Final Tax Bill Will Have Significant Impact on Business Decisions and Operations of U.S. Companies

President Trump signed this morning the final version of the tax reform bill commonly known as the Tax Cuts and Jobs Act (the “Act”), which was passed by Congress on December 20, 2017.1

Regardless of whether one’s political views lean red or lean blue, the Act is unmistakably a very big deal. It is generally fair to say that the Act was designed by the Republican Congress and championed by the Trump Administration with an objective to encourage investment inside the U.S. In particular, the Act provides significant tax benefits for businesses that make substantial investments in U.S.-based employees and/or U.S.-based tangible property. Similarly, the Act’s cross-border and international provisions provide powerful incentives for the repatriation of offshore cash to the U.S, and provide disincentives for the movement of intangible property to low-taxed overseas destinations.

While we do not purport to be economists and we certainly have no idea whether the Act will provide the enhanced economic growth that the Republican Congress expects, we do know this: Companies, funds and investors that carefully review their business operations will find that the Act provides (i) meaningful opportunities for tax minimization, but also (ii) traps for the unwary. We try to highlight some of these opportunities — and these traps — below.

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At a very high level, the Act does the following:

• Reduces the corporate income tax rate from 35% to 21%;

• Creates a preferential tax rate for investors in certain flow-through businesses and REITs through a 20% deduction;

• Retains capital gains tax rates for carried interest allocations, but imposes a three-year holding period before certain income qualifies for long-term capital gains tax rates;

• Limits the deductibility of interest by a leveraged business to 30% of EBITDA (as defined in the Act) until 2021 and to 30% of EBIT (as defined in the Act) for 2022 and thereafter;

• Allows an immediate write-off of the full cost of certain business property;
• Limits use of net operating losses (“NOLs”) generated in taxable years beginning in 2018 to 80% of taxable income and prohibits carrybacks of such NOLs; and

• Fundamentally overhauls the taxation of cross-border investments.

Changes to Taxation of Business Operations in General

The Act will likely drive significant changes in current market practice for raising investment capital, organizing business operations, and structuring and financing M&A transactions.

I. Changes in Tax Rates

a. Statutory Changes2

(i) 21% Rate for Corporations

Among the most significant developments in the Act is the reduction in the federal corporate income tax rate from 35% to 21%. As described below, this dramatic reduction in the corporate tax rate may significantly impact the way in which taxpayers structure investments and business operations going forward.

(ii) 20% Rate for Long-Term Capital Gain (Including Carried Interest)

The individual federal income tax rate on long-term capital gain remains 20%, but the Act imposes a new three-year holding period for investments held by an investment fund with respect to which carried interest is received in order for allocated gain from the sale of such investments to be eligible for long-term capital gains tax rates.

(iii) Decreased Tax Rate on Individuals’ Ordinary Income

The Act reduces the individual tax rate on ordinary income from a top marginal rate of 39.6% to 37%, and repeals the limitations on itemized deductions that effectively raised the prior top marginal rate to approximately 40.5%. In addition, the Act includes a 20% deduction for specified flow-through income (“SFTI”), resulting in an effective top marginal rate of 29.6% on SFTI.3 The 20% deduction for SFTI generally applies to specified income from flow-through businesses (e.g., a sole proprietorship, an S corporation, or an entity treated as a partnership for U.S. federal income tax purposes), dividends paid from real estate investment trusts (“REITs”), and certain kinds of income from publicly traded partnerships (which is most relevant in the oil and gas area).

Eligibility for the 20% deduction for SFTI is generally subject to three key limitations:

• Limitation #1: Service Business Exception. The 20% deduction for SFTI generally does not apply with respect to businesses that primarily involve the
provision of personal services. These businesses include health, law, consulting, financial services, brokerage services and investing, trading or dealing in securities (a “Disqualified Service”). Notably, the provision of investment management and advisory services by a management company of a private equity fund will likely constitute a Disqualified Service. A Disqualified Service would not appear to include banking, insurance, financing or leasing, although the line may be difficult to draw in certain cases.

