



# House Tax Reform Bill – Initial Observations on Chairman Brady's Mark

**CAUTION:** This report is based on Chairman Brady's mark as released on November 3, 2017. Significant changes can be expected to be made when the Ways and Means Committee marks up tax reform. We will release an updated version of this report after the markup is complete. In the interim, you can find more information on the *TaxNewsFlash-Tax Reform* page about amendments adopted during the mark up.

November 5, 2017

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On November 2, Ways and Means Chairman Kevin Brady (R-TX) released H.R. 1, the “Tax Cuts and Jobs Act,” as well as a section-by-section summary (summary) of the proposed tax reform legislation. On November 3, Brady released amended legislative text of H.R. 1, which revises the version released on November 2, and constitutes the so-called “Chairman’s mark.” The Chairman’s mark serves as the starting point for consideration of the legislation by the Ways and Means Committee.

Markup—formal consideration of the bill by the Ways and Means Committee—is scheduled to begin on Monday, November 6, and to continue throughout the week as necessary. Chairman Brady has indicated that he expects to make other modifications to his proposal before next week’s markup begins.

This report includes the preliminary analysis and observations regarding the Chairman’s mark—with text of H.R. 1 referred to as “the bill.” KPMG will continue to provide preliminary analysis and observations regarding future amendments the Chairman may make to his mark. KPMG will do the same with regard to amendments made to the bill during mark up.

## Documents

- [Chairman’s mark](#) [PDF 934 KB] (425 pages)
- [JCX-50-17](#) - Description of H.R. 1, the “Tax Cuts And Jobs Act” prepared by the Joint Committee on Taxation
- [JCX-49-17](#) - Distribution effects of Chairman’s mark
- [JCX-48-17](#) - Description of changes in Chairman's mark
- [JCX-47-17](#) - Revenue estimate of Chairman's mark
- [Section-by-section summary](#) [PDF 643 KB] of H.R. 1 prepared by the Ways and Means Committee

## KPMG observation

The release of legislative text of the Chairman’s mark represents another significant step towards tax reform. Along with the November 2 version of the text, it provides the first look at the details of many proposals that have been discussed at a high level for several months. It also reveals what other proposals the taxwriters are considering, including dozens of revenue raising provisions that would offset the revenue cost of some of the policy modifications and tax cuts.

The Chairman’s mark is, however, just the first step on the long road to potential tax reform. As explained below, there are numerous other steps that need to occur for tax

reform to become law, and a great many changes may be made to the bill unveiled this week.

## Highlights

### Business provisions

Perhaps the centerpiece of the bill is the reduction in the corporate income tax rate from 35% to 20%. The 20% rate would be effective beginning in 2018. But the full list of proposed changes for businesses is extensive, including additional tax benefits and offsetting tax increases.

Notably, the bill would introduce “expensing” as the principal capital cost recovery regime, allowing taxpayers to write off the costs of equipment acquisitions as made. This rule generally would apply to both new and used property (but not to property used in a real property trade or business or by a regulated public utility company).

The bill would also implement a new 25% maximum tax rate on business income earned by passthrough businesses such as partnerships, S corporations, and sole proprietorships. The bill proposes several rules that define and limit the income that is eligible for this lower rate, including special rules for owners of certain personal services businesses.

To offset the costs of these tax benefits, the bill would repeal or modify dozens of existing items in the tax law. For example, the bill generally proposes to:

- Repeal the section 199 domestic manufacturing deduction
- Impose a limit on interest deductibility (a limit based on a percentage of an alternate version of taxable income and with an exception for interest incurred with respect to a real property trade or business)
- Limit the carryover and carryback of net operating losses
- Repeal tax credits including the work opportunity tax credit, new markets tax credit, and several others
- Revise several rules governing the taxation of private activity, refunding, tax credit, and tax-exempt bonds
- Provide significant revenue-raising changes for taxation of the insurance industry

The bill does not address the pending expiration of the moratorium with respect to the medical device excise tax, and does not modify or repeal any other tax provisions of the Affordable Care Act.

The bill would retain the research credit and the low income housing tax credit. Extensive changes to provisions in the areas of real estate, tax-exempt entities, executive compensation, and excise taxes are also included in the bill as well as the repeal of dozens of special business credits and deductions.

With respect to natural resources, minerals other than oil and gas would remain subject to the higher of cost or percentage depletion under section 613(a). Oil and gas would remain subject to the higher of cost or percentage depletion under section 613A.

