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Ways and Means Republicans fill in the blanks on tax reform

House Ways and Means Committee Republicans unveiled a tax reform legislative draft November 2 that, among other things, calls for ambitious cuts to tax rates for corporations, passthrough entities, and individuals; a more generous expensing regime; significant increases to the individual standard deduction and the child tax credit; repeal of the estate tax and the individual alternative minimum tax; and a shift to a territorial system for taxing foreign-source income of US multinationals.
URL: https://waysandmeansforms.house.gov/uploadedfiles/bill_text.pdf

The committee also released a section-by-section summary in conjunction with the bill.
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/171102_1_suppA.pdf

Building on the GOP 'framework'

The legislation – formally known as the Tax Cuts and Jobs Act (TCJA) – advances the objectives of the tax reform framework put forward in late September by the "Big Six" team of congressional Republican leaders and White House officials (that is, House Speaker Paul Ryan, R-Wis., Senate Majority Leader Mitch McConnell, R-Ky., House Ways and Means Committee Chairman Kevin Brady, R-Texas, Senate Finance Committee Chairman Orrin Hatch, R-Utah, Treasury Secretary Steven Mnuchin, and National Economic Council Director Gary Cohn.)
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/170927_1.html

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But the framework addressed GOP tax policy goals largely in broad strokes, with few details on how various tax relief provisions would operate and how they would be paid for. (Unofficial estimates from the nonpartisan Tax Policy Center suggested the Republican-backed framework could cost several trillion over 10 years, but the recently approved unified budget resolution for fiscal year 2018 only affords budget reconciliation protections to a tax bill that increases the federal deficit on net by up to $1.5 trillion over 10 years.)

The TCJA fills in those blanks: for example, it includes income thresholds for the proposed new individual rate brackets, “guardrails” for the proposed new passthrough regime, and deemed repatriation rules and base erosion protections to accompany the transition to a territorial tax regime; moreover, it lays out an array of proposed base-broadening provisions that would have a significant impact on corporations, passthrough entities, individual taxpayers, and tax-exempt organizations. An initial estimate from the Joint Committee on Taxation projects the bill as released would result in a 10-year deficit spike of $1.49 trillion – just under the limit established in the budget resolution.
URL: https://www.jct.gov/publications.html?func=startdown&id=5026

But some of the emerging details have the potential to become lightning rods for opposition as the legislation advances. The drafting process for the TCJA was highly secretive – so much so that many of the finer points of the proposal were unknown even to a number of Ways and Means Republicans and their staff until just recently. Indeed, as Republican committee members learned just what was being proposed and voiced their concerns with specific provisions, Chairman Brady and his staff scrambled to make last-minute modifications, and as a result the proposal’s official release slipped beyond the original November 1 target date. Other pockets of opposition could emerge among rank-and-file House Republicans as they study the measure in the coming days.

What’s here, what’s ahead…

This special edition of *Tax News & Views* offers an overview of the package, makes observations on key provisions, and looks at some of the political and policy challenges ahead as the tax reform process unfolds on Capitol Hill.

Corporate tax provisions

In general, the TCJA would retain the current corporate tax system, with a tax imposed at the corporate level on gain or income and at the shareholder level upon a disposition or corporate distribution, that is, a double tax regime. There is some softening due to rate reduction, however, and more fundamental changes in the cross-border context (discussed elsewhere in this report). The TCJA also preserves the treatment of tax-free transactions – including for corporate formations and contributions (section 351), reorganizations (section 368), separations (section 355), and liquidations (section 332) – with the exception for certain contributions to capital (discussed below). Accordingly, transactions with respect to stock of a corporation will generally be treated the same. Finally, the proposal does not propose any changes to the consolidated return provisions.

Corporate rate reduction: The TCJA would reduce the general corporate tax rate to 20 percent effective as of January 1, 2018, eliminating the current brackets that have a maximum tax rate of 35 percent. The rate reduction would be immediate rather than implemented in a phased approach. The corporate alternative minimum tax would also be eliminated.

Cost recovery

The TCJA would permit taxpayers to expense 100 percent of the cost of qualified property acquired and placed in service after September 27, 2017, but before January 1, 2023. An additional year is provided for certain property with longer production periods. Qualified property excludes property used by a regulated public utility company or other property used in a real property trade or business. The proposal achieves full expensing by increasing the bonus depreciation provision under section 168(k)(1)(A) to 100 percent (from 50 percent).

The full expensing proposal also would eliminate the requirement that the original use of the property begin with the taxpayer. Thus, the property would qualify for full expensing as long as the property was not used by the taxpayer prior to the time of acquisition. However, the proposal does include safeguards that exclude taxpayers from fully expensing property sold among related parties, members of a controlled group, or where a taxpayer churns pre-September 27, 2017, used assets.

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For qualified property that was acquired by the taxpayer prior to September 28, 2017, the proposal includes a gradual phase-down of the amount of bonus depreciation available for such asset. The amount of the bonus depreciation depends on the placed in service date, and varies from 50 percent to 30 percent.

No portion of this full expensing provision can be used to carryback a net operating loss in the case of any taxable year that includes the period beginning September 28, 2017 and ending December 31, 2017.

AMT repealed

The TCJA would repeal the alternative minimum tax (AMT) for individuals, estates, and trusts, as well as corporations, effective for tax years beginning after December 31, 2017. With respect to AMT credit carryovers, a taxpayer would be able to claim a refund of 50 percent of remaining credits (to the extent the credits exceed regular tax for the year) in the tax years beginning in 2019, 2020, and 2021. Taxpayers would be able to claim a refund of all remaining credits in the tax year beginning in 2022.

Business-related exclusions and deductions

To offset the cost of business tax relief and simplify the tax code, the TCJA would repeal or otherwise limit a number of business deductions and exclusions available under current law.

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 TCJA would amend and replace section 163(j) with an expanded provision limiting interest deductibility. 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 is defined as interest paid or accrued on indebtedness which is properly allocable to a trade or business, with business interest income defined similarly. Business interest and business interest income do not include investment interest and investment income, respectively, within the meaning of section 163(d)(3). Adjusted taxable income 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) net operating losses; and (4) depreciation, amortization, and depletion.

The provision would generally apply to all taxpayers, with an exception for certain small businesses and for interest allocable to certain enumerated businesses (generally, performing services as an employee, a real property trade or business (defined in section 469(c)(7)(C)), and businesses of certain regulated public utilities). Special rules would apply to partnerships.

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 to the fifth year following the year in which paid or accrued. Further, disallowed business interest would be treated as an allowed deduction on a first-in, first-out basis. Section 381(c) would be amended to include disallowed business interest as a tax attribute thereunder, and conforming amendments would be made under section 382 to treat disallowed business interest as a pre-change loss under subsection (d).

The modifications described above apply to taxable years beginning after December 31, 2017. Amended section 163(j) appears to apply to interest on debt existing prior to a taxable year beginning after December 31, 2017, to the extent such interest is paid or accrued on or after such a taxable year.

Modification of the net operating loss deduction: The TCJA would modify aspects of current law regarding net operating losses (NOLs) including:

- The amount of NOLs that may be deducted; and
- The carryback and carryforward periods for NOLs.

Under current law, NOLs generally have a carryback period of two years and a carryforward period of 20 years. Under the TCJA, the carryback period would generally be eliminated. There is a limited exception for certain "eligible disaster

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losses" and a transition rule for taxable years that include any portion of the period beginning on September 28, 2017 and ending on December 31, 2017 (and, for this transition period for NOLs and related items, the increased expensing under bill section 3101 (discussed elsewhere in this report) would not be taken into account). In addition, the NOL carryforward period would be indefinite.

The amount of the NOL deduction allowed would be limited to 90 percent of taxable income computed without regard to the NOL deduction. The amount of NOLs, or so-called indefinite NOLs, carried to a succeeding year would be increased, however, by an annual interest factor (that is, the annual short-term rate (determined under section 1274(d)) for the last month ending before the beginning of the taxable year, plus 4 percentage points).

Conforming amendments would include but not be limited to (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).