- **Limitation #2: W-2 Wage and Capital Expenditure Exception.** The 20% deduction for SFTI is subject to limitation (in part or in whole) to the extent that the amount of such deduction exceeds an alternative calculation that takes into account (i) “W-2 wages” attributable to the business and (ii) the business’s original tax basis in certain types of tangible property. These W-2 and basis-based calculations are extremely complex and fact-specific, and will require a detailed business-by-business and year-by-year analysis with respect to any business. At a very high level, businesses with substantial U.S.-based labor costs or investments in U.S. tangible property will generally be able to take full advantage of the 20% deduction, while businesses with limited U.S.-based labor or tangible property may not fully realize the benefits of the SFTI deduction even if otherwise eligible.

- **Limitation #3: Compensatory Payments.** The 20% deduction for SFTI is not available with respect to specified compensatory payments made from the business to the taxpayer for services rendered (including so-called “guaranteed payments” made from a partnership to a partner). The rules also require that all individuals be paid reasonable compensation, thus preventing the owners of pass-through businesses from converting all of their income to SFTI income.

Importantly, none of the limitations described above apply with respect to REIT dividends, and only Limitation #1 applies with respect to income attributable to an interest in a publicly traded partnership.4

**(iv) Limitation on Excess Business Losses Claimed By Individuals**

Current law allows non-corporate taxpayers to deduct losses from pass-through businesses against business profits from other non-business investments, subject to certain limitations under the “passive loss” rules. Under the Act, the ability to deduct losses will be subject to new limitations that go beyond the current law “passive loss” rules. In particular, an individual taxpayer cannot claim more than $250,000 of losses from pass-through business investments (or $500,000 in the case of married taxpayers) as a deduction against such taxpayer’s taxable income. Any disallowed losses are added to the taxpayer’s net operating loss and carried over to future years (subject to the 80% limitation described above).

**b. Impact on Market Practice**

We expect these changes in effective tax rates to prompt a rethinking of market practice on a number of key points in the M&A and investment structuring context, including the following:
(i) Choice of Entity

Whether an investment is held through a C corporation (which generally pays entity-level taxes on operating income) or a flow-through entity (which generally passes on operating income to its equity holders) requires a complex analysis in all cases. However, it appears likely that at least in some instances, investments held in C corporations may become relatively more attractive under the Act.

The increased attractiveness of C corporations under the Act is due in part to a strong likelihood that C corporations will enjoy a much lower effective tax rate on operating income as compared to individuals receiving allocations from a flow-through entity. Under the Act, a C corporation pays a 21% federal income tax rate on its operating income, plus state and local income taxes. These state and local taxes for corporations are in many cases lower than the state and local taxes imposed on individuals, and state and local taxes continue to be deductible for C corporations under the Act. Individuals, by contrast, (i) are subject to a highest federal marginal income tax rate of at least 29.6% (assuming the 20% deduction for SFTI applies to 100% of the business income — which it may not, in many situations, because of the limitations discussed above), (ii) in many cases pay state and local taxes at higher income tax rates relative to C corporations, and (iii) are no longer permitted a federal deduction for these state and local taxes in excess of a flat $10,000 cap. Accordingly, the blended state and federal income tax rate for flow-through operating income allocated to individuals (and typically paid out as tax distributions) could in many cases substantially exceed the blended state and federal income tax rate for C corporations. Even after accounting for the additional tax that would be owed by a C corporation shareholder with respect to dividends or sales of the C corporation stock (which may not occur until many years in the future), these changes may make C corporations more attractive as investment vehicles on a relative basis.

