorandum

President Trump and GOP Congressional Leaders Release Tax Overhaul Plan

September 28, 2017

Introduction

Yesterday President Trump, the House Committee on Ways and Means and the Senate Committee on Finance released their framework for tax reform (the "framework"), which represents the most detailed proposal for changes to the tax code issued during the Trump administration. The framework's key elements include:

- a reduction in corporate tax rates to 20% and partial limitation on the deductibility of interest for corporate taxpayers;
- a shift to a modified "territorial" regime of corporate taxation that eliminates tax on dividends from foreign subsidiaries but subjects all foreign earnings to current taxation at a minimum rate to be determined;
- immediate expensing of certain capital expenses for five years;
- a 25% maximum tax rate applicable to income derived from small and family-owned businesses conducted through pass-through entities or sole proprietorships; and
- an increase in the standard deduction and the elimination of most itemized deductions (including the deduction for state and local taxes).

Although details of the tax overhaul remain uncertain, and formal tax legislation has yet to be submitted for congressional vote, the framework represents the most concrete depiction to date of how tax reform could unfold and which constituencies might gain or lose.

Implications for Businesses

C Corporations. The framework would reduce the top marginal corporate tax rate from 35% to 20% and eliminate the corporate alternative minimum tax ("AMT").

Certain Pass-Through Businesses. The framework provides for a maximum rate of 25% applicable to income of small and family-owned businesses conducted as sole proprietorships, partnerships and S corporations, but does not provide information on the requirements to qualify for this treatment. The proposal does contemplate that Congress will implement measures to prevent individuals from avoiding the top personal tax rate by recharacterizing personal income as business income, and it is expected that partners in most service partnerships will not benefit from the regime.

It remains unclear how this proposal will impact investors or sponsors of private equity or real estate funds, or whether the current taxation of carried interest will be addressed as part of legislation.

Interest Expense for C Corporations. The framework proposes to partially limit the deduction for net interest expense incurred by C corporations, and reserves on the appropriate treatment of interest paid by non-corporate taxpayers. Limitations on interest deductibility could have wide-ranging effects, including reducing the attractiveness of leveraged acquisitions or debt-financed stock buybacks and the preference for corporate debt over equity financing.

Five-Year Expensing of Capital Investments. The framework allows businesses to immediately write off the cost of new investments in depreciable assets (other than structures) made after September 27, 2017, for at least five years. Although it is likely that buildings would be excluded from this favorable treatment, it is unclear what other assets would be ineligible for immediate expensing.

International Business Taxation. The framework proposes a departure from the current worldwide taxation of corporate earnings in favor of a "territorial" regime that would provide a 100% exemption for dividends from foreign subsidiaries in which the U.S. parent owns at least a 10% stake. The proposed regime would presumably eliminate the foreign tax credit that is currently in place to avoid duplicative taxation of foreign-source income.

Previously accumulated earnings would be subject to deemed repatriation at an unstated rate (with earnings held in illiquid assets subject to a lower tax rate than those held in cash or cash equivalents). Taxpayers would be required to pay the tax liability associated with such deemed repatriation in installments over several years.

The framework promises to protect the U.S. tax base and curtail any incentive for U.S. companies to shift future profits to "tax haven" jurisdictions by implementing rules that would tax the foreign profits of U.S. multinational corporations on a current basis at a reduced rate and level the playing field between U.S.-

headquartered parent companies and foreign-headquartered parent companies.

Although the framework provides an overview of potential international tax changes, more details will be necessary to determine the impact of these proposals on the tax planning of multinational corporations, "inversion" transactions and income shifting transactions.

Implications for Individuals

The framework proposes a number of important changes to the taxation of individuals, including:

- reducing the number of individual tax brackets from seven to three (12%, 25% and 35%), repealing the individual AMT and lowering the top marginal rate from 39.6%, while providing flexibility for the inclusion by Congress of an additional top marginal rate;
- doubling the size of the standard deduction and eliminating most itemized deductions (including, presumably, the state and local tax deduction), although the home mortgage and charitable contribution deductions are specifically retained; and
- eliminating the estate tax and generation-skipping transfer taxes.

As a result of the elimination of most itemized deductions, it is possible that a high-income taxpayer in a state with high taxes such as New York or California could pay more under the framework's approach than under current law, even taking into account the reduction in the top marginal tax rate.

Conclusion

While the framework provides an early indication of the potential direction of tax reform, the framework's details remain sparse and the ultimate outcome of tax reform remains uncertain. We will continue to monitor developments in this area.

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