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Tax reform enters the home stretch

The House and Senate are scheduled to vote this week on the conference agreement to the Tax Cuts and Jobs Act (H.R. 1, TCJA), a massive tax reform package that would lower tax rates on corporations, passthrough entities, individuals, and estates and move the US toward a territorial-style system for taxing foreign-source income of domestic multinational corporations, with some of the cost of that tax relief offset by provisions that would scale back or eliminate many current-law deductions, credits, and incentives for businesses and individuals. The unoffset costs – roughly $1.45 trillion, according to a "very preliminary" estimate from the Joint Committee on Taxation (JCT) staff would be added to the deficit.
URL: http://docs.house.gov/billsthisweek/20171218/CRPT-115HRPT-466.pdf

The floor votes in both chambers are expected to be a partisan exercise. House and Senate Democrats remain in lockstep against the legislation, but Republicans currently appear to have mustered enough votes from within their own ranks to ensure success. If all goes according to plan and the legislation clears both chambers, President Trump could sign it into law before Christmas.

Conference agreement overview

The TCJA conference agreement, which was unveiled December 15, is an amalgam of competing versions of the legislation that were approved in the House on November 16 and the Senate on December 2, although in some significant ways it tracks more closely with the Senate bill. That outcome is a likely nod to several factors, including strict procedural and budgetary rules in effect in the Senate as well as the GOP's narrow margin of control in that chamber, which leaves Senate Republican leaders with little margin for error in securing final passage.

Here are just a few of the highlights:

- **Corporations:** The TCJA replaces the current graduated corporate rate structure with a flat 21 percent rate, effective in 2018 and fully repeals the corporate alternative minimum tax (AMT). It also permits items that are amortized under current law to be fully expensed in the year placed in service through 2022, with a phase-out of that benefit thereafter. On the offset side, it imposes new limits on the deduction for net business interest, repeals the section 199 manufacturing deduction and the deduction for state and local lobbying expenses, and disallows like-kind exchanges other than for real property.
- **Passthroughs:** The TCJA allows a deduction of up to 20 percent of passthrough income for specified service business owners with income under $157,500 (twice that for married filing jointly), but the definition of "specified service" no longer includes architecture or engineering. The deduction is available to electing small business trusts (EBSTs) as well as individuals, and owners are allowed to calculate their maximum deduction based on either 50 percent of their share of W-2 wages paid or a combination of 25 percent of their share of W-2 wages paid plus 2.5 percent of the unadjusted basis of all qualified property. Carried interest income retains its treatment as a capital gain, although it will be subject to a longer holding period (three years as opposed to one year in current law) in order to qualify.
- **International:** The TCJA moves the US from a worldwide tax system to a participation exemption system by giving corporations a 100 percent dividends received deduction for dividends distributed by a controlled foreign corporation (CFC). To transition to that new system, the measure imposes a one-time deemed repatriation tax, payable over eight years, on unremitted earnings and profits at a rate of 8 percent for illiquid assets and 15.5 percent for cash and cash equivalents. The conference agreement generally follows the Senate-passed structure in establishing new base erosion prevention provisions, with modifications. It does not adopt proposals in the House and Senate bills that would have made permanent the lookthrough rules for CFCs under section 954(c)(6); nor does it include a proposed new section 163(n) that would have placed a further limit on interest deductions of multinational corporations by measuring US interest expense and equity against the similar ratios for the worldwide group.
- **Individuals:** The TCJA conference agreement generally follows the Senate structure – and current law – by maintaining seven individual income tax brackets. The top individual income tax rate will be 37 percent (lower than in either the House or Senate bills) but will include a significant "marriage penalty." It also nearly doubles the standard deduction, repeals the current Pease limitation on itemized deductions, and expands the refundability of the child tax credit. It retains the deduction for unreimbursed medical expenses (and even offers a boost for 2017 and 2018) and leaves intact the current-law capital gains exclusion on the sale of a primary residence. On the revenue side, the measure repeals personal exemptions, retains the individual AMT (albeit with higher exemption amounts), pares back the deduction for home mortgage interest (with existing mortgages grandfathered), and places substantial new limits on the ability of taxpayers to deduct state and local taxes. *As in the Senate-passed bill, all of the TCJA's individual tax changes expire after 2025*.
- **Estates:** The TCJA generally follows the Senate-passed bill by retaining the estate tax at its current rate but doubling the exemption amounts. *As in the Senate bill, the expanded estate tax exemption amounts would sunset after 2025.*

A deeper dive…

This special edition of *Tax News & Views* offers a detailed discussion of the TCJA conference agreement, makes observations on key provisions, and looks at some of the political dynamics ahead in the coming days as the legislation makes its way through Congress.

> A series of side-by-side comparisons showing how the TCJA conference provisions align with those in the House and Senate bills and with current law is also available from Deloitte Tax LLP.
> **URL:** http://newsletters.usdbriefs.com/2017/Tax/TNV/171218_1_suppA.pdf

Corporate tax provisions

In general, the TCJA as approved in the conference committee contains similar corporate tax provisions as in the earlier versions approved in the House and Senate, and therefore does not significantly modify the current corporate tax system. There would still be softening of this double-tax system due to rate reduction, however, and more fundamental changes in the cross-border context (discussed elsewhere in this report), but without an adoption of a direct corporate integration measure. Furthermore, similar to the prior bills, transactions with respect to stock of a corporation will generally be treated the same as under current law, and the proposal does not propose changes to the consolidated return provisions.

Corporate rate reduction: The conference agreement would reduce the general corporate tax rate to 21 percent for taxable years beginning after December 31, 2017. It would eliminate the current brackets and the special tax rate for personal service corporations. As in the House bill (but not the Senate version), the corporate alternative minimum tax would also be eliminated, with an expanded utilization (and potential refundability) of existing AMT credits for tax years beginning before 2021. The conference agreement appears to take the same approach to fiscal year taxpayers as did the Senate version: section 15 explicitly does not apply to the temporary individual rate changes and, thus, it appears that the provision would apply to the corporate rate reduction. Under section 15, a fiscal year taxpayer may obtain the benefit of the reduced corporate rate as of January 1, 2018, by computing a tentative tax under both rates, and then prorating the tentative tax based on number of days with and without the rate change to arrive at a "blended" tax.

Dividends received deduction: The conference agreement would reduce the dividends received deduction (the DRD, applicable to corporate shareholders receiving a dividend from certain domestic corporations) for the 70 percent and 80 percent brackets, to 50 percent and 65 percent, respectively. The 100 percent DRD would remain intact for dividends from affiliated group members. This appears to be the identical provision as in the House and Senate bills, and would generally retain the current effective tax rate on such distributions after reducing the corporate tax rate. The DRD provision is effective for tax years beginning after December 31, 2017. There are also DRD provisions related to the international tax provisions in the Senate bill (discussed elsewhere in this report).

Modification of the net operating loss deduction: As in prior bills, the conference agreement would modify aspects of current law regarding net operating losses (NOLs).

Under current law, NOLs generally have a carryback period of two years and a carryforward period of 20 years. As in prior bills, the NOL carryback period would generally be eliminated and the carryforward period would become indefinite. The amount of the NOL deduction allowed would be limited to 80 percent of taxable income computed without regard to the NOL deduction, however, rather than 90 percent, as in the House version and the introductory period in the Senate version. Special rules apply to certain farming and insurance losses.

The conference report does not increase the amount of NOLs, or so-called indefinite NOLs, by an annual interest factor, as proposed in the House bill (but not the Senate version).

Conforming amendments would appear to include: (1) the repeal of carrybacks of specified liability losses defined in section 172(f) and (2) excess interest losses related to corporate equity reduction transactions under section 172(g) (the so-called CERT rules); but this was not explicit in the conference agreement (although it was included in the House-approved bill).

In general, the effective date is December 31, 2017, with the amendments to carryback and carryforward periods applying to NOLs arising in taxable years ending after December 31, 2017, and with the limitation on NOL utilization (tied to 80 percent of taxable income) applying to losses arising in taxable years beginning after December 31, 2017. The effective date provisions are consistent with the Senate bill and not the House version.

Limitation on business interest: Under current law, section 163(j) limits the ability of certain corporations to deduct interest paid or accrued on indebtedness. In general, this limit applies to interest paid or accrued by certain corporations (where no US federal income tax is imposed on the interest income) whose debt-to-equity ratio exceeds 1.5 to 1.0, and where net interest expense exceeds 50 percent of its adjusted taxable income.

The conference agreement would expand interest deductibility limitations consistent with the prior bills with certain adjustments. The general rule appears to remain the same as compared to prior bills: the new provision would generally limit the interest deduction on business interest to (1) business interest income, plus (2) 30 percent of the taxpayer's adjusted taxable income. Business interest and business interest income appear to be defined in the same manner (*i.e.*, generally, as allocable to a trade or business and not investment interest and income, within the meaning of section 163(d), with the conference report clarifying that all interest and interest income of a corporation is business interest and business interest income). Adjusted taxable income in the conference agreement is computed without regard to any (1) item of income, gain, deduction, or loss, which is not allocable to the trade or business; (2) business interest income or expense; (3) any deduction allowed under section 199A (*i.e.*, the 20 percent deduction for certain passthrough income, as described elsewhere in this report); (4) the NOL deduction; and (5) depreciation, amortization, or depletion for taxable years beginning before January 1, 2022, but taking into account depreciation, amortization, and depletion thereafter.

The limitation described above generally applies at the taxpayer level. There are special rules that apply to partnerships (more on that below). In the case of a group of affiliated corporations that file a consolidated return, the conference agreement clarifies that the limitation applies at the consolidated tax return filing level.

For partnerships, the limitation is applied at the partnership level, with business interest expense taken in account in determining the partnership's nonseparately stated taxable income or loss. A partner may also be subject to the new interest deduction limitation with respect to the partner's own business interest expense. If so, the adjusted taxable income of the partner will not include the partner's distributive share of all items of income, gain, deduction, or loss of the partnership. This avoids double counting of adjusted taxable income to allow for interest deductibility twice for the same taxable income. The partnership, however, may have excess taxable income. This excess taxable income may be taken into account by the partner in computing the partner's limitation. This allows the partner to deduct more business interest if the partnership could have deducted more business interest.