In addition, the Act may make flow-through investments less attractive on a relative basis by decreasing the value of asset-level tax basis. Under current law, a key advantage of holding an investment in flow-through form is the ability to deliver an asset-level tax basis step-up to a buyer when exiting an investment, which generates deductions that the buyer could use to offset a 35% federal income tax. However, by reducing the federal corporate tax rate by about 40% (from 35% to 21%), the Act in turn reduces the value of tax assets by 40%. By decreasing the value of a step-up in tax basis, the Act may make flow-through investments less attractive as compared to under current law. On the other hand, the immediate expensing opportunity, discussed below, may result in significant benefits to a basis step-up transaction for a business with significant tangible assets.

In each case, the relative attractiveness of a corporate or a flow-through investment will need to be modeled, taking into account the investor base, the type of business, the financial accounting effects of the transaction and the amount of cash taxes expected to be paid. We expect that unlike under current law, where flow-through
investments are reliably more attractive from a tax perspective, the choice between flow-through and corporate investment structures will be less intuitively certain.

(ii) Utilization of Up-C Structures

The Act may also change the way that market participants think about so-called “Up-C” structures. In an Up-C structure, a business is owned partially in flow-through form (typically by its historic interest holders) and partially through a C corporation (typically a publicly traded entity). Holders of flow-through interests are generally able to exchange flow-through units for the publicly traded C corporation's shares at their election, and this exchange generates an asset-level tax basis step-up for the C corporation. Going forward, whether an Up-C structure remains attractive in a particular case will depend on the same factors discussed above for determining whether a C corporation is preferable to a flow-through entity for use as a holding company. In addition, the lower tax rate for C corporations may preserve more operating cash flow for the publicly traded C corporation to pursue investments in the business or acquisition opportunities.

(iii) Spin-Off v. Sale

In light of the decreased corporate tax rate, it may be the case that certain taxpayers who were considering a tax-free spin-off of a business may instead opt to engage in a taxable sale of that business. Whether to pursue a spin-off or a sale will remain a complex determination under the Act, and in some cases even a 21% federal income tax rate would generate an unacceptably large amount of tax leakage on a taxable sale of a business, especially if the business has taken advantage of the 100% expensing provisions discussed below and in light of the new limitations on the ability to utilize NOLs. However, on the margins, we would expect taxable sales to become more attractive to taxpayers under the Act.

II. Limitation on Interest Deductibility

The Act limits most companies’ ability to claim business interest deductions to an amount that is roughly equal to 30% of EBITDA for years prior to 2022, and 30% of EBIT beginning in 2022. There is no grandfathering or phase-in for existing debt. The House proposal included an additional limitation on the deductibility of interest payments for U.S. corporations who are members of a multinational tax group, but that limitation was not included in the Act.

The impact of this limitation on any particular investment should be carefully modeled in connection with the other changes discussed herein, including the significant reduction in the corporate tax rate, which may mitigate the effect of the limitation in whole or in part. In particular, the revised calculation from EBITDA to EBIT in 2022 could be dramatic for certain taxpayers, especially if such taxpayers have substantial tax basis in depreciable and/or amortizable assets (e.g., as a result of an acquisition that provides an asset-level tax basis step-up). In some cases, taxpayers may consider using alternative forms of financing (including preferred equity) if interest deductions with respect to an investment are expected to be disallowed.
III. Immediate 100% Expensing of Qualified Property

The Act allows most businesses to take a bonus depreciation deduction equal to 100% of the adjusted basis of “qualified property” acquired and placed in service after September 27, 2017, and before January 1, 2023. “Qualified property” is defined as (i) tangible personal property with a recovery period of 20 years or less under current law, (ii) certain computer software, and (iii) property used in qualified film, television and theatrical productions. The deduction will be phased-down for property acquired from January 1, 2023, through December 31, 2026.