In general, the effective date is December 31, 2017. The amendments to carryback and carryforward periods apply to NOLs arising in taxable years beginning after December 31, 2017. The limitation to NOL utilization (tied to 90 percent of taxable income) applies to taxable years beginning after December 31, 2017, with the annual increase in indefinite NOLs applying to amounts carried to taxable years beginning after December 31, 2017.

Like-kind exchanges of real property: The bill would limit the scope of the gain deferral of like-kind exchange to real property, thus excluding personal property. As a result, it would preserve the ability to defer built-in gains when exchanging like-kind real property. The effective date of this provision applies to exchanges completed after December 31, 2017; however, a transition rule provides that the current like-kind exchange rules still apply if the taxpayer either has disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

Contributions to capital: Under current law, contributions by shareholders and, in certain specified cases, nonshareholders of money and other property to the capital of a corporation (a transferee corporation) – that is, transfers without an issuance of stock by the corporation as consideration – are not included in the gross income of the transferee corporation under section 118. To the extent stock is issued by the transferee corporation, no gain or loss is recognized under section 1032(a).

The TCJA would repeal the exclusion from gross income under section 118 for the transferee corporation with the contribution included under proposed section 76(a) in the gross income of that corporation.

An exception is provided under section 76(b) to the extent that the transferee corporation issues stock in an amount equal to the amount of money or the fair market value of the property transferred and no gain or loss is recognized upon the issuance of such stock.

Conforming changes would be made to the following code provisions:

- Sections 362(a)(2) and section 362(c), governing basis in money and other property contributed as a contribution to capital, to reflect proposed sections 76(a) and (b); and
- Section 108(e)(6), which currently governs the determination of cancellation of indebtedness (COD) income on the contribution of debt to the capital of the debtor corporation, would be repealed. Note that section 108(e)(6) can limit the potential for COD income by treating the debtor corporation as retiring debt for an amount equal to creditor's basis in the debt.

The foregoing proposed amendments do not specify whether and how they may apply to contributions to capital that historically would have qualified for nonrecognition treatment under section 351 or similar nonrecognition provisions under subchapter C of the Code without an actual issuance of stock by the transferee corporation. Under current law, for example, contributions to the capital of a wholly owned corporation generally qualify for nonrecognition treatment to both the transferor and the transferee, regardless of whether the transferee corporation issues stock to the transferor. It is unclear whether proposed section 76 was intended to override this longstanding treatment; if it did, the need for a valuation on stock issued that would otherwise be meaningless to issue may be very burdensome.

Finally, The TCJA would extend treatment under proposed section 76 to other types of transferee entities (for example, partnerships), with gross income including any contribution to the capital of any such entity under section

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76(a), and the exception under section 76(b) when interests are issued applying under rules similar to the rules applicable to corporations.

These amendments would be effective and apply to contributions made, and transactions entered into, after the date of the enactment.

Lobbying expenses: The TCJA would repeal the deduction for local lobbying expenses, which includes lobbying before an Indian tribal government, which is currently provided under current-law sections 162(e)(2) and (7). Currently, 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 bill would repeal the deduction for domestic production activities under IRC section 199, effective for tax years beginning after 2017. A separate provision (bill section 4401) provides that the section 199 deduction would be available retroactively for domestic production gross receipts from Puerto Rico for the tax years beginning after December 31, 2016 and before January 1, 2018.

Entertainment and similar expenses: Under the proposal, no deduction would be allowed for entertainment, amusement or recreation activities, facilities, or membership dues. Additionally, no deduction would be allowed for transportation fringe benefits, including benefits in the form of on-premises gyms and other athletic facilities, or for amenities provided to an employee that are primarily personal in nature and that involve property or services not directly related to the employer's trade or business, except to the extent that those benefits are treated as taxable compensation to an employee (or includible in gross income of a recipient who is not an employee). The 50-percent limitation under current law would apply only to expenses for food or beverages and to qualifying business meals, with no deduction allowed for other entertainment expenses. In addition, no deduction would be allowed for reimbursed entertainment expenses paid as part of a reimbursement arrangement that involves a tax-indifferent party (for example, a foreign person or tax-exempt entity). The provision would be effective for amounts paid or incurred after 2017.

Unrelated taxable business income increased by certain fringe benefits: Tax-exempt entities would be taxed on the value of providing their employees with transportation fringe benefits, and on-premises gyms and other athletic facilities, by treating the funds used to pay for such benefits as unrelated business taxable income. As a result, the value of those employee benefits would be subject to a tax equal to the corporate tax rate. The provision would be effective for amounts paid or incurred after 2017.

Treatment of self-created property: The bill would exclude patents, inventions, models or designs, or secret formulas or processes as qualifying as a capital asset under section 1221. Under current law, these items are treated as capital assets. As a result of this proposal, the gain or loss from the sale of a self-created patent, invention, model or design, or secret formula or process would be ordinary in character. The proposal also repeals the election to treat musical compositions and copyrights in musical works as a capital asset. This provision is effective for disposition of such property after 2017.

Sale or exchange of patents: The TCJA would repeal a provision in section 1235 that treats any gains from the transfer of a patent from its creator to an unrelated individual as long-term capital gain. Therefore, these transfers would no longer automatically qualify as an exchange of a capital asset. This provision would be effective for dispositions occurring after 2017.

Business credits

The TCJA similarly would repeal or otherwise limit a number of business credits available under current law.

Clinical testing expenses: The bill would repeal the credit applicable to drug manufacturers who incur qualified clinical testing expenses under section 45C. This provision would be effective for tax years beginning after December 31, 2017.

Employer-provided child care: The measure would repeal the employer-provided child care credit under section 45F. Currently, employers can claim a credit equal to 25 percent of qualified expenses for employee child care, and 10 percent of qualified expenses for child care resource and referral services. This provision would be effective for tax years beginning after December 31, 2017.

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Historic building rehabilitation credit: The bill would repeal the rehabilitation credit under section 47 for the restoration of old and historic buildings. Under a transition rule, the credit would continue to apply to qualified expenditures incurred through the end of a 24-month period, which is required to begin within 180 days after January 1, 2018.

Work opportunity tax credit: The bill would repeal the work opportunity tax credit under section 51, which permits an employer to claim a credit of up to 40 percent of qualified first-year wages of employees belonging to certain target groups. The repeal would be effective for wages paid or incurred to individuals who begin work after December 31, 2017.

Unused business credits: The bill would repeal the deduction for certain unused business credits under section 196. Under current law, taxpayers may carry unused business credits back one year and forward 20 years. The repeal of this provision would be effective for tax years beginning after December 31, 2017.

New markets tax credit: The bill provides that no additional new markets tax credits would be allocated after December 31, 2017; however, any credits that have already been allocated may be used over the course of up to seven years. New markets tax credits under section 45D are currently available for certain taxpayers who invest in qualified community development entities, which generally serve low-income communities and individuals.

Expenditures to provide access to disabled individuals: The bill would repeal the credit under section 44 for expenditures by certain small business taxpayers to provide access to disabled individuals, effective for tax years beginning after December 31, 2017.

Employer Social Security taxes on employee cash tips: The bill would modify section 45B to reflect the current minimum wage and add a new reporting requirement for all restaurants claiming the credit for the portion of employer social security taxes paid with respect to employee cash tips. This provision would be effective for tips received for services performed after December 31, 2017.

Energy credits

The TCJA also proposes to repeal or modify a number of current-law energy credits.

Production tax credit: The bill would maintain the scheduled phase-out of the production tax credit (PTC) in section 45, but would repeal the inflation adjustment to the base amount of the PTC, effective for projects that begin construction on or after the date of enactment. Thus, the proposal would permanently reduce the maximum PTC rate from the current inflation-adjusted 2.4 per kilowatt-hour to 1.5 cents, with no inflation adjustment going forward. The proposal also specifies that construction may not be treated as beginning before any date unless there is a continuous program of construction which begins by such date and ends on the date the property is placed in service.