The conference agreement would generally apply to all taxpayers. It provides an exception for certain small businesses whose average annual gross receipts for the three-taxable-year period ending with the prior taxable year do not exceed $25 million, and for interest allocable to performing services as an employee and businesses of certain regulated public utilities. The conference agreement follows the Senate bill, which allows, at the taxpayer's election, a taxpayer not to apply the limitation to certain real property-related trades or businesses and certain farming businesses. The conference agreement includes a narrow exception for so-called "floor plan financing indebtedness" that, in general, would apply to certain financing of acquisitions for the sale or lease of certain motor vehicles.

Under the conference agreement, business interest that is not otherwise allowed as a deduction by reason of 163(j) would be treated as paid or accrued in the succeeding taxable year, and could be carried forward indefinitely. Similar to prior bills, section 381(c) would be amended to include disallowed business interest as a tax attribute thereunder, and section 382 would be amended to treat disallowed business interest as a pre-change loss under subsection (d).

The conference agreement removes the separate interest deduction limitation provision under section 163(n) that would have applied to domestic corporations that are members of worldwide affiliated groups under the prior bills (discussed elsewhere in this report). Under prior bills, taxpayers would only obtain the lesser of interest deductions allowed under new sections 163(j) and (n).

The modifications described above apply to taxable years beginning after December 31, 2017.

Cost basis of specified securities: The conference agreement did not adopt the Senate proposal to require the "first-in first-out" method for identifying specified securities sold at different dates except if otherwise allowed. Under current law, a taxpayer generally must apply a "first-in first-out" approach in identifying stock in a corporation acquired at different dates or at different prices, when selling or transferring some of the shares of that stock. If a taxpayer makes an adequate identification of shares of stock sold (referred to as "specific identification"), however, such a determination would control. Special rules apply to shares of stock in regulated investment companies (RICs) that generally permit an averaging approach. The conference agreement would not affect current law.

Contributions to capital: The conference agreement would modify the treatment of contributions to capital but narrowly and not as broadly as proposed in the House-approved measure. The conference agreement preserves tax-free treatment for capital contributions at the corporate transferee level, but provides that such term does not include (1) contributions in aid of construction or any other contribution as a customer or potential customer, and (2) any nonshareholder contribution by any governmental entity or civic group. Thus, its application is focused on nonshareholder contributions. The House bill would have applied more broadly by its flush language, as well as revoking section 108(e)(6).

Alternative minimum tax

The TCJA repeals the corporate alternative minimum tax for tax years beginning after December 31, 2017. Taxpayers may claim a refund on any AMT credit carryovers – 50 percent of remaining AMT credits in tax years 2018, 2019, and 2020, and a refund on all remaining credits in the tax year 2021.

Full expensing of qualified property

The TCJA modifies section 168 bonus depreciation to allow for full expensing of qualified property placed into service after September 27, 2017, and before January 1, 2023. Thereafter, the bonus depreciation percentage phases down annually through 2026 (80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026). Property with longer production periods and certain aircrafts receive an additional year of full expensing, with phase downs also beginning a year later. The full expensing provision also eliminates the current requirement that the original use of the property begins with the taxpayer. Thus, property qualifies under this provision as long as the property was not used by the taxpayer prior to the time of acquisition.

Deductions, exclusions, income recognition

Revenue recognition: The TCJA requires taxpayers to recognize income no later than the taxable year in which such income is taken into account as income on the taxpayer's applicable financial statement. However, this requirement does not apply with respect to any special methods of accounting other than for certain rules involving bonds and debt instruments. The TCJA also codifies the deferral method of accounting for advanced payments for goods and services currently provided under Rev. Proc. 2004-34. These provisions are effective for the taxable year beginning after December 31, 2017.

Like-kind exchanges of real property: The TCJA limits the scope of like-kind exchange nonrecognition treatment to real property not held primarily for sale. Thus, personal property that previously qualified for nonrecognition treatment no longer qualifies under the TCJA. The provision does not apply to any exchange where the property disposed of or received in the exchange by the taxpayer was disposed of or received before December 31, 2017.

Local lobbying expenses: The TCJA repeals the deduction for local lobbying expenses, which includes lobbying before Indian tribal governments. Therefore, amounts paid or incurred after the date of enactment would not be deductible. Under current law, other lobbying and political expenses are nondeductible, and the deductibility of local lobbying expenses has been an exception to this general rule.

Section 199 deduction: The TCJA repeals the section 199 deduction, effective for tax years after December 31, 2017.

Treatment of self-created property: The TCJA excludes patents, inventions, models or designs, and secret formulas or processes as qualifying as a capital asset under section 1221. Under current law, these items are treated as capital assets. Under the legislation, the gain or loss from the sale of a self-created patent, invention, model or design, or secret formula or process will not receive capital gain treatment. This provision is effective for disposition of such property after 2017.

Recovery period of real property: The TCJA eliminates the separate definitions of qualified leasehold improvements, qualified restaurants, and qualified retail improvement property, but rather provides for a single asset class called "qualified improvement property" (QIP). According to the conference report, QIP is intended to have a 15-year regular MACRS recovery period and 20-year ADS recovery period. These provisions apply to property placed in service after December 31, 2017. The TCJA maintains the current-law MACRS recovery period for nonresidential real and residential rental property.

Section 179 expensing: The TCJA increases the section 179 expense election threshold to $1 million. The phase-out of this expense election begins when the cost of qualifying property reaches $2.5 million. The TCJA also expands the definition of section 179 property to include certain property used in furnishing lodging, and roofs, heating, ventilation, air-conditioning property, fire protection and alarm systems, and security systems for nonresidential real property that are placed in service after December 31, 2017.

Accounting methods for small taxpayers: The TCJA expands the scope of eligible taxpayers who may use the cash method of accounting. It allows taxpayers with annual average gross receipts of $25 million or less to use the cash method. This gross receipt limit also applies to farming C corporations.

The TCJA also generally exempts taxpayers that meet the $25 million gross receipts test from the requirement to keep inventories. Rather, these qualifying taxpayers either can treat inventories as nonincidental materials and supplies or move to a method that conforms to its applicable financial statement method. Taxpayers qualifying under the $25 million gross receipts test are also excluded from the uniform capitalization rules of section 263A.

The TCJA also expands the exception for small construction contracts from using the percentage-of-completion method under section 460 for contracts that are expected to be completed within two years of commencement of the contract, and that are performed by a taxpayer that meets the $25 million gross receipts test.

Research and experimental expenditures: Beginning in 2022, research and experimental expenditures are required to be capitalized and amortized ratably over a five-year period. Any such expenditures attributable to research conducted outside the United States must be capitalized and amortized over a 15-year period. These rules do not apply to expenditures for the acquisition or improvement of land, or for expenditures paid to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas. Software development expenditures shall be treated as research or experimental expenditures.

Sexual harassment or sexual abuse payments: The TCJA denies a deduction for payments related to sexual harassment or sexual abuse, where the payment is subject to a nondisclosure agreement. Additionally, attorney's fees related to such settlement or payment may not be deducted. This rule applies to payments made after the date of the enactment.

Fines and penalties: The TCJA denies a deduction for any amounts paid or incurred to, or at the direction of, a government or governmental entity in relation to the violation of any law or investigation into the potential violation of any law. This provision thus increases the scope of nondeductible fines and penalties under section 162(f). Restitution payments are, however, excluded from this limitation, and can be deducted. The TCJA also adds the reporting requirement that an appropriate official of the government or governmental entity provide the IRS and each party to the settlement information detailing the amount and nature of any payments and agreement. The effective date applies to any amounts paid or incurred on or after the date of enactment.

Interest capitalization for beer, wine, and distilled spirits: Producers must capitalize interest associated with property with a production period exceeding two years, or an estimated production period exceeding one year and costing more than $1 million. Under current law, the production period includes the aging period of goods. However, the TCJA excludes the aging period for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Therefore, many of these goods may now be excluded from having to capitalize interest.

Business credits

"Orphan drug" credit: The TCJA modifies the orphan drug credit, a tax credit for clinical testing expenses for certain drugs for rare diseases or conditions. Section 45C currently provides a 50 percent credit for qualified clinical testing expenses incurred in the testing of certain drugs to treat rare diseases or conditions. The TCJA reduces the credit rate to 25 percent of qualified clinical testing expenses.

Rehabilitation credit: The TCJA modifies the rehabilitation credit under section 47 for the restoration of old and historic buildings. Currently, a 20 percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure, and a 10 percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated pre-1936 building.

The TCJA repeals the 10 percent credit for pre-1936 buildings. Under the legislation, a 10 percent credit (not 20 percent) is provided for qualified rehabilitation expenditures with respect to a certified historic structure. The TCJA modifies the transition rule under the effective date relating to qualified rehabilitation expenditures under certain phased rehabilitations for which the taxpayer may select a 60-month period. The provision applies to amounts paid or incurred after December 31, 2017. A transition rule provides that in the case of qualified rehabilitation expenditures (for either a certified historic structure or a pre-1936 building), with respect to any building owned or leased (as provided under present law) by the taxpayer at all times on and after January 1, 2018, the 24-month period selected by the taxpayer (section 47(c)(1)(C)(i)), or the 60-month period selected by the taxpayer under the rule for phased rehabilitation (section 47(c)(1)(C)(ii)), is to begin not later than the end of the 180-day period beginning on the TCJA's enactment date, and the amendments made by the provision apply to such expenditures paid or incurred after the end of the taxable year in which such 24-month or 60-month period ends.

Credit for paid family and medical leave: The TCJA creates a new employer credit for paid family and medical leave in section 45S that permits eligible employers (employers that allow all qualifying full-time employees at least two weeks of annual paid family and medical leave and allow part-time employees a commensurate amount of leave on a pro rata basis) to claim a business credit for 12.5 percent of the wages paid to qualifying employees during any period in which such employees are on family and medical leave if the payment rate under the program is 50 percent of the wages normally paid to an employee. The credit would be increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent.

The credit is effective for wages paid in tax years beginning after Dec. 31, 2017, but would not apply to wages paid in tax years beginning after Dec. 31, 2019.

Other general business credits: Notably, the TCJA generally retains other general business credits, including the research credit, low-income housing tax credit (with modifications), new markets tax credit, work opportunity tax credit, FICA tip credit, employer provided child care credit, access to disabled individuals credit, production tax credit, energy investment tax credit, plug-in electric vehicle credit, enhanced oil recovery credit, marginal well credit, and nuclear production tax credit. Further, it leaves in place the deduction for certain unused business credits under section 196.