It is particularly significant that bonus first-year expensing is permitted for both new and used tangible property. Accordingly, in transactions in which a taxpayer purchases the assets of a business, a very significant portion of such business assets may be eligible for 100% expensing at the time of acquisition, making asset acquisitions even more attractive from a buyer’s perspective. Coupled with the reduced corporate rate, this write-off has the potential to significantly reduce or eliminate the buyer’s tax liability on business income, which in turn reduces the impact of the limitation on business interest deductibility and may make operating a business in corporate solution more appealing. This benefit of immediate expensing may, however, be offset somewhat by the new limits on NOLs, discussed below.

IV. Recognition of Deferred Revenue

Under current law, a taxpayer generally recognizes income at the time property is actually received, in the case of a cash method taxpayer, or when the taxpayer has legally become entitled to receive the income, in the case of an accrual method taxpayer, subject to certain exceptions. The Act requires accrual method taxpayers to recognize income no later than the tax year in which such income is included in revenue on such taxpayer’s “applicable financial statement.” An “applicable financial statement” includes certain financial statements filed with the SEC or another federal agency and certain audited financial statements. In addition, the Act allows accrual method taxpayers to defer inclusion of income for certain advance payments to the end of the tax year following the year of receipt if such income is also deferred on the taxpayer’s applicable financial statement, codifying Revenue Procedure 2004-34. Items of income received in connection with mortgage servicing contracts are excluded from these timing rules.

The joint explanation of the House and Senate conference agreement notes that the application of these rules is considered a change in the taxpayer’s method of accounting under Section 481. Taxpayers will want to work with their tax advisers to determine whether these changes impact gain recognition or cause a change in method of accounting. From an M&A perspective, it will be important for buyers to diligence any of these accounting method changes and price in the effect of any future income inclusions caused by the Section 481 adjustment.
V. International Tax Reform

Overall, the Act moves the U.S. towards a modified territorial tax system. This is accomplished through a “participation exemption” structure in which domestic corporations receive a 100% deduction for foreign-source portions of dividends received from 10%-owned foreign corporations, including amounts treated as a dividend in connection with the sale or exchange of stock of a foreign corporation. This deduction does not apply to dividends received by non-corporate U.S. shareholders.

Among the most significant issues for market participants to consider with respect to the transition to a territorial system is a one-time deemed repatriation tax on deferred foreign earnings of foreign subsidiaries. The one-time deemed repatriation tax applies at a 15.5% rate to deferred foreign earnings held as cash and cash equivalents, and at an 8% rate to other deferred foreign earnings. U.S. shareholders may elect to pay the tax over a period of eight years, with the majority of the tax due after the fifth year, with no interest charge. Additionally, foreign tax credits will be partially available to offset the resulting tax liability. This liability will need to be examined during due diligence and should be taken into account, presumably as debt, in pricing acquisitions involving shareholders of foreign entities, as we expect most eligible taxpayers to elect to defer and pay the tax over eight years. After the deemed repatriation, a U.S. shareholder can repatriate any historic foreign cash back to the U.S. with no further tax cost and with no restrictions on how the cash must be used.

The Act also contains new provisions designed to discourage U.S. companies from locating their intellectual property in low-tax jurisdictions. One such rule requires an annual U.S. income inclusion with respect to “global intangible low-taxed income” or “GILTI.” U.S. corporations are allowed a 50% deduction for any GILTI, which produces a 10.5% effective tax rate.

In addition to these penalty provisions, the Act also contains a new incentive for U.S. companies to keep their intellectual property in the U.S. in the form of a 37.5% deduction for “foreign-derived intangible income” or “FDII” (for a 13.125% effective tax rate). FDII is broadly calculated by reference to property or services provided to foreign customers from the U.S.

Of particular interest to multinationals, the Act applies a new 10% minimum tax to U.S. corporations called the “base erosion and anti-abuse tax” or “BEAT.” The BEAT is designed to protect the U.S. tax base by ensuring a minimum amount of tax is paid on U.S. earnings, disregarding certain deductible payments made to related foreign entities, including interest and royalties. The BEAT only applies to corporations with annual gross receipts of at least $500 million (measured on a trailing three-year basis), and as such is most likely to impact larger multinational enterprises with substantial presence in the U.S.