Solar investment tax credit: The bill would maintain the scheduled phase-down of the solar investment tax credit (ITC) in section 48, but repeal the permanent 10 percent ITC for property the construction of which begins after 2027. This provision also would extend previously expired “orphaned” energy tax credits and seeks to harmonize the expiration dates and phase-down schedules for these credits based on the current beginning-of-construction rules applicable to solar electric generation property. The proposal provides that the 30 percent ITC for solar energy, fiber-optic solar energy, qualified fuel cell, and qualified small wind energy property would be available for property the construction of which begins before 2020 and is then phased down for property the construction of which begins before 2022, with no ITC available for property the construction of which begins after 2021. Additionally, the 10 percent ITC for qualified microturbine, combined heat and power system, and thermal energy property is made available for property the construction of which begins before 2022. Finally, the permanent 10 percent ITC available for solar energy and geothermal energy property would be eliminated for property the construction of which begins after 2027.

Credit for residential energy-efficient property: The bill would extend the IRC section 25D credit for residential energy-efficient property for all qualified solar, geothermal, small wind, and fuel cell property placed in service prior to 2022, subject to a reduced rate of 26 percent for property placed in service during 2020 and 22 percent for property placed in service during 2021. This provision would be effective for property placed in service after December 31, 2016.

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Oil recovery credit: The bill would repeal the current-law credit of up to 15 percent of qualifying enhanced oil recovery available under section 43. This provision would be effective for tax years beginning after December 31, 2017.

Credit for oil and gas production from marginal wells: The bill would repeal the credit under section 45I for producing oil and gas from marginal wells. Under current law, oil and gas producers may claim a $3 per barrel credit for the production of crude oil and a 50-cent per 1,000 cubic feet credit for the production of qualified natural gas. This provision would be effective for tax years beginning after December 31, 2017.

Credit for production from advanced nuclear power facilities: The bill would provide a credit allocation process for the credits for electricity produced at qualifying advanced nuclear power plants (section 45J). The proposal provides that beginning after January 1, 2021, the Secretary shall reallocate any national megawatt capacity that remains unused under the cap, first to qualifying facilities to the extent such facilities do not receive an allocation equal to their full capacity, and then to facilities placed in service after such date. The bill also would add a new credit transfer provision with respect to certain public utilities. Under the proposal, certain public entities would be eligible for an election to transfer advanced nuclear production tax credits to specified project participants. This provision would be effective for tax years beginning after the date of enactment.

Credit for plug-in electric vehicles: The bill would repeal the credit for new qualified plug-in electric drive motor vehicles under section 30D, effective for vehicles placed in service in taxable years beginning after December 31, 2017.

Territoriality

One of the TCJA's key reforms for businesses is a transition from the current worldwide regime to a territorial system for taxing foreign-source income of US multinationals – a change intended to make US businesses more competitive on a global playing field.

Dividends received deduction: Under the provision, any US corporation that is a US shareholder of a foreign corporation (other than passive foreign investment companies that are not controlled foreign corporations) ("10-percent-owned foreign corporation") shall be entitled to a 100 percent dividends received deduction on the foreign-source portion of any dividends paid by the foreign corporation. Special rules are provided for distributions of earnings and profits attributable to pre-87 layers. No foreign tax credit is allowed for any dividend with respect to which the dividends received deduction applies and such dividend is not treated as foreign-source income for purposes of the general foreign tax credit limitation. In addition, consistent with this provision, section 956 is repealed with respect to US corporations that are US shareholders of such foreign corporations.

It is important to note that this provision only applies to entities classified as corporations for US federal income tax purposes, and does not treat foreign business operations as foreign corporations for which the deferral of their earnings would be available. However, special rules have been added to increase the recapture of foreign losses attributable to foreign branch operations transferred to 10-percent-owned foreign corporations.

Limitation on losses with respect to 10-percent-owned foreign corporations: Under this provision, 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.

Deemed repatriation of deferred foreign income upon transition to territoriality: A US shareholder owning at least 10 percent of a foreign subsidiary would generally include in income, in its year in which the subsidiary's last tax year beginning before 2018 ends, the shareholder's pro rata share of the accumulated post-1986 deferred foreign income of the foreign subsidiary, net of the shareholder's share of deficits of other foreign subsidiaries allocated to the first foreign subsidiary. The amount of such deferred income generally takes into account earnings and profits as of November 2, 2017, or December 31, 2017 (whichever is higher), without diminution by reason of dividends distributed in the year that includes such date. The netting of earnings and deficits takes into account the US shareholder's earnings and profits deficits of foreign subsidiaries of the US shareholder or members of the US shareholder's affiliated group.

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The US shareholder can claim a deduction against this inclusion, sufficient to reduce the resulting US tax to 12 percent of the inclusion (to the extent of the shareholder's shares of its subsidiaries' "cash positions") and to 5 percent for the remainder of the inclusion.

The transition tax can potentially be offset by a proportionate share of the foreign taxes deemed paid upon the inclusions, and by the full amount of the US shareholder's pre-existing foreign tax credit carryforwards (if any). The inclusion would not trigger overall foreign loss recapture. At the election of the US shareholder, the tax liability would be payable over a period of up to eight years, in equal annual installments of 12.5 percent of the total tax liability due. Special rules apply with respect to S corporations and their shareholders.

Base erosion provisions

In conjunction with the shift to a territorial tax system, the TCJA also includes several provisions intended to prevent erosion of the US tax base.

High returns of foreign subsidiaries: Under the bill, a US parent of one or more foreign subsidiaries is subject to current US tax on 50 percent of the US parent's foreign "high returns." Foreign high returns are generally based on the excess of the US parent's foreign subsidiaries' aggregate net income (net of the items listed below) over a routine return (7 percent plus the federal short-term rate) on the relevant portions of the foreign subsidiaries' aggregate adjusted bases in their depreciable tangible property, adjusted downward for interest expense. For this purpose, income excludes income effectively connected with a US trade or business, subpart F income, insurance and financing income that meets the requirements for the active finance exception (AFE) or high-tax exception from subpart F income, income from the disposition of commodities produced or extracted by the taxpayer, and certain related-party payments. As in the case of subpart F income, the US parent is taxed on foreign high returns each year, regardless of whether those earnings are repatriated to the United States.

Inclusions of foreign high returns trigger deemed payments, by the US parent, of the subsidiaries' foreign income taxes. However, the taxes will be deemed paid only to the extent of 80 percent of the relevant portion of the controlled foreign corporation's foreign income taxes. Credits for these deemed-paid taxes would not be allowed against US tax imposed on other foreign-source income (that is, such foreign tax credits would only be allowed to offset US tax on foreign high return inclusions), and are not be allowed to be carried back or forward to other tax years.

Limitation on interest deductibility: The TCJA rewrites section 163(j), making it a rule that limits the deduction for the "business interest" expense of every taxpayer, corporate or otherwise, to the amount of the taxpayer's business interest income plus 30 percent of businesses adjusted taxable income. Any deductions disallowed could be carried forward for only five years. This provision does not apply to a business with average gross receipts of $25 million or less, or to certain regulated utilities and real property trades or businesses. (See the section on corporate tax issues elsewhere in this report for additional discussion.)

Interest paid by a domestic corporation that is a member of an international financial reporting group: Under the provision, interest deductions of a US corporation that is a member of an international financial reporting group are generally limited to 110 percent of the US corporation's proportionate share of the group's reported net interest expense, where the proportion is based on the ratio of US corporation's earnings before interest, taxes, depreciation, and amortization (EBITDA) to the group's EBITDA. This limitation applies in addition to the general rules for disallowance of interest expense elsewhere in the code and taxpayers would be disallowed interest deductions pursuant to whichever provision denies a greater amount of interest deductions. Any disallowed interest expense can be carried forward for up to five tax years, with carryforwards exhausted on a first in, first out basis.

An international financial reporting group is a group of entities that includes at least one foreign corporation engaged in a trade or business in the United States, or at least one domestic corporation and one foreign corporation; prepares consolidated financial statements; and has annual global gross receipts of more than $100 million.

Excise tax on payments to related foreign corporations: Under the provision, payments (other than interest) made by a US corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset are subject to a 20 percent excise tax, unless the related foreign corporation elects to treat the payments as income effectively connected with the conduct of a US trade or business. Consequently, the foreign corporation's net profits (or gross receipts if no election is made) with respect to

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those payments would be subject to full US tax. Exceptions would apply for intercompany services which a US company elects to pay for at cost (that is, no markup) and certain commodities transactions. To determine the net taxable income that is to be deemed effectively connected income, the foreign corporation's deductions attributable to these payments would be determined by reference to the profit margins reported on the group's consolidated financial statements for the relevant product line. In addition, no credit is allowed for foreign taxes paid with respect to the profits subject to US tax. Further, in the event no election is made, no deduction would be allowed for the US corporation's excise tax liability.