Base Erosion and Anti-Abuse Tax: It is noteworthy that certain multinational companies claiming any general business credits could be impacted by the Base Erosion and Anti-Abuse Tax (BEAT) imposed by new code section 59A. The BEAT is the excess of (1) a fixed percentage of "modified taxable income" over (2) regular tax liability reduced by tax credits, but not by all credits until 2026. In the pre-2026 period, the credits that are deemed to not reduce "regular tax liability" for purposes of this computation are research credits and 80 percent of low-income housing, renewable energy production, and energy credits. Thus, for years beginning before 2026, research, low-income housing, renewable energy production, and energy credits may take on an especially favored status in the eyes of potential BEAT-payers (because these specified credits claimed as an offset against regular tax liability will not potentially result in an increase in the taxpayer's BEAT liability).

The BEAT provision may have a significant impact on the ability of major financial institutions to participate in the tax equity financing marketplace. The BEAT would be applicable to credits generated as a result of projects that began operating in prior years. (See additional discussion on the BEAT in the international tax section of this report.)

Passthrough provisions

The TCJA introduces new rules aimed at providing greater parity between the tax treatment of owners of passthrough entities and corporations but also includes guardrails intended to prevent passthrough owners from recharacterizing wage income as more lightly taxed business income.

20 percent deduction of domestic qualified business income: Under the TCJA conference agreement, an individual, estate, or trust taxpayer generally may deduct the sum of:

- 20 percent of the domestic qualified business income with respect to a qualified trade or business from a partnership, S corporation, or sole proprietorship (subject to certain limitations based on W-2 wages and capital and, with respect to specified service businesses, only below certain taxpayer income thresholds), and
- 20 percent of aggregate qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income.

Qualified business income for a taxable year means the net amount of domestic qualified items of income, gain, deduction, and loss with respect to the taxpayer's qualified trades or businesses (that is, any trade or business other than specified service trades or businesses, defined below).

Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not (to the extent provided in regulations) include any amount allocated or distributed by a partnership to a partner who is acting other than in his or her capacity as a partner for services rendered with respect to the trade or business, and does not include any amount that is a guaranteed payment for services actually rendered to or on behalf of a partnership to the extent that the payment is in the nature of remuneration for those services. In addition, qualified business income does not include certain investment-related income, gain, deductions, or loss.

For taxpayers with income lower than a threshold amount ($157,500 for single filers, $315,000 for joint filers, with any potential deduction phased out over the next $50,000 or $100,000 of taxable income, respectively), there is no wage limitation on the 20 percent deduction for qualified business income. (Note that the threshold amount is determined by reference to the taxpayer's taxable income, which may include income from other sources.) These taxpayers also are not subject to the limitation on specified service businesses described below.

For taxpayers with income above a threshold amount, a limitation on the 20 percent deduction applies. With respect to each qualified trade or business, the amount of the deduction is limited to the greater of (1) 50 percent of the W-2 wages with respect to the qualified trade or business or (2) 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

Qualified property means: (1) tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, (2) which is used in the production of qualified business income, and (3) for which the depreciable period has not ended before the close of the taxable year. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (1) the date 10 years after that date, or (2) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (without regard to section 168(g)).

As mentioned above, a specified service business is not a qualified trade or business. A "specified service business" means any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more 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. For this purpose a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (sections 475(c)(2) and 475(e)(2), respectively. A specified service business, however, does not include a trade or business involving engineering or architecture.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level, as the case may be. Each partner takes into account the partner's allocable share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the partner's allocable share of W-2 wages of the partnership. The partner's allocable share of W-2 wages is required to be determined in the same manner as the partner's share of wage expenses. Similarly, each shareholder of an S corporation takes into account the shareholder's pro rata share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the shareholder's pro rata share of W-2 wages of the S corporation. A partner's allocable share or an S corporation shareholder's pro rata share of the unadjusted basis of a partnership's or S corporation's qualified property is determined in the same manner as the partner's or shareholder's allocable or pro rata share of depreciation from the partnership or S corporation.

In addition to a 20 percent deduction for a taxpayer's qualified business income, a 20 percent deduction is also available for (1) dividends from a REIT (other than any portion that is a capital gain dividend) and (2) qualified publicly traded partnership (PTP) income (generally including domestic business income allocated from a PTP and excluding investment related items from PTPs).

With respect to trusts and estates, rules similar to the rules under present-law section 199 (as in effect on December 1, 2017) apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital.

The Secretary is required to provide rules for applying the limitation in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the year. The Secretary is required to provide guidance applying rules similar to the rules of section 179(d)(2) to address acquisitions of property from a related party, as well as in a sale-leaseback or other transaction as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W-2 wages and capital. Similarly, the Secretary is required to provide guidance prescribing rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions, and guidance for the application of the provision in the case of tiered entities.

The provision would apply to taxable years beginning after December 31, 2017, and would expire for taxable years beginning after December 31, 2025.

Accuracy-related penalty applies to the 20 percent deduction: Section 6662(d) imposes an accuracy-related penalty on taxpayers with a substantial understatement of tax. The TCJA conference agreement provides that for a taxpayer claiming the passthrough business deduction, there is a substantial understatement of income tax for any taxable year if the understatement for the year exceeds 5 percent of the tax required to be shown on the return, rather than the current 10 percent. This provision adds section 6662(d)(1)(C) and is effective for tax years beginning after December 31, 2017.

Repeal of technical termination of partnerships: Under current law, a partnership terminates if within a 12-month period there is a sale or exchange of 50 percent or more of the total interests in partnership capital and profits (commonly referred to as a “technical termination”). When a technical termination occurs, the business of the partnership continues in the same legal form, but the partnership is treated as newly formed and, thus, must, among other things, make new elections for various accounting methods and restart depreciation lives.

Under the provision, the technical termination rule would be repealed. Thus, a partnership would be treated as continuing even if 50 percent or more of the total capital and profits interests of the partnership are sold or exchanged, and new elections would not be required or permitted.

The provision applies to partnership taxable years beginning after December 31, 2017.

Recharacterization of certain gains in the case of partnership profits interests held in connection with performance of investment services: The provision treats as short-term capital gain taxed at ordinary income rates the excess of (1) the taxpayer’s net long-term capital gain with respect to an applicable partnership interest (API) for the taxable year over (2) the amount of net long-term capital gain with respect to the API for the taxable year calculated as if a three-year (not one-year) holding period applies under section 1222. In making this calculation, the provision calculates long-term capital losses as if a three-year holding period applies.

An API is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The services may be performed by the taxpayer or by any other related person or persons in any applicable trade or business. It is intended that partnership interests will not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent. An API does not include an interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.

An API does not include an interest in a partnership directly or indirectly held by a corporation.

An applicable trade or business means any activity (regardless of whether the activity is conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets.

Specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.

A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third-party investors. Third-party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is – or was – not related to a person so engaged). A related person for this purpose is a family member (within the meaning of attribution rules) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

The three-year holding period requirement also applies notwithstanding the rules of section 83 or any election in effect under section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the API, or that an individual may have made a section 83(b) election with respect to an API, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the API.

If a taxpayer transfers any API, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income as short-term capital gain so much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted).

The Secretary is directed to require reporting (at the time and in the manner determined by the Secretary) necessary to carry out the purposes of the provision. The Treasury Department is directed to issue regulations or other guidance necessary to carry out the provision. Such guidance is to address prevention of the abuse of the purposes of the provision, including through the allocation of income to tax-indifferent parties. Guidance is also to provide for the application of the provision in the case of tiered structures of entities.

The provision applies to taxable years beginning after December 31, 2017.

Tax gain on the sale of a partnership interest on lookthrough basis: Under Rev. Rul. 91-32, 1991-1 C.B. 107, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applied the asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that US business. Under the ruling, if there is unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a US trade or business if those assets were sold by the partnership, some or all of the foreign person's gain or loss from the sale or exchange of a partnership interest may be treated as effectively connected with the conduct of a US trade or business. However, a 2017 Tax Court case rejects the logic of the ruling and instead holds that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a US trade or business is foreign-source (*Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017)).

Under the proposal, gain or loss from the sale or exchange of a partnership interest is effectively connected with a US trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The proposal requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss.

The proposal also requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

The proposal would require Treasury and the IRS to issue regulations as the Secretary determines appropriate to address coordination with the nonrecognition provisions of the code, including in exchanges described in in sections 332, 351, 354, 355, 356, or 361.

Additionally, the conferees intend that, under regulatory authority provided by the Senate amendment to carry out withholding requirements of the provision, the Secretary may provide guidance permitting a broker, as agent of the transferee, to deduct and withhold the tax equal to 10 percent of the amount realized on the disposition of a partnership interest to which the provision applies. For example, such guidance may provide that if an interest in a publicly traded partnership is sold by a foreign partner through a broker, the broker may deduct and withhold the 10 percent tax on behalf of the transferee.

The portion of the provision treating gain or loss on sale of a partnership interest as effectively connected income is effective for sales, exchanges, and dispositions on or after November 27, 2017; the portion of the provision requiring withholding on sales or exchanges of partnership interests is effective for sales, exchanges, and dispositions after December 31, 2017.

Modification of the definition of substantial built-in loss in the case of transfer of partnership interest: Under current law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election under section 754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer. Under section 743(d), a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

The TCJA modifies the definition of a substantial built-in loss for purposes of section 743(d), affecting transfers of partnership interests. Under the provision, in addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership assets in a fully taxable transaction for cash equal to the assets' fair market values, immediately after the transfer of the partnership interest. Therefore, the test for a substantial built-in loss under the proposal applies both at the partnership level and at the transferee partner level.

The proposal applies to transfers of partnership interests after December 31, 2017.

Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss: Under section 704(d), a partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis (before reduction by current year's losses) of the partner's interest in the partnership at the end of the partnership taxable year in which the loss occurred. Any disallowed loss is allowable as a deduction at the end of the first succeeding partnership taxable year, and subsequent taxable years, to the extent that the partner's adjusted basis for its partnership interest at the end of any such year exceeds zero (before reduction by the loss for the year). In applying the basis limitation on partner losses, Treasury regulations do not take into account the partner's share of partnership charitable contributions and foreign taxes paid or accrued.

The proposal modifies the basis limitation on partner losses to provide that the basis limitation on partner losses applies to a partner's distributive share of partnership charitable contributions (as defined in section 170(c)) and foreign taxes (described in section 901). In the case of a charitable contribution by the partnership of property whose fair market value exceeds its adjusted basis, a special rule provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess.

The proposal applies to partnership taxable years beginning after December 31, 2017.