### **Multinational entity taxation**

The bill proposes significant changes to the taxation of business income earned outside the United States. It would move from the current system, which permits deferral of the U.S. tax on foreign active business earnings until those earnings are repatriated, to a “territorial” system.

U.S. corporate shareholders that own 10% or more of a foreign corporation would receive a 100% exemption on the foreign-sourced portion of dividends paid by the foreign corporation to the U.S. shareholder.

As a transition to this new system, the bill would deem a repatriation of previously deferred foreign earnings. This repatriation would impose a 12% tax rate on cash and cash equivalents and a 5% rate on illiquid assets. The resulting tax could be paid in installments over eight years.

As expected, the bill would also implement what is effectively a new 10% minimum tax on “high return” foreign earnings of multinational businesses.

One of the more novel proposals in the bill—and one that is certain to engender discussion and debate in the coming weeks—is a proposed 20% excise tax on certain payments made by a domestic company to a foreign affiliate.

The bill also includes a number of other measures, including provisions to avoid erosion of the U.S. tax base through, for example, the excessive placement of debt in the United States relative to worldwide group debt.

### **Individual provisions**

The bill would reduce the seven current tax brackets to four: 12%, 25%, 35%, and 39.6%. The top rate would apply to single filers with income of \$500,000 and married joint filers with income of \$1,000,000—a substantial increase from the current income levels to which that rate applies.

The standard deduction would be increased to \$24,400 for joint filers and \$12,200 for individual filers with these deductions indexed annually. At the same time, the deduction for personal exemptions would be repealed, while the child tax credit would be enhanced and a new family tax credit created.

The revenue cost of these changes would be offset by modifying or eliminating a number of tax preferences, many of them significant and long-standing. These include new limits on (and other changes to) deductions for home mortgage interest, state and local taxes, personal casualty losses, and medical expenses. The exclusion of gain from the sale of

a principal residence would be phased out for taxpayers with adjusted gross income exceeding \$500,000 (\$250,000 for single filers) and modified. The “Pease” limitation would be repealed.

The individual AMT, like the corporate AMT, would be repealed. There would be no changes to the capital gains and dividends tax rate. The bill also does not include repeal of the net investment income tax.

Changes would be made to a large number of other individual tax items including repeal of the adoption and plug-in electric drive motor vehicles credits; consolidation and modification of education savings benefits; and modifications to the treatment of discharge of student loan debt. A large number of other special credits and deductions would be repealed.

The estate tax exclusion would be doubled to \$10 million (indexed for inflation). Beginning after 2023, the estate and generation-skipping taxes would be repealed, while maintaining a beneficiary’s stepped-up basis in estate property. The gift tax would be lowered to a top rate of 35%, retaining a basic exclusion of \$10 million and annual exclusion of \$14,000 (indexed for inflation).

### Impact of reconciliation rules

H.R. 1 or any subsequent version of a tax reform bill in the current legislative effort will be at least partially shaped by budget reconciliation requirements.

Budget reconciliation is a process by which spending and revenue legislation (including tax measures) can avoid potential Senate filibuster and be passed by simple majority vote. The ability to use these rules was “unlocked” when the House and Senate agreed to a budget resolution for FY 2018. The budget resolution permits the tax bill produced pursuant to its instructions to increase the deficit by a maximum of \$1.5 trillion over the 10-year budget window. Thus, the House bill presumably was structured with this revenue target in mind; the Joint Committee on Taxation (JCT) has estimated that the bill would lose approximately \$1.49 trillion over the 10-year period (not taking into account possible macroeconomic effects). This leaves a little extra money to offset the cost of provisions that may be added during the Ways and Means Committee markup.

The budget reconciliation requirements can be expected to be particularly significant when the Senate considers tax reform legislation. To retain the protection from a Senate filibuster that the reconciliation rules provide, provisions in the tax legislation being considered under the budget resolution must meet a number of complex requirements. Any senator could raise a point of order against any provision that does not meet these requirements.

The most relevant for tax legislation is one intended to prevent an increase in the long-term deficit of the United States. Even though a tax bill considered pursuant to the budget resolution could provide up to a \$1.5 trillion net tax cut **within** the 10-year window, no title



of the bill can result in a net tax cut in any year **beyond** the 10-year budget window unless offset by an equivalent reduction in spending.

### KPMG observation

Although the budget rules are primarily important in the Senate, they may also be taken into consideration by the House. This might explain, for example, why this bill does not include provisions like technical corrections to prior legislation. By definition, technical corrections do not have a revenue effect, potentially violating another requirement of budget reconciliation—that every provision must have more than an incidental effect on revenue or spending.