Information reporting requirements for payments subject to section 882(g)(1): The TCJA would impose new information reporting requirements relating to payments that are subject to section 882(g)(1). The bill would amend section 6038C to require reporting by foreign corporations receiving amounts that are subject to section 882(g)(1) and introduces section 6038E, Information With Respect to Certain Payments from Domestic Corporations to Related Foreign Corporations, which would require an information return by domestic corporations accruing or paying amounts that are subject to section 882(g)(1). Both provisions would require disclosure of specified information including identifying information of certain members of the international financial reporting group, amounts, and related product line information. These provision would be effective for amounts paid or accrued after December 31, 2018.

Other modifications

Foreign tax credit provisions: No foreign tax credit or deduction is allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend to which the dividend received deduction of the bill would apply.

However, a foreign tax credit would be allowed for any subpart F income that is included in the income of the US shareholder on a current-year basis. This foreign tax credit is computed without regard to pools of foreign unrepatriated earnings.

In addition, the source of income from the sale of inventory property produced within and sold outside the United States (or vice versa) would be allocated and apportioned between sources within and outside the United States solely on the basis of the production activities with respect to the inventory.

Subpart F provisions: The measure proposes several changes to the subpart F rules.

- The inclusion required based on a withdrawal of previously excluded foreign shipping income would be repealed.
- The provision requiring inclusion of foreign base company oil related income would be repealed.
- The *de minimis* exception to subpart F on a going forward basis would be indexed for inflation.
- Section 954(c)(6) ("the look through rule for payments between related controlled foreign corporations") would be made permanent.
- The stock attribution provisions would be modified to allow a US corporation to be treated as holding stock held by its foreign shareholders.
- The requirement that a corporation be a controlled foreign corporation for at least 30 days in order for a US shareholder to have a subpart F inclusion would be removed.

Provisions related to possessions of the United States: Proposals in this area include:

- **Extension of deduction allowable with respect to income attributable to domestic production activities in Puerto Rico:** Under the provision, eligibility of domestic gross receipts from Puerto Rico for the domestic production deduction would apply retroactively to tax years beginning after December 31, 2016 and before January 1, 2018.
- **Extension of temporary increase in limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands:** The $13.25 per proof gallon excise tax cover-over amount paid to the treasuries of Puerto Rico and the US Virgin Islands would apply retroactively to include imports after December 31, 2016, and be extended to rum imported into the United States before January 1, 2023.
- **Extension of American Samoa economic development credit:** The credit for taxpayers currently operating in American Samoa would retroactively apply to tax years beginning after December 31, 2016, and be extended to tax years beginning before January 1, 2023.

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Limitation on treaty benefits for certain deductible payments: Under the provision, if a payment of FDAP income is deductible in the United States and the payment is made by an entity that is controlled by a foreign parent to another entity in a tax treaty jurisdiction that is controlled by the same foreign parent, then the statutory 30-percent withholding tax on such income would not be reduced by any treaty unless the withholding tax would be reduced by a treaty if the payment were made directly to the foreign parent. The provision would be effective for payments made after the date of enactment. (Note that on November 3, Chairman Brady released a "Chairman's Mark" of modifications to the bill; that mark deletes this provision, reducing the likelihood of it passing.)

Restriction on insurance business exception to passive foreign investment company rules: The PFIC exception for insurance companies would be amended to apply only if the foreign corporation would be taxed as an insurance company were it a US corporation and if loss and loss adjustment expenses, unearned premiums, and certain reserves constitute more than 25 percent of the foreign corporation's total assets – or 10 percent if the corporation is predominantly engaged in an insurance business and the reason for the percentage falling below 25 is solely due to temporary circumstances. (See the section on insurance company taxation elsewhere in this report for additional discussion.)

Passthrough provisions

The TCJA aims to provide tax relief to small businesses by revamping the rules governing passthrough entities – including a substantial rate cut. But it also includes "guardrails" intended to prevent wealthy passthrough owners from reclassifying wage income as more lightly taxed business income. These provisions generally would apply to taxable years beginning after December 31, 2017.

25 percent rate: Under current law, businesses organized as sole proprietorships, partnerships, limited liability companies, and S corporations are generally treated for federal income tax purposes as "passthrough" entities subject to tax at the individual owner, partner, or shareholder level rather than the entity level. Net income earned by individual owners, partners, or shareholders of these entities is reported on their individual income tax returns and is subject to ordinary income tax rates, up to the top individual marginal rate of 39.6 percent.

Under the provision, a portion of net business income allocated by a passthrough entity to an individual owner, partner, or shareholder may be treated as "qualified business income" subject to a maximum rate of 25 percent, instead of ordinary individual income tax rates. The remaining portion of business income would be treated as compensation and continue to be subject to ordinary individual income tax rates. The provision also would apply a maximum 25 percent rate on certain dividends from a real estate investment trust (REIT) and patronage dividends from cooperatives.

The provision relates to the income rates applicable to individual owners. It does not apply to income earned by or allocated to corporations, such as a corporation's distributive share of income from a partnership.

Net business income or loss is determined with respect to any business activity by appropriately netting items of income, gain, deduction, and loss with respect to that business activity. Wages, payments described in section 707(a), guaranteed payments for services under section 707(c), and directors' fees that are properly attributable to any business activity are treated as items of income with respect to that business activity.

Income subject to preferential rates, such as net capital gains and qualified dividend income, would be excluded from business income and would retain its character. Certain other investment income that is subject to ordinary rates, such as short-term capital gains, dividends, and foreign currency gains and hedges not related to the business needs, also would not be business income. Interest income properly allocable to a trade or business would be eligible to be treated as business income.

Passive vs. active business activity: The determination of whether an owner, partner, or shareholder is active or passive with respect to a particular business activity would rely on current law material participation and activity rules within regulations governing the limitation on passive activity losses under section 469. Under these rules, the determination of whether an owner, partner, or shareholder is active generally is based on the number of hours the person spends each year participating in the activities of the business.

Net income derived from a *passive* business activity would be treated entirely as qualified business income and fully eligible for the 25-percent maximum rate. An owner, partner, or shareholder receiving net income derived from an

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active business activity (including any wages received) would determine how much of that income is qualified business income by reference to the “capital percentage” of the net income from that activity.

Capital percentage: Subject to exceptions for certain service activities noted below, owners, partners, or shareholders generally may apply a capital percentage of 30 percent to the net income derived from active business activities to determine the portion of that income that is eligible for the 25 percent rate. This determination would leave the remaining 70 percent subject to ordinary individual income tax rates.

Alternatively, owners, partners, or shareholders may elect to apply a formula based on the capital investments of their business to determine a capital percentage of greater than 30 percent. That formula generally would measure the capital percentage based on the amount by which a prescribed rate of return exceeds the interest which is paid or accrued, and for which a deduction is allowed, with respect to that activity for each taxable year. The prescribed rate of return would equal a deemed rate of return (the federal short-term rate plus 7 percentage points) multiplied by the capital investments of the business. For this purpose, the capital investments of the business generally equal the taxpayer’s adjusted basis of the property used in connection with the business as of the end of the taxable year (determined without regard to sections 168(k) and 179). Once made, the election of the alternative formula would be binding for five taxable years.

The default capital percentage for specified service activities (for example, businesses involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services) would be zero. As a result, a taxpayer that actively participates in one of these businesses generally would not be eligible for the 25 percent rate on income with respect to that business. However, in some cases the provision would allow owners, partners, or shareholders of capital-intensive specified service activities businesses to elect to use an alternative capital percentage based on the business’s capital investments.

A special rule included in the provision would limit the capital percentage in certain cases involving payments to the individual for services provided to the relevant activity by that individual.

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 must make new elections for various accounting methods, depreciation lives, and other purposes.

The TCJA would repeal the technical termination rule. Thus, a partnership would be treated as continuing even if more than 50 percent 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.