Loss limitation rules applicable to individuals: Under current law, a limitation on excess farm losses applies to taxpayers other than C corporations. If a taxpayer other than a C corporation receives an applicable subsidy for the taxable year, the amount of the excess farm loss is not allowed for the taxable year, and is carried forward and treated as a deduction attributable to farming businesses in the next taxable year.

The proposal expands the limitation on excess *farm* losses to apply to excess *business* losses of a taxpayer. Under the proposal, excess business losses of a taxpayer other than a C corporation are not allowed for the taxable year. Such losses are carried forward and treated as part of the taxpayer's NOL carryforward in subsequent taxable years. NOL carryovers are allowed for a taxable year up to the lesser of the carryover amount or 80 percent of taxable income determined without regard to the deduction for NOLs.

An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer, over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a taxable year is $500,000 for married individuals filing jointly and $250,000 for other individuals. The $500,000 and $250,000 thresholds are indexed for inflation.

In the case of a partnership or S corporation, the proposal applies at the partner or shareholder level. Each partner's or S corporation shareholder's share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation under the proposal for the taxable year of the partner or S corporation.

The proposal is effective for taxable years beginning after December 31, 2017.

Special subchapter S provisions: For subchapter S corporations, the conference agreement includes provisions related to electing small business trusts (ESBTs), special rules for conversions to C-corporation status, and a deferral election for S corporation shareholders for recognition of accumulated foreign income.

- **ESBTs:** The conference agreement expands the qualifying beneficiaries of an electing small business trust to including nonresident aliens. It also amends the ESBT S-portion charitable deduction rules to provide that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock. The provision applies to taxable years beginning after December 31, 2017.
- **Special rules on conversion of S corps to C corps:** Under the provision, any section 481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (*i.e.*, a change from the cash method to an accrual method) is taken into account ratably during the six-taxable-year period beginning with the year of change. An eligible terminated S corporation is any C corporation which (1) is an S corporation the day before the enactment of this bill, (2) during the two-year period beginning on the date of such enactment revokes its S corporation election under section 1362(a), and (3) all of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of such enactment. Under the provision, in the case of a distribution of money by an eligible terminated S corporation, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account bears to the amount the accumulated earnings and profits. Any increase in tax due to the section 481(a) adjustment, rather than the section 481(a) adjustment itself, is taken into account ratably during the six-taxable-year period beginning with the year of change. The provision is effective for distributions after the date of enactment.
- **Deferral election allowed for S corporation shareholders for recognition of accumulated foreign income:** A special rule permits deferral of the transition net tax liability for shareholders of a US shareholder that is a flowthrough entity known as an S corporation. The S corporation is required to report on its income tax return the amount includible in gross income by reason of this provision, as well as the amount of deduction that would be allowable, and provide a copy of such information to its shareholders. Any shareholder of the S corporation may elect to defer his portion of the net tax liability at transition to the participation exemption system until the shareholder's taxable year in which a triggering event occurs. The election to defer the tax is due not later than the due date for the return of the S corporation for its last taxable year that begins before January 1, 2018. The portion of the provision treating gain or loss on sale of a partnership interest as effectively connected income is effective for sales, exchanges, and dispositions on or after November 27, 2017. The portion of the provision requiring withholding on sales or exchanges of partnership

interests is effective for sales, exchanges, and dispositions after December 31, 2017. (See additional discussion of international tax issues elsewhere in this report.)

Transition to territoriality

Dividends received deduction: The TCJA conference agreement provides for a 100 percent dividends received deduction for the foreign-source portion of dividends received from specified 10-percent-owned foreign corporations by domestic corporations that are US shareholders. For this purpose, an amount received by a domestic corporation that is treated as a dividend under section 1248 is treated as a dividend for purposes of the DRD (provided the holding period requirements are satisfied). In addition, if the gain is recognized by a lower tier CFC and characterized as a dividend under section 964(e), then such amount is included in subpart F income for the year of the sale but the US shareholder can claim a DRD with respect to such amount.

No foreign tax credit or deduction is allowed for taxes paid or accrued with respect to such dividend that qualifies for the DRD.

In addition, consistent with the Senate legislation, the bill provides: (1) a limitation on the DRD for any dividend received if the foreign corporation receives a deduction (or other tax benefit) from taxes imposed by a foreign country (hybrid dividend) and (2) an expanded holding period requirement.

Finally, the explanation provides that any hybrid dividend received by a CFC is treated as subpart F income for the taxable year such dividend was received.

Limitation on losses with respect to 10-percent-owned foreign corporations: The basis in foreign corporations with respect to which the dividends received deduction applies is reduced by the amount of any such dividend, but only for purposes of computing loss on the sale or exchange of that stock.

Taxation of deferred foreign income upon transition: Consistent with the House bill and the Senate bill, a US shareholder of a foreign corporation must include in income for the subsidiary's last tax year beginning before January 1, 2018, the shareholder's pro rata share undistributed and previously untaxed post-1986 foreign earnings. Earnings and profits (E&P) is only taken into account to the extent it was accumulated during periods when the foreign corporation was a CFC or was a non-CFC foreign corporation that had at least one domestic corporation as its US shareholder.

The amount of such E&P is the greater of the amounts determined as of November 2, 2017, or December 31, 2017, unreduced by dividends (other than dividends to other specified foreign corporations) during the taxable year to which the provision applies.

The mandatory inclusion generally may be reduced by foreign earnings and profits deficits (including hovering deficits) that are properly allocable to that person. In addition, unlike the Senate bill, the mandatory inclusion may be reduced by the pro rata share of deficits of another US shareholder that is a member of the same affiliated group.

For purposes of this provision, the E&P is classified as either E&P that has been retained in the form of cash or cash equivalents, or E&P that has been reinvested in the foreign subsidiary's business (for example, property, plant, and equipment). The portion of the E&P comprising cash or cash equivalents is taxed at a reduced rate of 15.5 percent, while any remaining E&P is taxed at a reduced rate of 8 percent.

Rules will be provided to avoid the double counting of cash assets. In addition, the bill grants regulatory authority to the Treasury to issue regulations to prevent the avoidance of the rules, including through a reduction of earnings and profits, through changes in entity classification, or accounting methods, or otherwise.

Limitation on assessment extended: Consistent with the Senate bill, the TCJA conference agreement extends the assessment statute of limitations for taxpayers reporting a mandatory inclusion. The assessment statute of limitations is extended to six years from the date upon which the return was filed that initially reflects the mandatory inclusion.

Special rules for expatriated entities: Consistent with the Senate bill, the conference agreement increases the rate of tax imposed on the deferred earnings of a specified foreign corporation if within 10 years on the date of enactment, the US shareholder of such corporation engages in an "inversion transaction" subject to section 7874.

Other provisions: In addition, the legislation provides: (1) that foreign tax credit carryforwards are fully available, and foreign tax credits triggered by the deemed repatriation are partially available, to offset the US tax; (2) that at the election of the US shareholder, the tax liability would be payable over a period of up to eight years; (3) special rules which would apply with respect to S corporations and their shareholders, as well as REITs; and (4) an election not to apply any net operating loss deduction against the amount taken into account under the transition tax rules.

Rules related to passive and mobile income

Global intangible low-taxed income: The conference report largely adopts, with modifications, provisions in the Senate bill designed to tax currently global intangible low-taxed income (GILTI). Under the provision, a US shareholder is required to include in gross income the amount of its GILTI. However, the US shareholder is allowed a deduction equal to 50 percent of the GILTI and the amount treated as a dividend by reason of the US shareholder claiming a foreign tax credit as a result of the inclusion of the GILTI amount in income ("section 78 gross up").

GILTI is the excess of the shareholder's net tested income over the deemed tangible income return, which is defined as the excess of 10 percent of the shareholder's basis in tangible property used to produce tested income less the amount of interest expense allocated to net tested income. The reduction of this amount by allocated interest expense is a change from the original Senate bill and more closely follows an approach adopted by the House Ways and Means Committee with respect to their proposal.

Tested income for this purpose is the gross income of the corporation determined without regard to the following exceptions: (1) the corporation's effectively connected income under section 952(b); (2) any gross income taken into account in determining the corporation's subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under section 954(b)(4); (4) any dividend received from a related person (as defined in section 954(d)(3)); and (5) any foreign oil and gas extraction income and foreign oil related income, over deductions (including taxes) properly allocable to such gross income under rules similar to the rules of section 954(b)(5).

Consistent with the Senate bill, the amount of GILTI included by a US shareholder is allocated across all of such shareholder's CFCs, based on each CFC's proportionate share of tested income. In addition, the shareholder can claim a foreign tax credit for 80 percent of the taxes paid or accrued with respect to the tested income of each CFC from which the shareholder has an inclusion.

Deduction for foreign-derived intangible income: In addition to the immediate inclusion of GILTI, the proposal allows a domestic corporation a deduction for 37.5 percent of the foreign-derived intangible income and a 50 percent deduction of the GILTI plus the section 78 gross up, as discussed above. These deductions are reduced to 21.875 percent and 37.5 percent, respectively, in taxable years beginning after December 31, 2025.

Foreign-derived intangible income is an amount equal to the corporation's deemed intangible income multiplied by an amount equal to the corporation's foreign-derived deduction-eligible income over its total deduction-eligible income.

Deduction-eligible income is the gross income of the corporation determined without regard to: (1) the subpart F income of the corporation under section 951; (2) the GILTI of the corporation; (3) financial services income; (4) any dividend received from a CFC with respect to which the corporation is a US shareholder; (5) any domestic oil and gas income of the corporation; and (6) any foreign branch income (as defined in section 904(d)(2)(J)) of the corporation, over the deductions (including taxes) properly allocable to such gross income.

Deemed intangible income is the excess of a corporation's deduction eligible income over 10 percent of the basis in its tangible depreciable property used to produce deduction-eligible income.

Foreign-derived deduction eligible income means with respect to a taxpayer for its taxable year, any deduction-eligible income of the taxpayer that is derived in connection with (1) property that is sold by the taxpayer to any person who is not a US person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use or (2) services provided by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States. For this purpose, the terms sold, sells, and sale include any lease, license, exchange, or other disposition of property.

Unlike the Senate bill, the proposal does not provide a rule presumably intended to incentivize the onshoring of intangible property, by providing that if a CFC holds intangible property on the date of enactment, the fair market value of the property on the date of any distribution is treated as not exceeding its adjusted basis.