### What is next?

As indicated, Chairman Brady intends to begin markup in the Ways and Means Committee this week. Further modifications to the Chairman's mark may be made prior to the markup, including technical changes and substantive changes designed to increase the likelihood of committee approval of the bill or the political prospects of the bill in the future. Additionally, it is possible that amendments could be approved during the committee's markup of the bill.

If the Ways and Means Committee approves the bill and orders it to be reported, the bill would proceed to the House Rules Committee, and then would be debated and considered by the full House. It is possible the House could pass the bill as soon as mid-November, if there are no major setbacks causing a delay in either the Ways and Means Committee or in the full House.

As for the Senate, Finance Committee Chairman Orrin Hatch (R-UT) is also reportedly contemplating swift action on a tax bill. It is possible that Chairman Hatch could release his mark as early as this week with Finance Committee action possibly taking place prior to the Thanksgiving recess. How the Senate bill might differ from the House bill is uncertain, but Chairman Hatch has stated his intention to produce his own bill, regardless of the bill that ultimately might be approved by the House. During the Finance Committee's markup, it is possible that additional amendments might be made.

After the Senate Finance Committee finishes its markup and approves a bill, it would order its bill to be reported. During consideration by the full Senate, it is also possible that amendments could be adopted on the Senate floor. It is not yet certain when Senate floor action would commence or when a vote on final passage would take place. The Senate bill potentially could be very different from the House bill.

For tax reform to become law, the House and the Senate ultimately would have to pass identical legislation and send it to the president. If the House and Senate bills differ, as seems likely, a conference committee may be convened to work out the differences between the two bills. The more significant the differences between the two bills, the longer it can be expected to take to negotiate a conference agreement, and reaching an

agreement could be challenging. For tax reform to become law, the conference agreement would need to be approved by both the House and the Senate and signed by the president.

The often stated goal of Republican congressional leadership is to pass a bill prior to the end of 2017. The aggressive schedule outlined by House and Senate leaders is aimed at meeting this deadline. Significant hiccups at any of the many junctures along the path to enactment could derail this tight timeline and push the process over into 2018 or lead to the demise of the bill.

#### **KPMG observation**

There were some surprises in Chairman's mark, but overall, the bill makes good on the promises made in the "Unified Framework" for tax reform.

This bill is not a finished product and more changes, possibly significant ones, will be coming. And any broadening of the tax benefits in the bill will need to be matched by tax increases elsewhere. Because changes are expected, it is too early to be certain of the political viability of the bill.

There are scores of technical issues to highlight and observations to make regarding the Chairman's mark. That is the subject of this report.

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## Individual income tax

### Ordinary income tax rates

The bill would significantly alter the current income rate structure under which individuals are taxed. The bill also would provide a special rate for owners of certain passthrough businesses and sole proprietorships. See passthrough entities discussion below.

For tax years beginning after December 31, 2017, the current seven-rate structure (ranging from 10% to 39.6%) would be replaced by a structure with four rates: 12%, 25%, 35%, and 39.6%.

**For married taxpayers filing a joint return (or for a surviving spouse):** The 12% rate would apply to all income in excess of the standard deduction (see discussion below) up to \$90,000; the 25% rate would apply to all income over \$90,000, up to \$260,000; the 35% rate would apply to all income over \$260,000 up to \$1,000,000; and the 39.6% rate would apply to all income over \$1,000,000.

**For married taxpayers filing a separate return:** The 12% rate would apply to all income in excess of the standard deduction up to \$45,000; the 25% rate would apply to all income over \$45,000, up to \$130,000; the 35% rate would apply to all income over \$130,000 up to \$500,000; and the 39.6% rate would apply to all income over \$500,000.

**For taxpayers that file as head of household:** The 12% rate would apply to all income in excess of the standard deduction up to \$67,500; the 25% rate would apply to all income over \$67,500 up to \$200,000; the 35% rate would apply to all income over \$200,000 up to \$500,000; and the 39.6% rate would apply to all income over \$500,000.

#### KPMG observation

The staff explanation indicates that the 35% threshold for head of household would apply at the midpoint between the thresholds for unmarried individual and married taxpayers filing jointly (\$230,000). However, the proposed statutory language in the bill would apply the 35% threshold for head of household on all income over \$200,000 (the same threshold for an unmarried individual taxpayer with no children).