Insurance company provisions

The TCJA includes 10 proposals that are expressly applicable to insurance companies. In addition to these, two provisions related to the bill’s proposed overhaul of the US international tax regime – addressing the business exception to passive foreign investment company rules and the excise tax on payments from domestic corporations to related foreign corporations – may be particularly relevant for insurers.

A number of these proposals were included in similar form in the comprehensive tax reform bill introduced in 2014 by then-Ways and Means Committee Chairman Dave Camp, R-Mich., and do not come as a surprise to many in the industry. A few of the proposals would appear to simplify the insurance provisions of the code, while the logic of others is sometimes less apparent.

General corporate NOL Carryback and carryover periods would apply to life insurers: The bill would put life insurance companies on the general section 172 net operating loss rules for operations loss carrybacks (zero years under the bill) and operations loss carryovers (indefinite under the bill). The proposal would eliminate current sections

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810 and 844, which (1) allow life insurers three-year carryback and 15-year carryforward periods for operations losses (section 810) and (2) provide a special rule for insurance companies which move from life to nonlife insurance company status or vice-versa (section 844).

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.

This provision is consistent with the goal of simplification as it eliminates two code sections; on the other hand, the current loss carryover and carryback periods for life insurers, when enacted, were thought to be appropriately tailored to the long-term nature of the life industry's obligations.

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 insurance company deduction would no longer be available starting in taxable years beginning after December 31, 2017.

This provision was included in the 2014 Camp proposal. It is consistent with the goal of simplification, as it eliminates a code section that provides "special" treatment to a subset of all life insurance companies.

Life insurance reserves based on statutory reserves with "haircut": The bill would eliminate the federally prescribed reserve computation of life insurance reserves for tax purposes and instead base tax reserves on a flat percentage (76.5 percent) of statutory reserves for future unaccrued claims – that is, with a 23.5 percent "haircut."

Proposed section 807(e) would prescribe the computation of reserves for future unaccrued claims as follows: (1) life insurance reserves as defined in section 816(b) determined in accordance with the method prescribed by the National Association of Insurance Commissioners (NAIC) and reported by the taxpayer on its NAIC annual statement for the calendar year/taxable year, plus (2) unpaid losses included in total reserves under section 816(c)(2), and (3) the amount of reserves solely for claims with respect to insurance risks which are determined in accordance with the method prescribed by the NAIC and reported by the life insurance company on its NAIC annual statement for the calendar year/taxable year. The bill would exclude asset adequacy reserves, contingency reserves, unearned premium reserves, or "any other amount not constituting reserves for future unaccrued claims as provided in guidance by the Secretary [of the Treasury]."

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 proposal as written may eliminate the need for IRS guidance on how principles-based reserves (PBR) would be handled.

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, which was included in the 2014 Camp bill, would be effective for taxable years beginning after December 31, 2017. It may be seen as consistent with the goal of simplification and of minimizing special rules for different types of taxpayers.

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Modification of life company DRD proration rules: The bill would modify the life company proration rules by defining the "company's share" as a flat 40 percent, and defining the "policyholder's share" as 60 percent for purposes of the dividends-received deduction (DRD) and tax-exempt interest income.

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

A proposal to change the proration rules was included in the 2014 Camp bill. This provision differs from the previous proposal in that is prescribes flat percentages for the company's share and policyholders' share rather than looking to a net investment income computation.

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.

This provision is not expected to impact many insurers.

Modification of proration rules for property-casualty insurance companies: The bill would increase the proration percentage for property and casualty companies to 26.25 percent. Proration is a reduction of the exclusion for tax-exempt interest and the deduction for dividends received (DRD), other than for the 100 percent DRD, by a specified percentage. The proration percentage under current section 832(b)(5)(B) is 15 percent.

This provision would be effective for taxable years beginning after December 31, 2017. A proposal to increase the P&C proration rate was included in the 2014 Camp bill.

This amendment would increase the unfavorable permanent book-to-tax differences.

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 determined on the basis of the corporate bond yield curve as defined in section 430(h)(2)(D)(i).

Under the proposed transition rule, the difference between the January 1, 2018, loss reserve under current law and the proposed law would be spread into income over eight years beginning in 2018.

The property-casualty loss reserves proposal also would extend the number of years to which different lines of business are discounted. Three-year loss payment pattern lines of business would use the average payment pattern from years 1 and 2 and apply it to subsequent years up to a maximum of year 18. For lines of business subject to a 10-year loss payment pattern, the average payment pattern from the seventh, eighth, and ninth accident year would be used for the tenth and subsequent years up until the twenty-fifth year.

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.

A proposal to increase the property-casualty loss reserve discount rate was included in the 2014 Camp bill.

This proposal is expected to reduce deductible unpaid loss reserves (and increase taxable income) of property and casualty insurers.

Repeal of special estimated tax payments: The bill would repeal section 847, which provides for special estimated tax payments. No detail is provided with respect to transition rules for previous estimated tax payments.

Increase DAC capitalization rates: The bill would reduce the number of categories of "specified insurance contracts" from three (annuity, group life, other) to two (group and other), and increase the applicable capitalization rates for specified insurance contracts under section 848 (the so-called DAC rules). The proposed DAC capitalization rates would be 4 percent for premiums on group contracts, and 11 percent for premiums on all other specified insurance contracts, as compared to the current rates of 1.75 percent for annuities, 2.05 percent for group life

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contracts, and 7.7 percent for other specified insurance contracts. This would constitute a substantial increase in capitalized policy acquisition expenses.

Restrict insurance business exception to passive foreign investment company (PFIC) rules: The bill would amend the active insurance exception in the PFIC rules such that the exception would be 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 (or 10 percent if the foreign corporation is predominantly engaged in an insurance business and the reason for the percentage falling below 25 is solely due to runoff-related or rating-related circumstances involving such insurance business).

As relevant to insurers and reinsurers, section 1297(b)(2)(B) currently provides an exception from the definition of passive income for income "derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation" (the "active insurance exception"). In effect, the active insurance exception functions to remove the income generated by the assets of an insurer or a reinsurer from the definition of passive income for purposes of section 1297(a), such that those assets are not treated as producing passive income or as held for the production of passive income such that the insurance company can avoid PFIC status.

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

In view of the proposed thresholds for qualification for the active insurance exception, the proposed amendment could have significant ramifications for certain foreign insurers and reinsurers that predominantly write or reinsure coverages with respect to catastrophic or other high-severity, but low-frequency, risks.

Excise tax on payments from domestic corporations to related foreign corporations: The bill would impose a 20 percent excise tax (new section 4491) on certain payments ("specified amounts") from a US corporation to a foreign corporation that is in the same "international financial reporting group" as the US corporation. The US payer would be responsible for paying this nondeductible tax, but there would be joint and several liability for the excise tax for all group members. "Specified amounts" include payments that are deductible, includible in cost of goods sold, inventory, or includible in the basis of a depreciable or amortizable asset.

The excise tax would not apply to payments of interest, certain payments under section 475, and certain payments subject to the services cost method in section 482, or if the income is effectively connected income (ECI). An election into ECI would be available.

The proposal would impose a new reporting requirement for payments of specified amounts. The proposed new excise tax would apply to amounts paid or accrued after December 31, 2018.

This new excise tax, by its terms, could potentially encompass payments of insurance or reinsurance premiums, which themselves may already be subject to some excise tax under section 4371 (which is not being repealed in the TCJA).

Small business provisions

Section 179 expensing: The TCJA would increase and expand the election to expense section 179 property by increasing the deduction limitation threshold from $500,000 to $5 million. It also would increase the phase-out from $2 million to $20 million. Thus, under the proposal, the section 179 expense deduction does not begin to phase out until the taxpayer places in service more than $20 million of section 179 property in the given year. These increased thresholds are effective for taxable years beginning in 2018.

Additionally, the provision expands to include as section 179 property certain energy efficient heating and air-condition property.

Accounting methods: The bill would expand the use of the cash method of accounting for small and mid-size corporations. Currently, section 448 provides that C corporations and partnerships with C corporations as a partner can use the cash method of accounting only if their average gross receipts do not exceed $5 million. The bill would

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increase this threshold amount to $25 million, indexed to inflation. This $25 million threshold equally applies to certain farming corporations.