Treatment of hybrid transactions

The proposal includes the provision from the Senate bill that would deny the deduction for any disqualified related-party amount paid pursuant to a hybrid transaction or by or to a hybrid payment. A disqualified related-party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.

A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax.

A hybrid entity is any entity which is either: (1) treated as fiscally transparent for federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for federal income tax purposes.

Base erosion proposals

The conference agreement adopts the Senate bill's provisions related to base eroding payments, with certain modifications. Accordingly, a corporation (other than a RIC, REIT or S corporation) with excess base erosion payments for the taxable year must pay a tax equal to the excess of 10 percent (5 percent for taxable years beginning in 2018) of its taxable income (determined without regard to deductions attributable to base erosion payments) over its regular tax liability reduced by the excess of credits allowed under Chapter 1 against the regular tax liability over the sum of the R&D credit plus 80 percent of the sum of the low-income housing credit, the renewable electricity production credit determined under section 45(a), and the energy property investment credit determined under section 48.

For purposes of this provision, a base erosion payment generally means any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable, including any amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance of depreciation (or amortization in lieu of depreciation). A base erosion payment also includes any amount that constitutes reductions in gross receipts of the taxpayer that is paid to or accrued by the taxpayer with respect to: (1) a surrogate foreign corporation which is a related party of the taxpayer, but only if such person became a surrogate foreign corporation after November 9, 2017, and (2) a foreign person that is a member of the same expanded affiliated group as the surrogate foreign corporation. A surrogate foreign corporation has the meaning given in section 7874(a)(2).

A base erosion payment does not: (1) include any amount paid or accrued for services if such services meet the requirements for eligibility of the services cost method in Treas. Reg. sec. 1.482-9, without regard to certain requirements of that section and provided the payments are made without a mark-up and (2) a "qualified derivative payment." In addition, a corporation is not subject to the provision if it has average annual gross receipts for the three-taxable-year period ending with the preceding taxable year of less than $500 million or its base erosion percentage is less than 3 percent. (The term base erosion percentage means for any taxable year, the percentage determined by dividing the aggregate amount of deductions attributable to base eroding payments by the total amount of all deductions allowable to the taxpayer during the taxable year, without regard to deductions under sections 172, 245A or 250, any deduction for services which are not treated as base eroding payments, and any deduction for qualified derivative payments. In the case of a bank or registered securities dealer, the 3 percent base erosion percentage threshold is lowered to 2 percent.)

Information reporting requirement: The proposal provides for increased information reporting under sections 6038A and 6038C to require certain taxpayers subject to the new base erosion provisions to report information such as base erosion payments, information for determining the base erosion minimum tax, and other information deemed necessary by the Secretary of the Treasury. In addition, it proposes to increase the penalty from $10,000 to $25,000 for failure to comply with section 6038A and increases the penalty for failure to comply within 90 days after IRS notification to $25,000 for each 30-day period thereafter.

Interest expense limitation

Section 163(j): The general limitation on interest deductible contained in section 163(j) is modified and generally follows the proposal included in the Senate bill. Details on this provision are included in the discussion of corporate tax issues elsewhere in this report.

Section 163(n): The provisions that were originally included in both the House Senate bills addressing interest expense incurred by domestic corporations that are members of an international group were not included in the conference agreement.

Other international provisions

Codification of Rev Rul. 91-32: The bill adopts the Senate proposal with respect to Rev. Rul. 91-32. Accordingly, gain or loss from the sale or exchange of a partnership interest is effectively connected with a US trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The proposal requires that any gain or loss from the hypothetical asset sale by the partnership be allocated. In addition, the transferee of a partnership interest is required to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.

Although the provision would apply to sales or exchanges on or after November 27, 2017, the portion imposing the withholding tax obligation applies to sales or exchanges occurring after December 31, 2017.

In addition, the bill would:

- Modify the definition of a US shareholder to include any US person who owns 10 percent or more of the total value of the foreign corporation (as opposed to vote);
- Modify the definition of section 936(h)(3)(B) to include workforce in place, goodwill, and going concern value;
- Impose a limitation on claiming lower rates on dividends from certain corporations subject to section 7874;
- Impose a separate foreign tax credit limitation category for branch income;
- Repeal the fair market value method for allocating interest expense;
- Eliminate foreign base company oil related as a category of subpart F income;
- Provide for an inflation adjustment to the de minimis rule;
- Repeal subpart F inclusions based on the withdrawal of previously excluded subpart F income invested in foreign base company shipping operations;
- Eliminate the limitation on attribution of stock from a foreign person to a US shareholder;
- Eliminate the requirement that a foreign corporation must be a CFC for an uninterrupted period of 30 days for subpart F to apply;
- Repeal the section 902 credit and application of the section 960 credit on a current-year basis; and
- Change the source rules for the sale of inventory property.

Finally, and unlike the prior versions of the bill, the conference agreement does not repeal section 956, does not make permanent section 954(c)(6), and does not accelerate the election to allocate interest expense on a worldwide basis.

Insurance provisions

The TCJA as agreed to in conference includes 13 provisions that would change the taxation of US insurance companies and products.

- Five of these provisions were included in both the House and Senate bills: change in operating loss carrybacks and carryforwards for life insurers, small life company deduction repeal, change in basis (section 807(f)) revisions, repeal of section 815, and repeal of section 847.

- The provisions addressing life reserves, life company proration, and deferred acquisition costs (DAC, section 848) as well as the three life product-related provisions, were not included in the House bill as passed but were included in the Senate bill.
- The 8 percent surtax "placeholder" that passed the House was eliminated in conference.
- A few of the proposals would appear to simplify the insurance provisions of the code.

General corporate NOL carryback and carryover periods would apply to life insurers: The TCJA adopts substantially similar provisions in the House and Senate bills that put life insurance companies on the general section 172 net operating loss rules for operations loss carrybacks (zero years) and operations loss carryovers (indefinite). Under the revised NOL rules in section 172, the use of net operating losses from previous years would be allowed to offset up to 80 percent of current-year taxable income.

The general corporate loss carryover and carryback regime would apply to losses arising in taxable years beginning after December 31, 2017, that is, for losses arising in 2018 and thereafter for calendar-year taxpayers.

The bill would retain the special 2-year-back, 20-year forward carryback and carryover rule for nonlife insurance companies by amending section 172, and would exempt nonlife insurance companies from the 80 percent limitation on use of NOLs described above.

Repeal of small life insurance company deduction: The bill would repeal the small life insurance company deduction in current section 806 and would make corresponding revisions to sections 453B(e) and 953(b) as well. The small life deduction would no longer be available starting in taxable years beginning after December 31, 2017.

Repeal of change in basis 10-year-spread: The bill would treat a change in a taxpayer's basis of computing reserves under the regular change in method of accounting rules with a section 481 adjustment rather than allow a 10-year spread of the difference between year-end reserves under the old and new basis of computing reserves. The section 481 treatment would result in the recognition of an increase in reserves in the year of change and the spreading of a decrease in reserves over four years. The change would be treated as initiated by the taxpayer and made with the consent of the Secretary of the Treasury.

This provision would be effective for taxable years beginning after December 31, 2017. Presumably there would be no change in existing spreads for current 807(f) amounts; however, this is not addressed in the bill text or the description of the provision in the conference report.

Repeal special rule for distributions from policyholders surplus accounts: The bill would repeal current section 815, which prescribes rules regarding taxation of certain distributions from policyholder surplus accounts (PSAs). This provision is a remnant from the pre-1984 Act three-phase system of taxation of life insurers under the Life Insurance Company Tax Act of 1959. Any remaining balance of the policyholder surplus account would be included in income over eight years beginning in 2018.

Modification of proration rules for property-casualty insurance companies: The bill adopts a Senate proposal that would increase the proration percentage for property and casualty companies in section 832(b)(5) to 5.25 percent divided by the highest corporate tax rate, *i.e.*, the proration percentage would jump from 15 percent to 25 percent for the 2018 taxable year.

This provision would be effective for taxable years beginning after December 31, 2017.

The House bill would have increased proration to a flat percentage.

Repeal of special estimated tax payments: The bill would repeal section 847, which provides for special estimated tax payments.

This provision would be effective for taxable years beginning after December 31, 2017. Any special loss account balances would be included in taxable income for the 2018 taxable year. Any excess tax payments would be treated as payments under section 6655.

Life insurance reserves based on statutory reserves with "haircut": The bill adopts, with modifications, a Senate proposal that eliminates the federally prescribed reserve (FPR) computation for life insurance reserves and instead bases tax reserves on the greater of the net surrender value of a contract and 92.81 percent of statutory reserves.

The proposal would impose a reporting requirement on life insurers to report the opening balance and closing balance of reserves with respect to the method of computing reserves for purposes of determining income. The details of this method are not specified.
The revised reserve computation would be effective for taxable years beginning after December 31, 2017. A transition rule would allow any difference between the prior year-end reserves computed on the old basis and on the new basis to be spread over eight years as either income or a deduction.

The House bill as passed did not include a life reserves change and instead included the 8 percent surtax on life companies.

Modification of life company DRD proration rules: The bill adopts a Senate proposal that would modify the life company proration rules by defining the section 812 "company's share" as 70 percent, and defining the "policyholder's share" as 30 percent for purposes of the dividends-received deduction and tax-exempt interest income.

This provision would be effective for taxable years beginning after December 31, 2017.

The House bill as passed did not include a proration change and instead included the 8 percent surtax on life companies.

Increase DAC capitalization rates: The bill would increase capitalization rates for determining "specified policy acquisition expenses" and extend the amortization period for capitalized DAC amounts.

The provision would increase the capitalization rate for annuity contracts from 1.75 percent to 2.09 percent, the rate for group life insurance contracts from 2.05 percent to 2.45 percent, and the rate for all other specified insurance contracts from 7.7 percent to 9.2 percent.

The amortization period for capitalized DAC amounts would be extended from the current 120 months to a 180 months.

This provision would be effective for taxable years beginning after December 31, 2017. A transition rule allows capitalized DAC amounts as of December 31, 2017 to continue under 10-year amortization.

The House bill as passed did not include a DAC change and instead included the 8 percent surtax on life companies.

Modification of discounting rules for property-casualty insurance companies: The bill would modify (generally, increase) the discount rate applied to compute unpaid loss reserves of property and casualty insurers under section 846. The rate would be modified from the 60-month rolling average of the applicable federal mid-term interest rate (AFR) to a rate based on the corporate bond yield curve for the preceding 60-month period on investment grade corporate bonds with varying maturities and that are in the top three quality levels available.

