HONG KONG TAX ALERT

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Update: The Trump Administration and U.S. Tax Reform

Summary

The Chairman of the House Ways and Means Committee, Kevin Brady, released a "Chairman's mark" of a tax reform bill, entitled the Tax Cuts and Jobs Act ("the TCJA") on 2 November 2017.

The release of the legislative text of the Chairman's mark represents another significant step towards tax reform. If enacted, the TCJA would represent the most comprehensive reform to the U.S. tax code in over thirty years.

However, it is expected to undergo further amendments and modifications as it works its way through Congress.

The Chairman of the House Ways and Means Committee, Kevin Brady (R-TX) released a "Chairman's mark" of a tax reform bill called the Tax Cuts and Jobs Act ("the TCJA"). The Chairman's mark generally represents the Ways and Means Chairman's—and by proxy, the committee staff's—proposal for tax reform. It does not necessarily include the input and priorities of the full committee. Although the legislation is in its infancy, and we expect it to undergo further amendments and modifications as it works its way through Congress, the following are some notable highlights:

Business and international tax reform:

1. Reduction of corporate income tax rate: Flat 20% US federal corporate income tax rate starting in 2018.

2. Expensing of CapEx: Full expensing of business equipment placed into service after 27 September 2017 and before 1 January 2023 (subject to certain exceptions)

3. Interest deduction limitation (1): Interest expense is disallowed to the extent such expense exceeds 30% of the business's adjusted taxable income (essentially EBITDA). Interest expense disallowance is determined at the filer level (e.g., at the partnership level, not the partner level). Any disallowed interest expense can be carried forward for five years. Exceptions: businesses with average gross receipts of US$25 million or less, certain regulated public utilities, and real property trades or businesses.

4. Interest deduction limitation (2): The deductible net interest expense of a U.S. corporation that is a member of an international financial reporting group would be limited to the extent the U.S. corporation's share of the group's global net interest expense exceeds 110% of the U.S. corporation's

share of the group's global EBITDA. This limitation would apply in addition to the general rules for disallowance of interest expenses described in point (3) immediately above. Taxpayers would be disallowed interest deductions pursuant to whichever provision denies a greater amount of interest deductions.

Any disallowed interest expense would be carried forward for up to five tax years, with carry-forwards exhausted on a first in, first out basis. For this purpose, an international financial reporting group is a group of entities that includes at least one foreign corporation engaged in a trade or business in the United States or at least one domestic corporation and one foreign corporation, prepares consolidated financial statements, and has annual global gross receipts of more than US$100 million.

5. Net operating losses ("NOLs"): Carry-overs and carry-backs can offset only up to 90% of taxable income. In addition, NOLs can only be carried forward – no more carry-backs generally. Additionally, NOLs arising after 2017 that are carried forward will be increased by an interest factor.

6. Full exemption of foreign source dividends: 100% of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the foreign corporation would be exempt from U.S. taxation. No credits or deduction would be allowed with respect to foreign taxes with respect to the exempt dividend.

7. One-time tax (12% on cash / 5% on noncash) on offshore earnings, 8-year instalment payment option: U.S. shareholders owning at least 10% of a foreign subsidiary, generally, would include in income for the subsidiary's last tax year beginning before 2018 the shareholder's pro rata share of the net post-1986 historical earnings and profits (E&P) of the foreign subsidiary to the extent such E&P has not been previously subject to U.S. tax, determined as of 2 November 2017, or 31 December 2017 (whichever is higher). The portion of the E&P comprising cash or cash equivalents would be taxed at a reduced rate of 12%, while any remaining E&P would be taxed at a reduced rate of 5%. Foreign tax credit carry-forwards would be fully available, and foreign tax credits triggered by the deemed repatriation would be partially available, to offset the U.S. tax. At the election of the U.S. shareholder, the tax liability would be payable over a period of up to 8 years, in equal annual instalments of 12.5% of the total tax liability due.

8. Deemed inclusion of 50% of US parent's foreign high returns: A U.S. parent of one or more foreign subsidiaries would be subject to current U.S. tax on 50% of the U.S. parent's foreign high returns. Foreign high returns would be measured as the excess of the U.S. parent's foreign subsidiaries' aggregate net income (subject to certain adjustments) over a routine return (7% plus the Federal short-term rate) on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expenses.

9. 20% excise tax on deductible payments made to foreign related parties (in excess of US$100 million annually) in international financial reporting groups: Payments (other than interest) made by a U.S. corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset would be subject to a 20% excise tax, unless the related foreign corporation elects to treat the payments as income effectively connected with the conduct of a U.S. trade or business. The provision would apply only to international

financial reporting groups with payments from U.S. corporations to their foreign affiliates totalling at least US$100 million annually.