Taxpayers (other than a tax shelter) who meet the $25 million threshold also would be permitted to use the cash method of accounting and account for inventories as nonincidental material and supplies under section 162, or in accordance with the method of accounting reflected on the financial statement. Furthermore, taxpayers that satisfy this increased gross receipts threshold also would be exempt from the Uniform Capitalization (UNICAP) rules under section 263A.

The TCJA also would increase the threshold for taxpayers who are exempt from the percentage-of-completion method of accounting under section 460 from $10 million average gross receipts to $25 million. These exempt taxpayers therefore would be permitted to use the completed-contract method of accounting.

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

Exemption from limitation on business interest deduction: Businesses with average gross receipts of $25 million or less would be exempted from the TCJA's proposed interest limitation rules. Thus, the proposal would preserve the business interest expense deduction for small taxpayers.

Ordinary income tax rates for individuals

Although the TCJA reduces the total number of tax brackets from seven to four, it does so while also retaining the 20 percent tax special 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-Hospital Insurance tax rate on certain levels of earned income, while also introducing a new 25 percent special rate for business passthrough income.

As illustrated in this chart, the TCJA makes significant changes to the income thresholds applicable to each tax bracket. The interaction of these various rate structures is not simple.
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/171103_1suppA.pdf

For example, ignoring the special rates for income classes, the 35 percent bracket for a married taxpayer filing jointly taxpayer begins with $260,000 of taxable income under the TCJA, whereas under current law for 2018 that taxable income amount would place that taxpayer in the 33 percent bracket. Another example would be that the 39.6 percent bracket begins at $480,050 for that same taxpayer in 2018 under current law, but begins at $1 million of taxable income under the TCJA.

Note that high income taxpayers will be required to recapture the benefits of the lower 12 percent bracket. This will cause married individuals filing jointly with adjusted gross income (AGI) in excess of $1.2 million ($1 million for single filers) to begin to lose the benefit of the 12 percent income tax rate bracket. This increased liability will not exceed 27.6 percent (the highest rate bracket of 39.6 percent less the 12 percent bracket) of the lesser of:

- The taxpayer's taxable income, or
- $90,000 ($45,000 for single filers).

For certain passthrough "business" income from partnerships, LLCs and S Corporations, the TCJA provides for a reduced rate of 25 percent, but also imposes rules that limit passthrough owners of these from converting compensation income subject to ordinary income tax rates up to 39.6 percent (or more) into preferential business income taxed at the lower rate of 25 percent. (What constitutes business income and how the anti-abuse "guardrails" would operate is discussed at length at elsewhere in this report.)

For taxpayers in the 39.6 percent bracket, particularly those with passthrough income, with the 2018 proposed rate structure taxing more income at lower rates than under current law, there is an incentive to analyze whether income deferral into 2018 should be considered. Additionally, such taxpayers should further analyze whether deductible expenses should be accelerated into 2017 to potentially offset income being taxed at higher rates or simply not being available for deduction in 2018 (as discussed below).

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Although there would be certain changes to existing law, the TCJA continues to allow taxpayers to deduct from their earned income contributions to qualified retirement savings vehicles such as 401(k) plans and Individual Retirement Accounts. As a general rule, such income is only taxed when distributed from the account.

Itemized deductions and personal exemptions

The TCJA proposes significant changes with respect to an individual's adjustments to income, itemized deductions, and personal exemptions. First, by nearly doubling the standard deduction, many individuals would no longer need to itemize their deductions. However, for those individuals who would still itemize, this chart summarizes how the items affected by the TCJA compare to current law.
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/171103_1suppB.pdf

The TCJA proposes a reduced benefit for mortgage interest deduction for newly acquired homes. Specifically, it would limit the deduction to interest on new loans of up to $500,000 on the taxpayer's principal residence. Existing mortgages would remain subject to current law, which limits the deduction to interest on loans up to $1 million. Refinancing of a debt on a current home would still be subject to the $1 million limitation so long as the refinanced indebtedness does not exceed the principal amount of the refinanced debt. The TCJA would repeal the deduction for interest on home equity indebtedness incurred after the effective date of November 2, 2017.

For taxpayers with total itemized deduction in excess of the increased standard deductions, the itemized deduction for charitable contributions would be retained and the AGI limit for gifts of cash to public charities would be increased from 50 percent to 60 percent. Taxpayers possibly affected by this change should consider analyzing whether it is advantageous to accelerate their charitable giving into 2017 or to defer it until next year. A number of considerations go into this type of an analysis, such as understanding what income will be offset by the deduction and the need to consider the impact related to the phase-out of itemized deductions under current law. Currently, the amount of certain otherwise allowable itemized deductions of a high-income taxpayer, including charitable contributions, is subject to this itemized deduction phase-out. This limitation provision would be repealed as part of the TCJA.

With the potential repeal of medical and dental expenses, state and local income taxes, domestic property taxes greater than $10,000 (which is not indexed for inflation annually), personal casualty losses, and nearly all miscellaneous itemized deductions such as tax preparation expenses, moving expenses, and unreimbursed employee business expenses, a taxpayer should analyze whether a benefit would be realized by paying those expenses prior to year-end 2017 as they would no longer be deductible under the TCJA if enacted. However, since many of these deductions are not available under the current alternative minimum tax, its applicability in 2017 is an important consideration in that planning.

Finally, the TCJA proposes repeal of the deduction for personal exemptions. Current law allows a personal exemption of $4,050 for the taxpayer, taxpayer's spouse, and each of the taxpayer's dependents. The TCJA would consolidate this exemption into a larger standard deduction and an expanded child tax credit and a new family tax credit, both of which are discussed more fully below.

Other individual provisions and items to note

AMT: The alternative minimum tax (AMT), which has created much complexity for individual filers, would be repealed under the TCJA. The complexity created by the AMT was a result of requiring a taxpayer to calculate his or her tax liability under an entirely different tax system, with different rules and tax rates, and then compare the tax liability under the AMT to the regular tax liability. Ultimately, a taxpayer is required to pay the higher of the two liabilities.

With the potential repeal of the AMT system, individual return preparation would become simpler. An individual would need to carefully model the implications of the repeal of the AMT to understand how this might affect tax liabilities in 2017 and beyond. Consideration should be given to AMT credit carryforwards as well. Taxpayers would be able to claim a refund of 50 percent of the remaining AMT credits (to the extent the credits exceed regular tax for the year) in tax years 2019-2021 and would be able to claim a refund of all remaining credits in the tax year beginning in 2022. An individual who does not anticipate being in AMT in 2017 would typically benefit from prepaying prior to year-end certain expenses, like state income taxes, that would not be deductible for AMT purposes. This analysis becomes even more important with the potential for not receiving a deduction for state and local income taxes under the proposal.

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Exclusion of gain from sale of principal residence: The proposal retains the opportunity for married taxpayers filing jointly to exclude up to $500,000 ($250,000 for other taxpayers) of gain from the sale of their primary residence. However, this benefit would be phased out by $1 for every dollar by which the taxpayer's adjusted gross income exceeds $500,000 ($250,000 for single filers). Additionally, whereas current law requires the home be used as the taxpayer's principal residence for two out of the previous five years, the TCJA changes this to five out of the previous eight years, and, an individual would only be allowed to use this exclusion once every five years.

The TCJA also proposes the repeal of the:

- Tax credit for adoption,
- Rehabilitation credit for historic buildings,
- Additional standard deduction for the elderly, and
- The deduction for alimony payments (but at the same time the TCJA no longer treats the receipt of alimony payments as income).

Child credit: Under current law an individual may claim, subject to AGI limitations, a tax credit for each qualifying child of $1,000. Based on the text of the TCJA, this credit would increase to $1,600 but be reduced to $300 for any dependent who is not a qualifying child. This credit is subject to phase-out based on modified AGI. The proposed law would be effective for taxable years ending before January 1, 2023.