**For all other taxpayers:** The 12% rate would apply to all income in excess of the standard deduction up to \$45,000; the 25% rate would apply to all income over \$45,000, up to \$200,000; the 35% rate would apply to all income over \$200,000 up to \$500,000; the 39.6% rate would apply to all income over \$500,000.

#### KPMG observation

The overall effect of these changes to the tax rates and thresholds would be to slightly expand the number of people falling into the 25% bracket, significantly expand the number of people falling into the 35% bracket (due to the significantly lower threshold for

35%), and significantly reduce the number of people falling into the 39.6% bracket (particularly for married taxpayers filing jointly for whom the threshold at which the highest rate of tax applies is more than doubled.)

The bill would attempt to mitigate the impact of the “marriage penalty” that affects some married individuals if both spouses have taxable income. Under current law an unmarried individual becomes subject to the 28% rate if his or her taxable income exceeds \$91,900 (2017). However, if that individual is married to someone with a similar amount of income, they would become subject to the 28% rate when their combined income exceeds \$153,100, which is less than double the threshold at which the 28% rate applies to unmarried individuals.

Under the bill, the marriage penalty would not affect married individuals unless their combined taxable income is in excess of \$260,000 (the threshold at which the 35% rate would become effective for married taxpayers).

**High income taxpayers:** The benefit of the 12% rate is partially phased out for certain high income taxpayers with adjusted gross income in excess of \$1,200,000 if married filing jointly and \$1,000,000 for all other taxpayers. The benefit of the 12% rate would be phased out at a rate of \$6 of tax savings for every \$100 of adjusted gross income in excess of the threshold. The additional amount of tax for 2018 would be a maximum of \$24,840 for taxpayers filing married filing jointly, and \$12,420 for all other taxpayers.

**The “kiddie tax”:** The bill would slightly change how the tax on a child’s net unearned income (kiddie tax) is calculated, taking into account the proposed income tax thresholds.

## JCT estimate

The JCT has estimated that the proposed rate structure would lose approximately \$1.09 trillion over a 10-year period.

## New indexing method

The bill would introduce a new method for indexing the tax rate thresholds, standard deduction amounts, and other amounts for inflation.

Under current law, annual inflation adjustments are made by reference to the consumer price index (CPI). The bill, however, would use “chained CPI,” which takes into account consumers’ preference for cheaper substitute goods during periods of inflation.

Chained CPI would generally result in smaller annual increases to indexed amounts and is estimated by JCT to increase revenues by \$128.2 billion over a 10-year period.

## Tax rates on capital gains and dividends

The bill would keep in place the current system whereby net capital gains and qualified dividends are generally subject to tax at a minimum rate of 20% or 15%, with higher rates



for gains from collectibles and unrecaptured depreciation. The bill retains the same “breakpoints” for application of these rates as under current law, except the breakpoints would be adjusted for inflation after 2017. For 2018, the 15% breakpoint would be \$77,200 for married taxpayers filing jointly and \$38,600 for single filers. The 20% breakpoint would be \$479,000 for joint returns, and \$425,800 for single filers.

The bill also leaves in place the 3.8% net investment income tax.

The JCT estimate regarding any potential impact of these changes appears to be incorporated into the score for proposed rate structure listed above.

### **Filing status, standard deductions, and personal exemptions**

The bill would retain the filing statuses available to taxpayers under current law:

- Single
- Married filing jointly
- Married filing separately
- Head of household
- Qualifying widow(er) with dependent child

The bill would significantly increase the standard deduction for all taxpayers for tax years beginning after December 31, 2017. Under current law, the standard deduction for 2018 is \$6,500 for a taxpayer filing as single or married filing separately, \$9,550 for a taxpayer filing as head of household, and \$13,000 for taxpayers filing as married filing jointly. Under the bill, the standard deduction would be \$12,200 for a taxpayer filing as single or married filing separately, \$18,300 for a taxpayer filing as head of household, and \$24,400 for taxpayers filing as married filing jointly (and surviving spouses). These amounts would be adjusted for inflation.

The proposed increase in the standard deduction, in conjunction with the repeal of many itemized deductions (discussed below), is intended to significantly reduce the number of taxpayers who itemize their deductions and thus to simplify the tax return preparation process. The increased standard deduction is also intended to compensate for the loss of the deduction for individual exemptions (\$4,150 for 2018), which would be repealed by the bill. This repeal would apply to the exemptions for the taxpayer, the taxpayer’s spouse, and any dependents.