The provision also would change applicable loss payment patterns for long tail lines of business to extend a maximum of 24 years rather than 15 years.

The proposal also would repeal the current section 846(e) election which allows an insurer to use its own historical payment patterns for discounting unpaid losses.

This provision would be effective for taxable years beginning after December 31, 2017. Under a transition rule for the first taxable year beginning in 2018, the amount of unpaid losses and expenses at the end of the preceding taxable year (2017) would be determined as if the provision had applied to these items in such preceding taxable year. Any adjustment would be spread over eight taxable years beginning in 2018.

Tax reporting requirement for life settlement transactions: The bill adds new section 6050Y and imposes a tax reporting requirement on the purchaser for certain purchases of existing life insurance contracts (*i.e.*, "reportable policy sales") and on the insurance company upon payment of death benefits in certain situations (*i.e.*, "reportable death benefits").

The acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured would be treated as a reportable policy sale. In the event of such sale, the buyer would be required to report information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. Upon payments of death benefits, reporting would be required by the insurance company that issued the relevant contract.
The reporting requirement is effective for reportable policy sales occurring after December 31, 2017, and reportable death benefits paid after December 31, 2017.

Clarify tax basis of life insurance contracts: The bill provides that the owner of an annuity or life insurance contract determines basis in the contract without reduction for the cost of insurance or mortality charges. This provision would reverse the IRS's recent views on reduction of basis for purposes of determining gain or loss on the disposition of a life or annuity contract.

The proposed clarification of the basis rules for life insurance and annuity contracts is effective retroactively to 2009 for transactions entered into after August 25, 2009.

Narrow the exception to transfer-for-value rules: The bill narrows the exceptions to the transfer for value rules in section 101(a)(2) in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale as described in bill section 13520.

The modification of exception to the transfer-for-value rules is effective for transfers occurring after December 31, 2017.

Restrict insurance business exception to passive foreign investment company (PFIC) rules: The bill would amend the active insurance exception in the PFIC rules to add subsection (f) to section 1297 and provide that the exception would be generally available only to a foreign corporation that would be taxed as an insurance company if it were a domestic corporation and if its loss and loss adjustment expenses and reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks constitute more than 25 percent of the foreign corporation's total assets.

The amendment to the active insurance exception to the PFIC rules is effective for taxable years beginning after 2017.

ASC 740 Implications

Pursuant to US Generally Accepted Accounting Principles, the tax effects of new tax legislation are accounted for in the interim and annual reporting periods in which a tax law is enacted. In the US jurisdiction, the enactment date generally is the day the President of the United States signs the legislation into law. The resolution reached by House and Senate conferees and release of the official conference report for the Tax Cuts and Jobs Act on December 15, 2017, does not, in and of itself, equate to enacted tax law. If the Tax Cuts and Jobs Act is enacted, as expected, the proposal will likely have a significant impact on companies' financial statements in the reporting period of enactment, including significant impacts to deferred tax accounts, current and noncurrent tax liabilities, and disclosures. As the probability of enactment appears to be quite high, companies should be actively analyzing the impact the provisions in the conference report would have on their tax accounts and disclosures, if enacted.

If the change in tax law is enacted subsequent to the balance sheet date, but prior to issuance of the financial statements, it would be considered a nonrecognized subsequent event and companies would need to discuss the new tax law and, potentially, disclose an estimate of its effect on the entity's financial statements and tax accounts.

To the extent potential income tax reform could materially affect the company or its business, SEC registrants should also consider possible disclosure requirements under Risk Factors and Management's discussion and analysis of financial condition and results of operations.

Tax provisions affecting individuals

The individual tax provisions in the TCJA conference agreement generally track with those in the Senate-approved bill – including, most significantly, the fact that all of the TCJA's changes to the individual side of the code expire after 2025.

Tax rate modifications: Consistent with the Senate version, the final bill maintains seven brackets as in current law while reducing the highest tax bracket from the current-law level of 39.6 percent to 37 percent for single filers with taxable income over $500,000. (The Senate-approved version provided for a top rate of 38.5 percent.)

Notably, the threshold for the 37 percent bracket for married filing joint taxpayers is only $600,000, and as a result these new rate tables re-establish the so-called "marriage penalty." Also worth noting is the fact that the final bill also does not incorporate the "bubble tax" proposed in the House bill, which would have erased the benefits of the lowest tax bracket for high-income taxpayers.

As with both the House and Senate versions, the final bill retains the 20 percent special tax rate for long-term capital gains and qualified dividend income, the 3.8 percent tax rate on certain levels of net investment income and the 0.9 percent FICA-HI tax rate on certain levels of earned income.

A table illustrating how the tax rates under the TCJA conference agreement compare to current law is available from Deloitte Tax LLP.
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/171218_1_suppB.pdf

Individual alternative minimum tax: While the versions of the TCJA approved in the House and the Senate Finance Committee-passed would have repealed the alternative minimum tax, the final bill maintains the AMT for individual and fiduciary income taxpayers, albeit with a higher exemption amount of $70,300 for single taxpayers and $109,400 for married taxpayers filing a joint return. Further, the phase-out thresholds are increased to $500,000 and $1 million for single and joint filers, respectively. Both the exemption and phase-out threshold amounts are indexed for inflation.

Passthrough taxation on individual returns: For individuals and fiduciaries, the final bill includes a 20 percent deduction against "domestic qualified business income" from a partnership, S corporation, or sole proprietorship. This deduction was first introduced in the Senate version of the bill at a rate of 23 percent. Details on the deduction and on a provision related to excess business losses of individuals are discussed at length in the passthrough business section elsewhere in this report.

Itemized deductions: Consistent with the House and Senate versions, the final bill substantially increases the standard deduction to $12,000 for single taxpayers and $24,000 for married taxpayers filing jointly. Additionally, it maintains the current-law additional standard deduction for the blind and elderly. Increased standard deductions would allow many individuals to avoid itemizing their deductions. However, for those individuals who would still itemize, the final bill contains notable differences compared to current law on a number of items:

- Mortgage interest deduction reduced: The mortgage interest deduction will be limited to interest on $750,000 ($375,000 for married filing separate taxpayers) of acquisition indebtedness on a taxpayer's primary and secondary residences. Mortgages existing on or before December 15, 2017 (and certain others where there is a binding contract to purchase property before December 15, 2017 or are refinanced) are grandfathered under the current $1 million threshold. The interest deduction for home equity indebtedness is repealed.
- Medical and dental expense deduction expanded. Unreimbursed medical and dental expenses will be deductible subject to the extent they exceed 7.5 percent of adjusted gross income (AGI) in 2017 and 2018. The percentage increases to 10 percent (the threshold in effect under current law) in 2019. The threshold applies to both the regular and alternative minimum tax.
- Miscellaneous itemized deductions eliminated: The bill eliminates all miscellaneous itemized deductions that are not listed in section 67(b). For fiduciary taxpayers, the statutory wording of new section 67(g) now in the conference agreement appears to preclude a deduction for any administrative cost (*e.g.*, trustee fees, investment management and custodial fees, and attorney/accounting fees).
- Personal casualty losses limited: The bill provides that personal casualty losses are deductible pursuant to other current-law rules only if the losses were incurred in federally declared disaster areas.
- State and local income or sales and property tax deductions limited: An itemized deduction of up to $10,000 ($5,000 for married taxpayers filing a separate return) for the aggregate of nonbusiness (1) state and local property taxes, and (2) state and local income taxes or sales taxes is permitted. Nonbusiness foreign real property taxes are no longer deductible. It does not appear that the $10,000 limitation is indexed for inflation. Significantly, prepayments of state and local income tax for 2018 made in 2017 are treated as paid as of the last day of 2018.

- Charitable contributions modified: The AGI limit for gifts of cash to public charities and certain other organizations is increased from 50 percent to 60 percent. However, a charitable deduction is now denied for payments made in exchange for college athletic event seating rights.
- Pease limitation repealed: The reduction for overall itemized deductions for higher income taxpayers is eliminated.

Other deductions and exclusions: Consistent with both the House and Senate versions, the final bill repeals the deduction for personal exemptions.

The final bill also repeals the moving expense deduction other than for members of the Armed Forces of the United States moving on military orders and repeals the exclusion from gross income and wages for qualified moving expense reimbursements.

Interestingly, though the House and Senate versions of the bill would have modified the exclusion of gain from sale of principal residence provisions to expand the time period for which a taxpayer needed to have resided in the home, the final bill contains no such provision. Instead, the conference agreement retains current law, which permits up to $250,000 of gain for single and $500,000 for married taxpayers filing jointly to be excluded from gross income if the home was used as the taxpayer’s principal residence two of the past five years.

The final version of the bill generally follows the House provisions with respect to the taxation or deduction of alimony payments. Effective for any divorce or separation instrument executed after December 31, 2018 (or modified after December 31, 2018, to conform with this provision), alimony payments will neither be taxable to the recipient or deductible by the payer.

As expected, the final bill continues to allow an exclusion from earned income of contributions to qualified retirement savings vehicles such as 401(k) plans and individual retirement accounts.

Credits: The final bill increases the child tax credit to $2,000 per qualifying child, double the amount under current law; of this amount, $1,400 per qualifying child will be refundable. The credit begins to phase out for married filing joint taxpayers with AGI in excess of $400,000. In addition to the credit for qualifying children, the bill also provides for a $500 nonrefundable credit for qualifying dependents other than children.

Additional family-oriented provisions in the final version include the retention of the dependent care credit and the adoption credit. The final version also maintains the exclusion from gross income of up to $5,000 annually for employer-provided dependent care assistance.

Miscellaneous provisions: Other noteworthy provisions affecting individual taxpayers are described below.

- Carried interest holding period expanded. The bill expands the holding period requirement to three years for gains on qualified carried interests to be taxed at preferential long-term capital gains rates.
- Cost basis of specified securities remains unchanged. Whereas the Senate bill contained a provision requiring the cost basis of any security sold to be determined on a first-in first-out basis except to the extent average basis method is allowable (as in the case of a RIC), the final bill includes no such provision. Under current law, unless the average basis method is permitted, a taxpayer who sells stock that the taxpayer acquired on different dates or at different prices and who does not adequately identify the lot from which the stock is sold, must treat the stock sold on a first-in first-out basis to determine the basis and holding period.
- Basis in a life insurance policy modified. The final bill includes a Senate provision that provides that the basis in a life insurance policy or annuity contract on the sale of the cash value of the policy is determined without an adjustment for the cost of insurance (mortality expense under the contract), reversing the IRS position in Rev. Rul. 2009-13.
- Section 529 plans expanded. The final bill allows section 529 plan funds to be used in connection with elementary or secondary public, private, home school, or religious school tuition and eligible expenses. However, these distributions are limited to $10,000 per year on a per student basis.
- Individual mandate penalty eliminated. Consistent with the Senate bill, the final bill reduces the penalty to zero for individuals who do not maintain qualifying health insurance coverage under the Patient Protection and Affordable Care Act (the “individual mandate”). The reduced penalty is effective for months beginning after December 31, 2018. Unlike other individual provisions in the bill, this one does not sunset after the end of 2025.