The Act also includes highly punitive measures aimed at further curbing so-called “inversion” transactions. In light of the severity of these measures, such transactions
(even those motivated entirely by non-tax business reasons) will become less attractive under the Act.

Finally, the Act overturns the result in the recently decided Tax Court case *Grecian Magnesite Mining v. Comm'r* by (i) subjecting to U.S. taxation all of a foreign person's gain from the sale of an interest in a partnership to the extent attributable to a U.S. trade or business, and (ii) imposing a new 10% withholding tax on the amount realized by a foreign person on the sale or exchange of an interest in a partnership engaged in a U.S. trade or business.¹¹

**VI. Investment Income of Tax-Exempt Organizations**

The Act provides for a number of changes that may shift the way tax-exempt organizations ("TEOs") engage in investment activities. In particular, the Act (i) subjects investment income earned by private colleges and universities maintaining large endowments to a 1.4% excise tax, and (ii) mandates that unrelated business taxable income ("UBTI") be computed separately for each trade or business (effectively eliminating the ability of tax-exempt investors to use losses from one investment generating UBTI to offset income or gain from another investment generating UBTI).

Importantly, however, the Act does not include certain proposals from the House that would have subjected certain governmental entities (including, for example, state-sponsored pension plans) to taxation on UBTI.

*Impact on Specific Industries*

**I. Restructuring**

Several aspects of the Act will be of particular importance to distressed companies or companies undergoing a restructuring.

**a. 30% Limitation on Deduction of Net Business Interest**

The new limitation on the deductibility of net business interest, discussed above, has several special implications for distressed companies. First, because the deductibility of interest is based on a company's reported EBITDA/EBIT, a company with declining earnings will face increasing limitations on the ability to deduct interest and thus may not benefit from a reduced tax liability. In fact, such companies could face a higher tax liability notwithstanding a diminished financial ability to pay such increase in taxes. Second, companies in bankruptcy will have to re-evaluate the long-standing practice of continuing to accrue interest deductions during the pendency of a bankruptcy proceeding (particularly on unsecured debt) because such accrual would increase cancellation of indebtedness income while providing no offsetting benefit (i.e., because of the inability to deduct all such accrued interest). Third, liability management transactions, including debt modifi-
cations and debt exchanges, often give rise to significant “original issue discount” (“OID”), deductible like interest for tax purposes. Although the ability to deduct OID has for many years been limited by the so-called “AHYDO” rules, this new EBITDA/EBIT-based limitation is likely to more significantly limit distressed companies’ ability to claim these deductions.

b. New Limits on NOLs

The Act makes several significant changes to the treatment of NOLs. First, with a few narrow exceptions, the Act eliminates the ability to “carry back” NOLs generated in 2018 and later. If past is prologue, this will be significantly harmful for distressed companies, which often look to tax refunds generated by NOL carry-backs as a critical source of liquidity. Second, the Act permits NOLs to be carried forward indefinitely. Third, the Act provides that NOLs generated in 2018 and later may only offset 80% of a company’s taxable income. This results in what amounts to an “NOL minimum tax” of 4.2% (compared to 2% of alternative minimum taxable income under current law) and will potentially have significant implications for bankruptcy exit transactions. This provision also means that pre-2018 NOLs are significantly more valuable than NOLs generated in 2018 and later, which will likely increase distressed companies’ focus on protecting pre-2018 NOLs to the extent possible.

c. Significant Implications for Ownership Change Calculations Under Section 382

The new rules permitting 100% bonus depreciation for tangible property acquisitions may have a significant, beneficial impact on the calculation of the limitation applicable to tax attributes when a company undergoes an “ownership change” under Section 382. When a company undergoes an “ownership change,” its ability to use its tax attributes is limited to a calculation that has two components: one based on the equity value of the company (or, sometimes in the case of bankrupt companies, gross asset value), and another based on a complex comparison of asset value compared to tax basis.