### **KPMG observation**

Under current law, for the 2018 tax year a married couple with two qualifying dependent children would have a standard deduction of \$13,000 and individual exemptions of \$16,600, for a combined deduction of \$29,600, \$5,200 greater than the deduction allowed under the bill. However, personal exemptions are subject to phase outs under current law and the bill proposes an expanded child tax credit and a new family tax credit that could provide a greater tax benefit. Additionally, the new rates and income thresholds proposed

in the bill could potentially offset any loss of benefit from the repeal of the personal exemption.

The JCT has estimated that the proposed modification to the standard deduction would lose approximately \$921.4 billion over a 10-year period and the proposed repeal of deductions for personal exemptions would raise approximately \$1.562 trillion over a 10-year period.

### **Modify child and dependent tax credit**

The bill would increase the child tax credit to \$1,600 from the current credit of \$1,000 per qualifying child and would allow a new credit of up to \$300 for dependents other than children. Further, the bill would allow “family flexibility credit” of \$300 with respect to the taxpayer (and the taxpayer’s spouse if they file jointly). The \$300 family flexibility credit and the non-child dependent credit would only remain in place for tax years ending before January 1, 2023.

Similar to current law, \$1,000 of the child tax credit would be refundable. The refundable portion would be indexed for inflation in future years up to a limit of \$1,600. The \$300 family flexibility credit and credit for non-child dependents would not be refundable. Further, the income levels at which these credits are subject to phase-out would increase from \$110,000 to \$230,000 for joint filers, and from \$75,000 to \$115,000 for single filers. This increase would eliminate the “marriage penalty” by making the phase-out threshold applicable to joint filers twice the amount applicable to single filers.

To claim the refundable portion of the child tax credit, the bill would require the taxpayer to provide a work-eligible social security number (SSN). For married couples filing a joint return, only one spouse would have to provide a SSN to meet this requirement.

The JCT has estimated that the new credits and the phase-out thresholds for the credits would decrease revenue by \$639.9 billion over 10 years and the SSN requirement would increase revenue by \$21.7 billion over 10 years.

### **Modify earned income tax credit**

To reduce waste, fraud and abuse, section 1103 of the bill creates a requirement that a taxpayer must provide a work-eligible social security number in order to claim the refundable earned income tax credit.

The JCT estimates that this proposal will increase revenue by \$600 million over 10 years.

### **Repeal of credit for the elderly and permanently disabled**

Under current law, taxpayers who are over the age of 65 or who have retired due to permanent and total disability may claim a nonrefundable credit up to a maximum of \$750 where one individual qualifies for the credit, and \$1,125 where both spouses qualify.

The proposed statutory language (section 1102 of the draft legislation) would repeal the credit for the elderly and permanently disabled for tax years beginning after 2017.

The JCT estimates that repeal of this credit will increase revenues by less than \$50 million each year.

### **Repeal of credit for adoption expenses**

For 2017, a taxpayer may claim an adoption tax credit of \$13,570 per eligible child. The credit is phased out for taxpayers with modified AGI above a threshold amount. The credit is not refundable, but unused amounts may be carried forward for five years.

The bill would repeal the credit for adoption expenses for tax years beginning after 2017.

The JCT estimates that repeal of this credit will increase revenues by \$3.8 billion over 10 years.

### **Home ownership, financing, and sale**

The bill would limit or repeal certain deductions and exclusions available under current law to individual taxpayers who own and mortgage their principal residences.

#### *Modify exclusion of gain from sale of a principal residence*

Section 1402 of the bill would modify current law that allows individuals to exclude up to \$250,000 (or \$500,000 for joint filers) of gain from the sale of a principal residence. The bill would increase the required period of ownership from two of the previous five years to five of the previous eight years. In addition, the exclusion would be available only once every five years. The exclusion would be subject to phase-out for individuals whose average modified AGI over the year of sale and the two preceding tax years exceeds \$250,000 (or \$500,000 for joint filers). No phase-out of the exclusion exists under current law.

The provision would be effective for sales and exchanges after 2017 and is estimated by the JCT to raise \$22.4 billion over 10 years.

#### *Limit mortgage interest deduction*

Section 1302 of the bill would limit the deduction available for mortgage interest paid with respect to a principal residence by reducing the amount of debt that can be treated as acquisition indebtedness from the current level of \$1 million to \$500,000.

Debt incurred before November 2, 2017, would not be affected by the reduction and would therefore be “grandfathered.” Any debt incurred before November 2, 2017, but refinanced later, would continue to be covered by current law to the extent the amount of the debt does not exceed the amount refinanced.