Estate and gift tax provisions

Under the provisions of the House bill the existing transfer tax architecture (the estate, gift and generation-skipping transfer taxes) would be retained through December 31, 2023, with one modification: 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 generation-skipping transfer tax (GST) exemption (the amount that may be transferred to skip-persons outright or in trust without giving rise to a present or future GST tax) would be increased to $10 million from its existing $5.6 million for transfers occurring after December 31, 2017. Although not entirely clear from the text, the $10 million threshold appears not be indexed for inflation.

For income tax purposes, the adjustment of basis to the fair market value of inherited property on the date of death would continue as under current law.

The following changes to the estate tax regime would take effect beginning in 2024:

- **Estate tax:** For persons dying after December 31, 2023, the estate tax architecture would be retained but the application of the tax would be repealed. Thus, for US decedent's leaving non-US surviving spouses dying after December 31, 2023, there would no longer be a need to set up a Qualified Domestic Trust. However, tax collection from Qualified Domestic Trusts (QDT) would continue for 10 years beginning January 1, 2024, for QDTs set up prior to January 1, 2024.
- **Generation-skipping transfer tax:** The generation-skipping transfer tax architecture would remain in place but the application of the tax would be repealed for all GST transfers (whether outright or with respect to the property of generation-skipping trusts) occurring after December 31, 2023.
- **Gift tax:** The gift tax architecture would be retained and gift transfers would remain subject to gift tax under the current rate structure but with a maximum tax rate of 35 percent, down from the current 40 percent. The $10 million applicable exclusion amount would be indexed for inflation for years after 2024 in a manner similar to that existing today.
- **Income tax:** For income tax purposes, the adjustment of basis to the fair market value of inherited property on the date of death would continue exactly as it does under current law, notwithstanding the repeal of the estate tax. This would be true even for a surviving spouse's interest in community property. No mention is made as to how the basis is to be communicated to persons inheriting property but it could take the form of a more robust version of the Form 8971, *Information Regarding Beneficiaries Acquiring Property from a Decedent*.

Observation: The retention of the gift tax backstops the income tax by preventing the "friendly" transfer of assets prior to sale in an attempt to find the taxpayer best able to absorb the gain on sale with the sales proceeds migrating their way back to the source. However, the ability to move assets within the $10 million applicable exclusion amount remains possible.

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The retention of the basis adjustment rules at death is an acknowledgement of the practical difficulties of implementing carryover basis. Of interest is that the deemed sale at death rules promulgated by then-presidential candidate Donald Trump in 2016 finds no place in the current bill.

Executive compensation

The bill would make several changes to the tax treatment of nonqualified deferred compensation, the limitation on excessive employee remuneration, and the executive compensation paid by tax-exempt organizations.

Nonqualified deferred compensation: The TCJA would provide that employees are subject to tax on compensation once no longer subject to a requirement to provide future service. Compensation would be subject to tax without regard to whether there are other conditions on the right to receive the compensation, such as conditions related to performance metrics. Under the provision as drafted, options and stock appreciation rights would also be subject to taxation once no longer subject to service-based vesting conditions. The provision does not address how compensation would be calculated or situations in which the amount in fact paid is less than an amount previously included in income.

The proposal would be effective for amounts attributable to services performed after 2017, and so would apply to existing arrangements to the extent that services are required in 2018 or later to earn the compensation. Other arrangements would continue under existing law until the last tax year beginning before 2026.

Modification of limitation on excessive employee remuneration: The proposal would expand the current limitation on deduction of compensation paid to covered employees under section 162(m) by:

- Eliminating the exclusions for commissions or performance-based compensation, including performance-based bonus plans, stock options, and stock appreciation rights,
- Including the CFO as a covered employee subject to limitation, along with the CEO and three most highly compensated officers as shown in SEC disclosures, and
- Providing that status as a covered employee continues after separation from service.

The provision would be effective for tax years beginning after 2017, without exception for existing arrangements.

Excise tax on excess tax-exempt organization executive compensation: The provision would impose a 20 percent excise tax on compensation paid by a tax-exempt organization to any of its five highest-paid employees – a “covered person” – to the extent the compensation exceeds $1 million, taking into account all compensation, other than contributions to qualified retirement plans and amounts excluded from income. The excise tax would apply to any “excess parachute payments” to a covered person. Excess parachute payments are defined as payments contingent on a separation from employment with an aggregate present value of three times the employee’s base compensation (without reference to whether the amounts exceed $1 million). Any employee designated as a covered person for a year would continue to be a covered person for all future years. The provision would be effective for tax years beginning after 2017.

Savings, pension, and retirement provisions

The TCJA does not, as had been rumored in the days leading up to its release, call for limiting the amounts that individuals can contribute to their employer-sponsored retirement plans on a pre-tax basis. It does, however, propose a number of modifications to the rules governing employer-sponsored retirement plans and individual retirement accounts.

Repeal of special rule permitting recharacterization of Roth IRA contributions as traditional IRA contributions: Under current law, an individual is permitted to recharacterize a contribution made during a year to one type of IRA (whether regular or Roth) to the other type of IRA. The deadline for recharacterizing a contribution is the extended due date of the individual’s tax return for the year (generally October 15 of the following year) For tax years after December 31, 2017, the proposal would eliminate the ability of individuals to recharacterize Roth IRA contributions as traditional IRA contributions (or vice versa).

The proposal would also prohibit an individual from recharacterizing a conversion of an existing IRA to a Roth IRA. Existing rules that prohibit individuals with adjusted gross income in excess of certain amounts from making annual

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Roth IRA contributions remain unchanged. Thus, it is not clear what an individual who unknowingly has AGI in excess of the maximum allowable amount to make an annual Roth IRA contribution may do to correct his or her ineligible contributions. This would be a problem only for annual contributions, as there are no longer AGI limits in place for conversions to Roth IRAs.

Reduction in minimum age for allowable in-service distributions: The proposal would reduce the age at which in-service distributions from a defined benefit pension plan are permissible from age 62 to age 59-1/2. It additionally would reduce the minimum age for in-service distributions from age 70-1/2 to age 59-1/2 for participants in so-called "eligible" deferred compensation arrangements under section 457(b) that are maintained by state and local governments, as defined under section 457(e)(1)(A).

Modification of rules governing hardship distributions: For plan years beginning after December 31, 2017, the proposal would eliminate a rule in IRS regulations that, in many cases, prohibits an individual who takes a hardship withdrawal from making employee contributions to a 401(k) plan for a six-month period immediately following the hardship withdrawal. The proposal also includes vague language suggesting the Treasury may pursue further modifications to the regulations governing hardship withdrawals.

Modification of rules relating to hardship withdrawals from cash or deferred arrangements: For plan years beginning after December 31, 2017, the proposal would expand the type of contributions available for hardship withdrawal from employer-sponsored defined contribution plans qualified under section 401(k). Currently an employee can only access elective deferrals for purposes of a hardship withdrawal. The proposal would permit the employee to also draw on employer contributions, qualified nonelective contributions, qualified matching contributions, and earnings thereon, none of which may be currently withdrawn on account of hardship. Additionally, an employee would no longer be required to take any available loan under the plan first in order to be eligible for a hardship withdrawal.

Extended rollover period for the rollover of plan loan offset amounts in certain cases: If, as a result of a termination of employment or a default on a loan from a qualified employer plan as defined in code section 72(p)(4), an employee is deemed to have received a loan offset in the form of a distribution, the proposal would extend the permissible period for a rollover of the loan offset to the due date for filing the return for the taxable year (including extensions) in which the amount is treated as distributed from a qualified employer plan. The proposal would be effective for taxable years beginning after December 31, 2017.

Modification of nondiscrimination rules for certain "closed" plans: The TCJA would make certain modifications to the so-called "nondiscrimination" testing rules that would allow certain defined benefit plans that are "closed" plans to more easily satisfy the nondiscrimination testing rules. In addition, the bill would change the rules that apply to defined contribution plans that provide additional benefits to employees who are affected by an employer's decision to close its defined benefit plan.

Qualified plans are required to satisfy many requirements as a condition for receiving tax-favored treatment. Among the requirements that must be satisfied are requirements related to coverage, which relates to the individuals who may receive benefits under the plan, and nondiscrimination, which relates to how much an individual may receive under a plan. Both requirements are designed to ensure that the highest-paid individuals working for the plan sponsor do not receive a disproportionately large portion of the benefit provided by the plan.