- Filing requirements adjusted. The final bill clarifies that an individual is not required to file an income tax return if the taxpayer's gross income for the taxable year does not exceed the applicable standard deduction. Under current law, a return is required to be filed if an individual has income which equals or exceeds the personal exemption amount plus the standard deduction applicable to such individual.

Estate, gift, and GST tax provisions

The current tax regime with respect to the estate, gift, generation-skipping transfer (GST) taxes and the income tax basis adjustment to fair market value at death remain unchanged except that the applicable exclusion amount (the amount that each citizen is entitled to transfer either during life or, if otherwise unused, at death without incurring a current tax) and the GST tax exemption (the amount that may be transferred to skip-persons outright or in trust without giving rise to a present or future GST tax) is doubled to $11.2 million from its existing $5.6 million for transfers occurring after December 31, 2017.

The exclusion and GST exemption continue to be indexed for inflation. However, beginning January 1, 2026, the exclusion amount and the GST exemption will return to the levels that would have prevailed under current law.

Compensation and benefits provisions

The TCJA includes a number of provisions in the area of compensation and benefits that could have a significant impact on businesses as well as their employees.

Limitation on excessive employee remuneration: Under current law, an employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. Section 162(m) provides an explicit limitation on the deductibility of compensation expenses by applicable employers whose securities are publicly traded in the United States. The otherwise allowable deduction for compensation with respect to a "covered employee" of a publicly held corporation is limited to no more than $1 million per year unless specific exceptions apply. Covered employees include the principal executive officer and next three highest paid employees as of the last day of the employer's taxable year. The principal financial officer (*i.e.*, chief financial officer) is excluded from the definition of a covered employee.

The TCJA conference agreement includes provisions that:

- Repeal the performance-based compensation and commission exceptions to the section 162(m) $1 million deduction limitation.
- Expand the definition of applicable employer to entities that are either: (1) an issuer of securities that are subject to the registration requirements of section 12 of the Securities and Exchange Act of 1934 (the "Act"), or (2) an issuer that is required to file reports under section 15(d) of the Act.
- Revise the definition of a "covered employee" to include both the principal executive officer and the principal financial officer. An individual is a covered employee if the individual holds one of these positions at any time during the taxable year. Further, the provision defines as a covered employee the three most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer) who are required to be reported on the company's proxy statement for the taxable year, as well as officers of a corporation that are not required to file a proxy statement but which are otherwise included within the revised definition of an applicable employer. The provision includes officers of an applicable employer who would have been subject to proxy filing requirements but for special circumstances arising during the year that impacted the filing requirement.
- Status as a covered employee continues after separation from service, including years after the death of the individual.

The provision applies to taxable years beginning after December 31, 2017. A transition rule applies to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017 and which was not modified in any material respect on or after such date.

Excise tax on excess compensation paid to executives of tax exempt organizations: A TCJA provision adding an excise tax on certain types of compensation paid by tax-exempt organizations is discussed in the "Tax-exempt organizations" section of this report.

Limitation on deduction by employers for fringe benefit expenses: Similar to the Senate bill, the final agreement provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or (3) a facility (such as an airplane) used in connection with any of the above items. Thus, the final agreement repeals the current exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, as well as the related rule applying a 50 percent limit to such deductions.

While the final agreement retains the 50 percent deduction for food and beverage expenses associated with the operation of a taxpayer's trade or business (*e.g.*, meals consumed by employees on work travel), the final agreement expands the exception to the 50 percent limitation to employer expenses associated with providing food and beverages to employees through an eating facility that meets the requirements to be considered a de minimis fringe benefit under current law.

The final agreement also disallows the deduction for expenses associated with providing any qualified transportation fringe to employees. In addition, the deduction for expenses incurred for providing transportation (or any payment or reimbursement) related to commuting between the employee's residence and place of employment, other than as necessary for ensuring the safety of an employee, is disallowed under the final agreement.

The final agreement generally applies to amounts paid or incurred after December 31, 2017. However, for expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer, amounts paid or incurred after December 31, 2025 are not deductible.

Additional unrelated business income tax on tax exempt organizations: A TCJA provision that subjects certain fringe benefits provided by tax exempt organizations to Unrelated Business Income Tax (UBIT) is discussed in the tax-exempt organizations section of this report.

Qualified equity grants: Under existing tax rules, nonstatutory stock options (*i.e.*, options that are not incentive stock options or options granted under an employee stock purchase plan) granted at fair market value are generally not taxable until the exercise of the option if the service recipient receives fully vested stock. Additionally, restricted stock units (RSUs) that are exempt from, or comply with, the nonqualified deferred compensation rules under section 409A are generally not taxable until delivery of fully vested stock.

Under a provision in the House-approved version of the TCJA, a "qualified employee" may elect to defer the income attributable to a stock option or RSU received in connection with the performance of services for up to five years if the corporation's stock is an "eligible corporation." Instead of including income at exercise of a stock option (assuming fully vested stock is received) or at delivery of fully vested stock as required under current law, if the qualified employee makes a timely "inclusion deferral election," then the employee will be subject to income tax at the earlier of the following dates:

- The date the qualified stock is transferrable;
- The date the employee becomes an "excluded employee";
- The date on which any stock of the employer becomes publicly traded;
- Five years after the employee's right to the stock is substantially vested; or
- The date the employee revokes the election.

A "qualified employee" is generally an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary to ensure the income tax withholding requirements with respect to the qualified stock are met. An "excluded employee" includes the following:

- A 1 percent owner of the corporation at any time during the 10 preceding calendar years;
- The current or former chief executive officer or chief financial officer of the corporation (or an individual acting in either capacity);
- A family member of an individual described above; or
- The four highest-compensated officers of the corporation for any of the 10 preceding taxable years.

A corporation is an “eligible corporation” with respect to a calendar year if no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year. Additionally, the corporation must have a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the US (or any US possession) are granted stock options or RSUs with the same rights and privileges to receive qualified stock (the “80 percent requirement”). Note, the amount granted to each employee need not be identical under the plan.

Under this proposal, corporations that are members of the same controlled group are treated as one corporation.

An inclusion deferral election must be made no later than 30 days after the first date the employee’s right to the stock is substantially vested or is transferable, whichever is earlier. An election is generally made in the same manner as a section 83(b) election. An inclusion deferral election may be made on a statutory stock option (*i.e.*, incentive stock options or options granted under an employee stock purchase plan). If an election is made with respect to a statutory stock option, then the option is not subject to the statutory stock option rules.

With respect to the employer’s deduction, if an employee makes an inclusion deferral election, the employer’s deduction is also deferred until the employer’s taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee’s income. Also, the inclusion deferral election affects only the deferral of income tax and does not affect the timing of FICA and FUTA.

The House proposal includes certain employee notice requirements. Specifically, a corporation that transfers qualified stock to a qualified employee must provide notice to the employee at, or a reasonable period of time prior to, the point qualified stock becomes substantially vested certifying that the stock is qualified stock. Additionally, the employee must be notified:

- That the employee may (if eligible) elect to defer income inclusion with respect to the stock;
- If the employee makes an inclusion deferral election, the income inclusion amount at the end of the deferral period will be based on the value of the stock at the time the employee’s right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee’s tax liability with respect to such stock); and
- That the amount of income to be included at the end of the deferral period will be subject to withholding.

Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

The provision is generally applicable to options exercised, or restricted stock units granted, in 2018 and later taxable years.

The Senate proposal is generally the same as the House version; however, the Senate includes a transition rule providing that until regulations or other guidance implementing the 80 percent and employer notice requirements is issued, a corporation will be treated as complying with those requirements if it complies with a reasonable good-faith interpretation of the requirements.

The conference agreement follows the Senate proposal, with modifications. The definition of excluded employee is revised so that individuals who become a 1 percent owner or one of the highest four compensated officers during the current year are limited, not just those with that status during the 10 preceding years. The requirement that 80 percent of all employees be granted options or RSUs with the same rights is modified so that this test must be met with respect to options only or RSUs only, rather than a combination of the two. In addition, the language is modified so that income related to a deferral election on shares acquired under an employee stock purchase plan are disqualified and become subject to FICA and income tax withholding, in the same way as shares acquired through an ISO. The conference report confirms that the transition relief is intended to be limited to the 80 percent and employer notice provisions. It also confirms that the provisions related to coordination with sections 83 and 409A are intended to be limited to the specific issues raised by coordination with section 83(i).

Retirement accounts: The TCJA includes provisions related to the recharacterization of IRA contributions and rollovers of retirement plan loan offsets.

- **Recharacterization of IRA contributions:** The bill includes a provision that restricts individuals from recharacterizing IRA contributions. Under current law, an individual who makes a contribution to one type of IRA (traditional or Roth) is permitted to recharacterize that contribution and have it treated as if made to the other type of IRA. An individual must recharacterize this contribution no later than the extended due date of the tax return for the year the contribution is made. Current law permits an individual to recharacterize either an annual IRA contribution or a traditional-to-Roth IRA conversion. The TCJA eliminates the ability to recharacterize traditional-to-Roth IRA conversions. An individual will still be able to make a traditional to Roth conversion, but will no longer be able to change his or her mind. The provision permits regular annual contributions to be recharacterized.
- **Rollovers of plan loan offsets:** The conference agreement extends the rollover period for certain plan loan offsets. Normally, if a participant receives a distribution from a retirement plan, the distribution must be rolled over within 60 days of receipt, if not transferred directly to the other retirement plan. Under the conference agreement, if the individual has an outstanding loan when he or she terminates employment, the participant has until the extended due tax of his or her tax return for the year in which the offset occurs in order to roll over an amount equal to the outstanding loan balance.

Deductions and exclusions for employer-provided reimbursements and awards: The TCJA modifies several current-law deductions and exclusions related to various reimbursements and awards provided by employers to their employees.