The bill would eliminate the mortgage interest deduction for a loan secured by a second home (e.g., a vacation home).

The bill would repeal the deduction for interest on home equity indebtedness.

For the JCT estimate of revenue effect associated with this provision, see discussion of itemized deductions and income exclusions below.

### *Limit real property taxes*

Section 1303 of the bill would limit the annual deduction for state and local real property taxes to \$10,000 (not indexed for inflation) unless the taxes are incurred in carrying on a trade or business. In addition, foreign real property taxes, other than those incurred in a trade or business, would not be deductible.

For the JCT estimate of revenue effect associated with this provision, see discussion of itemized deductions and income exclusions below.

### **KPMG observation**

While the annual deduction for real property taxes in excess of \$10,000 would not be available in relation to a principal residence used exclusively by the taxpayer, such a deduction would continue to be available for taxes attributable to rental property used in a trade or business.

### **Repeal certain itemized deductions and income exclusions**

Under current law, the allowable amount of itemized deductions is reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount (referred to as the "Pease" limitation). The bill would repeal the overall limitation on itemized deductions.

In addition to the limitation or repeal of the deductions for mortgage interest and real property taxes discussed above, the bill would repeal certain other itemized deductions and income exclusions, including:

- State and local income taxes
- State and local sales taxes
- State and local personal property taxes unless incurred in a trade or business or otherwise incurred for the production of income
- Personal casualty losses (the deduction for personal casualty losses under special disaster relief legislation would not be affected)
- Tax preparation expenses
- Medical expenses
- Alimony payments (such payments would not be deductible by the payor or includible in the income of the payee)
- Moving expenses

- Contributions to medical savings accounts
- Expenses attributable to the trade or business of being an employee
- Wagering losses
- Educator expenses
- Employer-provided dependent care assistance programs
- Qualified moving expense reimbursements
- Adoption assistance programs

The JCT provided a number of estimates for the modifications to itemized deductions and income limitations (including the new limitations on the deductions for mortgage interest expense and state and local real property taxes). Combined, the JCT estimates that these provisions will increase revenue by \$1.3 trillion over 10 years.

#### **KPMG observation**

Repeal of the deduction for moving expenses would increase the cost of relocating employees. Businesses required to move employees to meet their business needs would face significantly higher costs after taking into account the gross up for taxes. The modifications made to the exclusion of gain on sale of a personal residence may also increase the cost of relocation.

#### **Limitation on exclusion for employer-provided housing**

The bill also proposes the section 119 gross income exclusion for housing provided for the convenience of the employer and for an employee of an educational institution would be limited to \$50,000 annually. The gross income exclusion would be phased out for highly compensated employees (income of \$120,000 for 2017, indexed for inflation) at a rate of \$1 for every \$2 of adjusted gross income earned in excess of the section 414(q)(1)(B)(i) threshold, but there would no exclusion for a 5% owner. The exclusion for employer-provided housing would be limited to one residence per employee.

The effective date would be for tax years beginning after 2017.

The JCT estimates that this provision will increase revenues by less than \$50 million each year.

#### **Repeal of exclusion, etc., for employee achievement awards**

In addition, the bill proposes that employee achievement awards would be taxable compensation to employees and the current section 74 exclusion from income is repealed. The bill would repeal the restrictions on the employer deductions for awards.

The effective date would be for tax years beginning after 2017.

The JCT estimates that this modification would increase revenues by \$3.8 billion over 10 years.

## JCT estimate

The JCT provided a number of estimates for the modifications to itemized deductions and income limitations (including the new limitations on the deductions for mortgage interest expense and state and local real property taxes). Combined, the JCT estimates that these provisions will increase revenue by \$1.315 trillion over 10 years.

## Charitable contributions

Section 1306 of the bill would make four distinct modifications to the rules regarding charitable contributions. These changes would apply to contributions made in tax years beginning after December 31, 2017. For the JCT estimate of revenue effect associated with this provision, see discussion of itemized deductions and income exclusions above.

### *Increased limitation for cash contributions*

The bill would increase the adjusted gross income limitation for charitable contributions of cash made by individuals to public charities and certain private foundations to 60% (from the current 50% limitation).

### *Denial of deduction for college athletic event seating rights*

The bill would eliminate the charitable contribution deduction for payments made for the benefit of a higher education institution that grant the donor the right to purchase seating at an athletic event in the athletic stadium of such institution. Current law (section 170(l)) generally permits a deduction of 80% of the value of the payment.