The second component of the calculation is based, in significant part, on the “hypothetical” depreciation that a purchaser of assets could claim on the property, compared to the actual depreciation claimed on such property. Although the issue is not entirely clear in the Act, it appears that the 100% expensing provisions discussed above should be factored into the determination of the “hypothetical” depreciation. If true, many taxpayers undergoing an ownership change will enjoy a significantly increased Section 382 limitation.

d. Taxable Bankruptcy Exits

It is common for bankruptcy plans to be structured as taxable asset dispositions to creditors in so-called “Bruno’s” transactions. Such structures may become more attractive to creditors because of the potential ability to then immediately expense a
portion of the property obtained in the transaction — potentially shielding most of the restructured company’s taxable income for a significant period of time. That may be particularly true in scenarios where pre-2018 NOLs can offset any taxable income associated with the bankruptcy exit without regard to the new limitations on NOL use.

II. Real Estate

The Act provides a number of advantageous provisions that can be expected to benefit the real estate industry.

a. Decreased Tax Rate on Pass-Through Income

As discussed above, the 20% deduction for SFTI is particularly beneficial for businesses that have either substantial U.S. labor costs or substantial investments in U.S. tangible property. For owners of asset-intensive real estate businesses (even without significant numbers of employees) that are held in pass-through form, this provision should provide a meaningful additional deduction that is not available under current law. The Act also provides that ordinary dividends from REITs are eligible for this 20% deduction. As a result of these changes, real estate investors’ net ordinary income may be eligible for an effective federal income tax rate as low as 29.6%.

b. Excess Business Losses

The limitation on excess business losses, discussed above, may be particularly relevant to investors in real estate businesses. Real estate businesses often generate significant operational losses (followed by capital gains in subsequent years), and under current law, these losses can sometimes be used to offset other sources of income (subject to the current “passive loss” rules). The new limitation on excess business losses may impose a meaningful limitation on that benefit.

c. Election Out of 30% Interest Expense Limitation

Unlike most other industries, investors in real estate businesses (both pass-through businesses and REITs) are permitted to elect out of the 30% limitation on interest expense deductibility, described above. However, any real estate business electing out of the interest expense limitation would be required to use the alternative depreciation system described below, rather than the slightly faster depreciation periods available under the “MACRS” rules.

d. Changed Depreciation Periods

Although real estate businesses are eligible for the bonus 100% expensing provision for qualified property, described above, in practice, most real estate assets (such as land and buildings) are not “qualified property” and thus not eligible for the immediate 100% expensing under the Act. However, certain “qualified improvements” to the interior of buildings may still be eligible for 100% expensing. Additionally, while
the Act retains the general MACRS accelerated depreciation periods of 39 years for nonresidential real property and 27.5 years for residential real property, in the case of a real estate business electing out of the 30% interest expense limitation, an alternative depreciation period of 40 years and 30 years, respectively, would apply.

e. Retained 1031 Exchanges

Finally, Section 1031 like-kind exchanges, an important tax-deferral opportunity for the real estate industry, will continue to be available for U.S. real estate assets (but will no longer be available for other asset classes).

III. Energy

The Act provides certain specific changes that benefit energy industry participants. Equally or more importantly, however, the energy industry also benefited from the fact that many of the special rules applicable to the industry were left unchanged by the Act. Specifically, oil and gas companies will generally still be able to immediately deduct intangible drilling costs, amortize oil and gas geological and geophysical costs and utilize cost or percentage depletion. In addition, oil and gas companies will generally still be able to utilize the enhanced oil recovery credit (and the credit for producing oil and gas from marginal wells for tax years beginning after December 31, 2017), which the House proposal sought to eliminate. Additionally, the Act does not include the House proposal to alter production tax credits and investment tax credits for the renewable energy industry, and instead will keep such credits intact without change.