Individual and small business tax reform:

1. Ordinary individual tax rates: The number of federal income tax brackets would be reduced from seven to four for ordinary income: 12, 25, 35 and 39.6%. Depending on the filing status, the tax brackets applicable to income in excess of the specified thresholds would be as follows:

Rate applicable to income over …	Married Filing Jointly	Married Filing Separately	Unmarried Individuals	Heads of Household
12%	-0-	-0-	-0-	-0-
25%	90,000	45,000	45,000	67,500
35%	260,000	130,000	200,000	230,000
39.6%	1,000,000	500,000	500,000	500,000

2. Standard Deduction and Personal Exemptions: The standard deduction would be increased from the 2017 amount of US$12,700 to US$24,000 for married couples filing jointly and surviving spouses, and from US$6,350 to US$12,000 for unmarried individuals. Single filers with at least one qualifying child in the household could claim a standard deduction of US$18,000. Personal exemptions for taxpayers and dependents (currently US$4,050 each for 2017) would be repealed.

3. Maximum rate on business income of individuals: The TCJA would implement a new 25% maximum tax rate on business income earned by pass-through businesses such as partnerships, S corporations and sole proprietorships. It proposes several rules to define what income is eligible for this lower rate.

4. Child tax credit: The child tax credit would be significantly increased from US$1,000 to US$1,600. In addition, a credit of up to US$300 could be claimed for dependents other than children. Also, a "family flexibility credit" of US$300 could be claimed by a taxpayer (and the taxpayer's spouse if they file jointly) who has either child or non-child dependents. The income levels at which these credits are subject to phase-out would increase from US$110,000 to US$230,000 for joint filers, and from US$75,000 to US$115,000 for single filers.

5. Deductions: The TCJA would eliminate many deductions, including the deductions for state and local income and sales taxes, personal casualty losses, wagering losses, tax preparation expenses, medical expenses, alimony payments, moving expenses, contributions to medical savings accounts, and employee business expenses.

   The deduction for charitable contributions would be largely retained in its current form, but the 50% limitation for cash contributions to public charities would be increased to 60%. The deduction for state and local property taxes would be retained but would be capped at US$10,000. Foreign real property taxes other than those incurred in a trade or business would not be deductible.

6. Mortgage interest deduction: Mortgage interest would only be deductible in relation to the taxpayer's principal residence.

   The current deduction regime for all mortgage interest would be retained for existing mortgage borrowers, subject to the current limitation on interest deductions for up to US$1,000,000 of qualifying acquisition indebtedness. However, this limitation would be reduced to US$500,000 of debt for mortgages taken out after 2 November 2017. For refinancing of mortgages incurred before this date, the refinanced debt would be treated as incurred on the same date as the original debt.

   The additional deduction for home equity indebtedness of up to US$100,000 would be retained, but home equity loans incurred after 2 November 2017 would become subject to the rule currently applicable for alternative minimum tax (AMT) purposes whereby the interest is only deductible if the loan proceeds are used to purchase or improve a qualifying residence.

7. Exclusion of gain from sale of principal residence: The TCJA would amend the exclusion for the gain from the sale of a principal residence by increasing the period for which the taxpayer must have owned and used the property as a principal residence from two of the previous five years to five of the previous eight years. Also, the exclusion could be claimed only once every five years and would be subject to phase-out for taxpayers with adjusted gross income in excess of US$500,000 (US$250,000 for single filers).

8. Alternative minimum tax (AMT): The AMT would be repealed. If a taxpayer has AMT credit carry-forwards, the taxpayer would be able to claim a refund of 50% of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning in 2019, 2020, and 2021. Taxpayers would be able to claim a refund of all remaining credits in the tax year beginning in 2022.

9. Estate tax: The TCJA would increase the estate tax exemption from its current level of US$5.49 million to US$10.98 million. The estate tax and generation-skipping transfer tax would be repealed entirely for individuals who die after 31 December 2023.

It is anticipated that the House Ways and Means Committee will begin acting on the bill on 6 November and Chairman Brady expects passage out of the House the week of 13 November 2017. The Senate Finance Committee has yet to release its version of a tax reform bill, although it is anticipated on 7 November 2017, and Senate Republicans hope to have the bill pass during the week of Thanksgiving. The legislative process is fluid so the timing may change, but KPMG will endeavour to keep Tax Alert readers informed of subsequent developments as they occur.

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