A proposed amendment to section 170(i) would remove the statutorily prescribed mileage rate for the charitable use of a passenger automobile (14 cents per mile) and replace it with “a rate which takes into account the variable cost of operating an automobile”). The JCT description states that the intent of the provision is to permit periodic adjustments to the rate, taking into account the types of costs that are deductible under section 170 when operating a vehicle in connection with providing volunteer services (i.e., out-of-pocket operating expenses).

### *Repeal of substantiation exception in case of contributions reported by donee*

The bill would repeal an inactive provision that exempts donors from substantiating charitable contributions of \$250 or more through a contemporaneous written acknowledgment, provided that the donee organization files a return with the required information.

## KPMG observation

Although the bill retains the charitable contribution deduction, even increasing the amount individual taxpayers may claim as a deduction in a single tax year, other proposed changes (e.g., lower tax rates and a higher standard deduction) may have an indirect impact on charitable giving.



## Simplification and reform of education incentives

### *Reform education credits*

The bill would replace the existing tax credits for education (lifetime learning credit, the hope scholarship credit and the American Opportunity Tax Credit) with one education credit, also called the American Opportunity Tax Credit (AOTC). The bill would expand the AOTC to apply to the fifth year of post-secondary education (under current law, the credit is only available for the first four years of a student's post-secondary education). The AOTC would be equal to 100% of the first \$2,000 of higher education expenses incurred for an eligible student plus an additional 25% credit for the next \$2,000 of higher education expenses incurred, for a total maximum credit of \$2,500 (same as current law). A portion of this amount (40% of the AOTC on the first \$2,000 of expenses, or \$800) would be a refundable credit. The maximum AOTC available for the fifth year of post-secondary education would be limited to \$1,250, one-half the amount applicable for the first four years, \$500 of which would be refundable.

#### **KPMG observation**

While the bill would make the AOTC available for the fifth year of post-secondary education (at a rate of one-half what is allowed for the first four years), including a refundable amount for the fifth year of \$500, the refundable amount of the credit for years one through four would be less each year (\$800) than under current law (\$1,000).

Similar to current law, the AOTC would begin to phase out for taxpayers with higher levels of income, starting at \$80,000 of modified adjusted gross income for single filers and \$160,000 for joint filers. However, unlike current law, under the proposed law those amounts would be indexed for inflation starting in 2018. Married taxpayers filing separate returns would not be eligible to claim the credit.

Section 1103 of the bill also will require a taxpayer to provide a work-eligible social security number to claim the refundable portion of the AOTC.

The JCT estimates these modifications will increase revenues by \$18.1 billion over 10 years.

### *Consolidate education saving*

The bill would prohibit contributions to Coverdell education savings accounts starting in 2018 except in the case of rollover contributions. The bill would also allow tax-free rollovers from existing Coverdell savings accounts into section 529 plans. Qualified expenses for purposes of section 529 plans would be expanded to include expenses for tuition for public, private or religious elementary and secondary schools, limited to \$10,000 per year and expenses such as books, supplies, and equipment required to enroll in registered apprenticeship programs. The definition of a designated beneficiary of a section 529 plan would be expanded to include unborn children.

The JCT estimates these modifications will increase revenues by \$600 million over 10 years.

#### *Exclude income from discharge of student debt*

The bill would exclude any income resulting from the discharge of student debt due to death or disability.

The JCT estimates that this provision would decrease revenues by \$100 million over 10 years.

#### *Repeal of education incentives*

The bill would repeal the following education incentives starting in 2018:

- Interest deduction on qualified education loans
- Deduction for qualified tuition and related expenses
- Exclusion for interest from U.S. savings bonds used to pay qualified higher education expenses
- Exclusion of qualified tuition reductions by educational institutions
- Exclusion for employer-provided education expenses

The JCT estimates that these provisions would increase revenues by \$47.5 billion over 10 years.

#### **KPMG observation**

Employers may face higher costs associated with tax gross-ups related to their qualified tuition reduction programs and employer-provided education assistance programs to the extent they wish to maintain the same level of benefit for their employees. The proposal to repeal the above-the-line interest deduction for qualified education loans would likely have a negative impact for recent college graduates who would no longer be able to deduct the interest on their student loans and would not benefit from any of the expanded credits for higher education costs as they are no longer in school.