When an employer "closes" a plan, new employees hired by the employer after the designated date will not become eligible for the plan. Existing employees participating in the plan continue to participate as they have in the past. Often, closing a plan is a precursor to terminating the plan, though that is not always the case. After a plan is closed, the population of employees receiving benefits under the plan dwindles over time. This can cause the plan to fail to satisfy coverage and nondiscrimination tests.

The TCJA would provide some relief in the form of special rules that these plans can use to satisfy the coverage and nondiscrimination requirements. The special rules allow the closed defined benefit plan to be combined with other defined contribution plans maintained by the employer much more easily than permitted under current law. In addition, if the employer provides special allocations in a defined contribution plan for employees who are not participating in a closed defined benefit plan, the bill provides special that would allow that plan to pass.

The special relief is available for only certain types of plans, and for a limited period. In order to qualify for the relief, the plan:

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- Must have been closed no later than April 5, 2017, or
- Must have been in effect for at least 5 years, with no significant increase in benefits during the 5 year period prior to becoming closed.

The bill permits plan sponsors to apply the relief retroactively, for plan years beginning after December 31, 2013.

Exclusions for employer-provided benefits

The TCJA would modify the current-law exclusions for several employer-provided fringe benefits.

Employer-provided housing: The bill would limit the exclusion for housing provided for the convenience of the employer and for employees of educational institutions to $50,000 ($25,000 for a married individual filing a joint return). The exclusion phases out for highly compensated individuals (income of $120,000 for 2017, as adjusted for inflation) at a rate of $1 for every $2 of adjusted gross income earned by the individual beyond the statutory threshold of being highly compensated. The exclusion also would be limited to one residence. The provision would be effective for tax years beginning after 2017.

Employee achievement awards: Under the proposal, the exclusion for employee achievement awards would be repealed. Instead, employee achievement awards would be treated as taxable compensation to the recipient, and the employer restrictions on deductibility would be removed. The provision would be effective for tax years beginning after 2017.

Dependent care assistance programs: The proposal would repeal the exclusion for employer-provided dependent care assistance programs, effective for tax years beginning after 2017.

Qualified moving expense reimbursement: The exclusion for qualified moving expense reimbursements provided by an employer to an employee would be repealed, effective for tax years beginning after 2017.

Adoption assistance programs: The proposal would repeal the exclusion for adoption assistance programs, effective for tax years beginning after 2017.

Tax-exempt organizations

As already noted in the discussion of executive compensation elsewhere in this report, the TCJA would impose a 20 percent excise tax on certain compensation paid by a tax-exempt organization to any of its five highest-paid employees.

Among the other revenue provisions in the bill target exempt organizations are proposals to:

- Simplify the excise tax on investment income of private foundations by replacing the current two-tiered rate structure with a single rate of 1.4 percent.
- Subject certain private colleges and universities to a 1.4 percent excise tax on their net investment income.
- Deny private operating foundation status to an art museum unless it is open to the public during normal business hours for at least 1,000 hours a year.

These provisions would be effective for tax years beginning after December 31, 2017.

ASC 740 Implications

Pursuant to US Generally Accepted Accounting Principles the tax effects of new tax legislation is not accounted for prior to the reporting period in which a tax law is enacted. In the US jurisdiction, the enactment date generally is the day the president signs the legislation into law. Because the proposed bill has not been enacted it should not directly impact financial statements. If enacted, the proposal may have a material impact on a companies' financial statements. As any tax effects would need to be accounted for in the reporting period of enactment, it may be prudent for companies to start to analyze the impact the proposed bill would have on its tax accounts and disclosures if enacted.

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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 will need to determine whether they need to disclose the change in tax law and an estimate of its effect in order to keep their financial statements from being misleading.

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.

State tax considerations

While the TCJA is a piece of federal tax legislation, the potential impact of its broad range of tax proposals on state and local taxes for businesses cannot be overstated. While many of the TCJA's provisions will expand the tax base by eliminating or limiting federal deductions (for example, the elimination of the domestic production activities deduction and the limitation on interest expense deductions) that several states will look upon favorably, there are other provisions that may be too expensive for individual states to afford to adopt (such as the immediate expensing of capital investments for five years and the expansion of the 179 deduction).

The TCJA language also clarifies several tax provisions that are of critical interest to state taxpayers. For example, the measure provides that the "deemed repatriation" of accrued foreign profits will be treated as subpart F income. Currently the states do not follow a common approach for taxing subpart F income: some states (such as Oregon) treat subpart F income as a deemed dividend subject to the state's dividends-received deduction, while others (such as California) have unique and complex rules that require close scrutiny. Given that over $2 trillion of accrued foreign profits may be treated as subpart F income under this provision for federal purposes, the state treatment of this income will be critical.

Other provisions of the TCJA may have an indirect impact on state taxes. The reduction in the federal corporate rate from 35 percent to 20 percent will presumably lead many taxpayers to accelerate deductions and defer income for federal tax purposes before the end of the 2017 tax year. Such taxpayers should consider the impact of such accelerations and deferrals on their state income tax deferred assets. Also, the federal incentive for immediate expensing of capital investments for five years is designed to lead to a massive investment in the US economy. While every state may not conform to this change, states will generally compete to attract this reinvestment, leading to increased opportunities for statutory credits and negotiated incentives that may extend beyond state income taxes to sales and use taxes, employment and payroll taxes, and even nontax incentives.

Next steps: Ways and Means mark-up, House floor vote

Ways and Means Committee Chairman Brady has indicated that his panel will take up the proposal and consider possible amendments beginning on November 6 – a process that he expects to last for several days and will play out mostly during regular working hours. Brady released a "manager's amendment" ahead of the mark-up on November 3 that includes drafting fixes as well as some small substantive changes (most notably related to treaty benefits available for payments made to foreign entities in jurisdictions other than that of the ultimate parent, discussed elsewhere in this document).

A static revenue estimate from the Congressional Budget Office and the Joint Committee on Taxation (link) confirms the bill meets the $1.5 trillion headroom afforded under the budget resolution. Brady expects to have a dynamic score – reflecting macroeconomic feedback from the proposed reforms – after the bill is approved by Ways and Means.
URL: https://www.jct.gov/publications.html?func=startdown&id=5027

Brady currently expects the measure will receive a vote on the House floor during the week of November 13.

Finance Committee guarding its prerogatives

Once the measure clears the House the focus will shift to the Senate, where lawmakers on the Finance Committee are expected to unveil their own tax reform proposal in the coming days. Tax reform is moving through Congress under "budget reconciliation" rules, which allow legislation that meets certain strict parliamentary and procedural rules to pass the House and Senate with simple majority votes, making it a powerful tool for Republicans who control 52

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Senate seats, short of the three-fifths majority – that is, 60 votes – normally needed to advance legislation under regular order in that chamber.

But moving a tax reform bill through the Senate will involve its own unique set of challenges – despite the fact that it will be immune to filibuster thanks to the baked-in budget reconciliation protections. With Republicans holding only a two-seat in that chamber and with few Democrats currently expected to support a GOP tax reform package, the margin for error is extremely small and – as leadership experienced during the debate over health care legislation this year – drafting a bill that satisfies the diverse interests of senators even within a single party can be a tortured process.

Moreover, even though Senate taxwriters, like their house counterparts, will use the Big Six tax reform framework as their starting point in developing their legislation, Finance Committee Chairman Orrin Hatch, R-Utah, has stated repeatedly in recent weeks that his panel intends to preserve its prerogatives and will not necessarily produce a bill that mirrors a House-approved package.

"[A]t the end of the day, my goal is to produce a bill that can get through this committee." he said during a September 14 hearing on the individual side of the tax code. "Anyone with any experience with the Senate Finance Committee knows that we are not anyone's rubber stamp," he added.

Emphasizing the challenge ahead, Tennessee Republican Sen. Bob Corker, who has offered unusually candid comments in the press on a wide range of issues since announcing that he will not seek re-election to the Senate in 2018, has stated publicly that "tax reform is going to make health care look like a piece of cake." The challenge of complying with various procedural limitations in the Senate as well as parsing potentially difficult political issues is likely to show how true that statement is.

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

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