Below is a summary of how key provisions of the Act will impact the energy industry:

a. Master Limited Partnerships

Unlike most other qualified business income, which is generally subject to the W-2 wage or depreciable property basis limitations discussed above when calculating the SFTI deduction, “qualified publicly traded partnership income,” including income allocations from master limited partnerships, is eligible for the full 20% SFTI deduction without regard to the W-2 wage or depreciable property basis limitations.

b. Limitations on Like-Kind Exchanges

As discussed above, the Act imposes limitations on the like-kind exchange rules found in Section 1031 by limiting the non-recognition of gain for such exchanges to real property that is not held primarily for sale. Oil and gas companies will benefit from the fact that economic interests in oil and gas generally constitute real property interests and thus would retain eligibility for like-kind exchange treatment. However, careful attention should be paid to any like-kind exchanges that include exchanges of personal or intangible property associated with such working interests. Like-kind exchanges continue to be unavailable for interests in entities like limited partnerships or limited liability companies.
c. Structuring Considerations

The corporate alternative minimum tax ("AMT") will be repealed, but other taxpayers will continue to be subject to the AMT. The repeal of the corporate AMT as well as several other factors including the lower corporate tax rate, limitations on the flow-through rate deduction, and the ability to immediately expense qualified property placed into service may make it preferable for private equity funds to structure oil and gas investments through entities taxed as C corporations, as repeal of the corporate AMT could result in many of these companies owing no tax. Depending on the facts, investors in the energy private equity space may wish to consider restructuring their pass-through entities into C corporations on a case-by-case basis.

Conclusion

The Act is a significant overhaul of the U.S. tax system, so great in fact that Treasury and the IRS will need to issue enormous amounts of guidance in the near term to clarify the many questions that taxpayers will face. Moreover, we would expect that Congress itself will need to enact additional legislation (in the form of technical corrections or otherwise) to correct a number of drafting errors or unanticipated consequences arising from the Act. In the meantime, we look forward to working with our clients to address the impact of this momentous legislation.

1 The formal title of the bill was changed at the last minute to “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018” in order to comply with the Byrd Rule, which prevents extraneous additions to bills that are permitted to pass with a simple majority, and thus avoid a filibuster, under the budget reconciliation rules.

2 Unless otherwise noted, tax rates described herein do not take into account the 3.8% net investment income tax generally imposed on individuals’ passive income or certain other adjustments to taxable income that may increase an individual’s effective tax rate.

3 The effective 29.6% tax rate is determined by applying a 20% deduction to the highest marginal tax rate of 37% (i.e., 37% x (1-20%) = 29.6%).

4 Exceptions to these limitations may also apply in the case of a taxpayer with total taxable income of less than $207,500 (or $415,000 in the case of a joint return). These exceptions are beyond the scope of this Alert.

5 Notably, however, if one accounts for individual-level tax on distributions from C corporations and/or gain upon sale of C corporation shares (each taxable at a 20% rate under the Act), the effective overall federal income tax rate for individuals holding shares in C corporations is 36.8% (i.e., 21% + [(1-21%) x 20%] = 36.8%), which exceeds the 29.6% federal income tax rate on flow-through income (assuming the 20% deduction for SFTI applies to 100% of the business income — which it may not, in many situations, because of the limitations discussed herein).

6 The one-time deemed repatriation tax applies to both corporate and non-corporate (i.e., individual and partnership) shareholders of foreign corporations, assuming a 10% ownership threshold is met.
7 The definition of GILTI is beyond the scope of this Alert.

8 The GILTI deduction is scheduled to be reduced to 37.5% starting in 2026, for an effective tax rate of 13.125%.

9 The FDII deduction is scheduled to be reduced to 21.875% starting in 2026, for an effective tax rate of 16.41%.

10 For 2018 only, the BEAT tax is imposed at a 5% rate.

11 For additional background on the Grecian Magnesite case, please see our Kirkland Alert.

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