- **Qualified bicycle commuting reimbursement:** Similar to the Senate bill, the TCJA repeals the income and employment tax exclusion for qualified bicycle commuting reimbursements provided by an employer as payment for reasonable expenses such as bicycle purchase, repair, and storage. The final agreement is effective for taxable years beginning with taxable years on or after January 1, 2018, through December 31, 2025.
- **Qualified moving expense reimbursement:** Similar to the Senate bill, the exclusion for qualified moving expense reimbursements provided by an employer to an employee would be repealed under the final agreement except for members of the armed forces moving on military orders. The repeal applies for both income and employment tax purposes. The final agreement is effective for taxable years beginning with taxable years on or after January 1, 2018, through December 31, 2025. (A separate deduction for qualified moving expenses is discussed in the section on individual tax reform elsewhere in this report.)
- **Employee achievement awards:** Similar to the Senate bill, the final agreement defines “tangible personal property” that may be considered a deductible employee achievement award to exclude the following items: cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. The final agreement is effective for taxable years beginning on or after December 31, 2017.
- **Length of service awards for bona fide public safety volunteers:** Similar to the Senate bill, the final agreement increases the aggregate amount of length of service awards that may accrue for a bona fide volunteer with respect to any year of service to $6,000 and adjusts that amount in $500 increments to reflect changes in cost-of-living for years after the first year the final agreement is effective. If the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. Actuarial present value is calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant’s age at the time of the calculation. The final agreement is effective for taxable years on or after December 31, 2017.

Tax-exempt organizations

The TCJA conference agreement includes a number of provisions related to the operation of or the treatment of contributions to tax-exempt organizations.

Excise tax on executive compensation of tax-exempt organizations: The TCJA assesses a 21 percent excise tax on a tax-exempt organization for any covered employee whose compensation is greater than $1 million (plus parachute/severance payments). The excise tax applies to any organization that is tax-exempt under section 501(a), farmer organizations, organizations whose income is excluded under section 115 (*e.g.*, governmental hospitals and state colleges and universities), and political organizations under section 527. A "covered employee" is any employee or former employee if the employee is one of the top five highest-compensated employees for the taxable year (note that this appears to be the organization's fiscal year) or was a covered employee in any preceding year beginning after December 31, 2016. Thus, once an individual is considered a covered employee the individual remains a covered employee for the remainder of his or her relationship with the organization.

Compensation means wages not including Roth designated contributions. Deferred compensation is taken into account when taxable pursuant to section 457(f). Notably, compensation for purposes of determining covered employees does not include amounts paid to a licensed professional for the performance of medical or veterinary services (physicians, nurses, and veterinarians). The conference report summary clarifies that compensation paid to such professionals in any other capacity (*e.g.*, administrative) is taken into account.

Compensation subject to the excise tax includes compensation for services performed at a related organization. The resultant tax is allocated back to each related organization on a pro rata basis.

Compensation whose deductibility is limited under section 162(m) is not taken into account.

The provision instructs the IRS to write regulations to prevent avoidance of tax through services as a non-employee or through the use of a passthrough or other entity. The excise tax is effective for tax years beginning after December 31, 2017.

Unrelated Business Income (UBI) related to the provision of certain fringe benefits: Under the legislation, UBI is increased for any amounts that would be disallowed under section 274 for qualified transportation fringe benefits, a parking facility used in connection with a qualified transportation fringe benefit, and/or an employer provided on-premises athletic facility. If the costs are allocable to a UBI activity and are disallowed under section 274 then the UBI treatment is not applicable. This treatment is also not applicable if employees are taxed on the benefit.

UBI determined by activity: The legislation provides that losses from one Unrelated Business Income activity may not offset income from another. Losses from an activity will carry forward and if appropriate and may offset future income from the activity. Net operating loss carryforwards from years beginning before January 1, 2018, will continue to carry forward and will not be affected by this change.

Excise tax on the net investment income of private colleges and universities: The bill proposes a 1.4 percent tax on net investment income of a private college or university. The tax is applicable to institutions that:

- Have at least 500 tuition-paying students at least 50 percent of whom are in the United States;
- Is not a state college or university; and
- Whose aggregate fair market value of assets at end of the previous taxable year (other than those used directly in carrying on tax-exempt purpose) is at least $500,000 per student.

The number of students is calculated as the average daily full-time attending the college or university. For purposes of determining net assets per student and net investment income subject to tax, net assets held by related parties, including organizations controlled by the college or university and organizations supporting the college or university are taken into account. The net investment income will be determined under rules similar to those used by private foundations.

Charitable contribution in return for the right to purchase athletic tickets: The TCJA repeals section 170(l) and states there is no charitable deduction for contributions required in order to obtain the right to purchase tickets to an athletic event at a college or university.

Tax-exempt bonds: The legislation repeals tax credit bonds and advance refunding bonds, but it does not include provisions in the House bill that would have repealed private activity bonds and tax-exempt treatment of interest on professional sports stadium bonds.

Provisions not included: The legislation does not include proposals from the House-approved bill that would have:

- Limited the exclusion of research income from unrelated business taxable income for certain tax-exempt organizations to income from publicly available research;

- Excluded certain entities from the definition of a “business enterprise” for purposes of the private foundation excess business holdings tax;
- Clarified that organizations (such as state pension funds) that are tax-exempt or whose income is excluded from tax under a section other than section 501 (such as organizations that perform an essential governmental function that exclude income under section 115) and who have also obtained tax exemption under section 501(a) (so-called dual status organizations) are subject to the UBIT rules under section 511;
- Restructured the excise tax on private foundation investment income;
- Added new Form 990 reporting requirements for sponsors of donor advised funds;
- Provided that art museums will not qualify for private operating foundation status unless the museum is open to the public during normal business hours for at least 1,000 hours a year; and
- Temporarily allowed section 501(c)(3) organizations to make statements relating to a political campaign in ordinary course of their tax-exempt activities as long as they do not incur more than incidental incremental expenses.

Tax compliance and procedural provisions

The TCJA conference agreement includes several new provisions related to tax preparer due diligence requirements, return filing requirements, and IRS levies.

Tax return preparer due diligence for filing status and certain credits: The bill amends section 6695(g) to apply a due diligence requirement to tax return preparers when determining the eligibility of a taxpayer to file as head of household as well as eligibility for the child tax credit, Hope and lifetime learning credits, and the earned income credit. Failure to meet the due diligence requirements, which are to be set forth in regulations, results in a penalty of $500 per violation. The provision applies to tax years beginning after December 31, 2017.

Wage, salary or other income exemption from IRS levy: The bill modifies the exempt amount of wages, salary, or other income (“wage exemption”) for IRS levies under section 6334(d) for tax years in which the personal exemption is suspended. During this period, the wage exemption is $4,150 multiplied by number of dependents plus the standard deduction, divided by 52, subject to inflation adjustments.

Individual income tax filing requirements: The bill modifies section 6012 to provide that every individual who has gross income for the taxable year shall be required to file an income tax return unless gross income is below certain specified dollar thresholds. Under the bill, an individual who is not married is not required to file a return unless the individual’s gross income for the year exceeds the applicable standard deduction. Married individuals filing jointly are not required to file a return if their combined gross income for the year is less than the standard deduction applicable to a joint return, provided that: (1) at close of the taxable year they had the same household; (2) neither spouse makes a separate return; and (3) neither is a dependent of another taxpayer who has income (other than earned income) in excess of $500 (indexed for inflation). This is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

Extension of time limit for contesting IRS levies: Section 6343 currently provides that if the IRS determines that property has been wrongfully levied upon, then the IRS can return to the taxpayer: (1) the specific property levied upon; (2) an amount of money equal to the amount of money levied upon; or (3) an amount of money equal to the amount of money received by the United States from a sale of such property. The specific property may be returned to the taxpayer at any time. If the property has been sold, then there is a nine-month period from the date of the levy to return to the taxpayer an amount equal to the amount of money levied upon or received from such sale. The conference bill extends the nine-month period to two years. This provision applies to levies after the enactment date of the bill and levies made in the nine months prior to enactment.

In addition, the bill extends the time periods in section 6532 to two years for filing a suit related to a levy. This provision applies to levies after the enactment date of the bill and levies made in the prior nine months prior to enactment.

Outlook

The TJCA conference agreement faces a vote in the House on December 19. The action then shifts to the Senate, where leaders will hold 10 hours of debate followed by a floor vote on December 20.

The House approved its version of the TCJA with relative ease last month, despite reservations about limitations on the SALT deduction on the part of several GOP lawmakers who represent constituents living in high-tax jurisdictions. A similar outcome is considered likely when the conference agreement comes up for final passage.

In the Senate, tax reform generally has faced a more difficult path forward because of the GOP's narrow – four seat – majority. (Indeed, the Senate version of the TCJA was approved earlier this month on a vote of 51-49.) But as they prepare to take up the conference agreement, Republican leaders find themselves on a much stronger footing now that GOP Sens. Bob Corker of Tennessee (who voted against the Senate version of H.R. 1 earlier this month) and Marco Rubio of Florida (who had threatened to withhold his support to win changes to strengthen the child tax credit) have declared themselves to be in the "yes" camp. Republican Sen. Susan Collins of Maine had expressed reservations about specific elements of the legislation, although in recent days has appeared willing to support it; meanwhile, Sen. Jeff Flake of Arizona has raised his own concerns about the bill and has not yet indicated how he will vote. Health issues of individual senators are also factoring into the calculus for GOP leaders: Sen. John McCain of Arizona, who is being treated for brain cancer, will be away from Washington until after the holiday recess, and Sen. Thad Cochran of Mississippi has been in the hospital and his availability for floor votes this week is unclear.

Vice President Mike Pence has delayed a planned trip to Israel so he could be on hand if needed to cast the deciding Senate vote in the event of a tie.

For its part, the Trump administration issued a statement following the release of the conference report that left no doubt that the president will sign the legislation once it reaches his desk.

"By lowering tax rates, simplifying the rigged and burdensome tax code, and repealing the failed tax on lower- and middle-income households known as the Obamacare individual mandate, this legislation will grow our economy, raise wages, and promote economic competitiveness. The president applauds the House and Senate conferees on coming to an agreement on the Tax Cuts and Jobs Act, and looks forward to fulfilling the promise he made to the American people to give them a tax cut by the end of the year," the statement said.

— Prepared by the tax professionals in Deloitte Tax LLP's Washington National Tax practice