#### **Simplification and reform of savings, pension, and retirement**

##### *Repeal of special rule permitting recharacterization of Roth IRA contributions as traditional IRA contributions*

Current rules allow either a traditional IRA to convert or recharacterize a contribution to a Roth IRA and vice versa. The bill proposes to repeal the section 408 rule allowing recharacterization of IRA contributions and conversions effective for tax years beginning after December 31, 2017.

JCT estimates this provision would increase revenue by \$500 million over 10 years.

**KPMG observation**

This proposal would eliminate the current rule allowing “backdoor” conversions to Roth IRAs for individuals above the Roth IRA contribution limits.

*Reduction in minimum age for allowable in-service distributions*

The bill proposes allowing in-service distributions at age 59 ½ (instead of age 62) for all defined benefit plans, and state and local government defined contribution plans.

The change would be effective for plan years beginning after 2017.

JCT estimates this provision would increase revenue by \$13.1 billion over 10 years.

*Modification of rules governing hardship distributions*

The bill would require the IRS to revise regulations to permit employees taking hardship distributions from their 401(k) plan to continue making contributions to the plan.

The effective date for the revised regulations would be for plan years beginning after 2017.

*Modification of rules relating to hardship withdrawals from cash or deferred arrangements*

The bill proposes allowing employers to choose to permit hardship distributions to include earnings and employer contributions. The effective date would be for plan years beginning after 2017.

The JCT estimates the provision would increase revenue by \$700 million over 10 years.

*Extended rollover period for the rollover of plan loan offset amounts in certain cases*

The bill would allow an employee who terminates employment (or the plan is terminated) while the employee has an outstanding plan loan to pay back the loan by the due date (including extensions) for filing their tax return for that year without the loan being taxed as a distribution.

The effective date would be for tax years beginning after 2017.

The JCT has determined that this provision would have a negligible revenue effect.

**KPMG observation**

The current rules only allow an employee 60 days to repay a loan upon termination of employment or the loan is treated as a distribution. The proposed bill would provide an employee with additional time to repay a plan loan and possibly avoid a taxable distribution.

### *Modification of nondiscrimination rules to protect older, longer service participants*

The bill would allow expanded qualified plan cross-testing between an employer's defined benefit and defined contribution plans for purposes of satisfying the nondiscrimination rules.

The effective date would be the date of enactment.

The JCT has determined that this provision would have a negligible revenue effect.

### **Estate, gift, and generation-skipping transfer tax**

#### *Increase in estate, gift and generation-skipping transfer tax exclusion and elimination of estate and generation-skipping transfer tax after 2023*

The proposed statutory language would increase the basic exclusion amount from \$5,000,000 to \$10,000,000 (as indexed for inflation for years after 2011) per individual. This enhanced exclusion would apply to estates of decedents dying, generation-skipping transfers, and gifts made after 2017.

After 2023, the estate and generation-skipping transfer taxes would be repealed. The gift tax would continue to apply and the lifetime gift tax exclusion would remain at the same inflation-adjusted \$10,000,000 previously discussed. The top gift tax rate would be reduced from the current 40% to 35%. The gift tax annual exclusion amount would remain an inflation adjusted \$10,000 (e.g., \$14,000 for 2017 and \$15,000 for 2018).

The proposed statutory language preserves fair market value as of date of death basis (often referred to as "stepped-up basis") even after the estate tax is eliminated.

The JCT has estimated that these provisions will decrease revenues by \$172.2 billion over 10 years.

### **KPMG observation**

The retention of the gift tax after repeal of the estate tax is believed to preserve the income tax system. Without a gift tax on transfers during life, taxpayers might shift income-generating assets to individuals in a lower bracket prior to a realization event; subsequently, those assets could be gifted back to the original taxpayer. In this manner, taxpayers could minimize their income tax liability without incurring a transfer tax cost. Although there was some speculation that a capital gains tax might be imposed at death in lieu of the estate tax, the proposed statutory language does not include such a tax. Moreover, the proposal maintains the fair market value as of date of death basis rules (stepped-up basis) rather than requiring heirs to utilize the decedent's "carryover" basis in inherited assets, even though no estate or capital gains tax would be imposed at death.

## Alternative Minimum Tax repeal

### Individual AMT

Section 2001 of the bill would repeal the alternative minimum tax (AMT) for individuals, with the result that income tax liability would be calculated under a single-rate structure. This proposal is generally applicable for tax years beginning after December 31, 2017.

#### KPMG observation

Under current law, incentive stock options are treated as compensation at exercise for AMT purposes. The repeal of AMT would mean incentive stock option would only be subject to federal income tax when sold.

The JCT has estimated that the repeal of AMT for individuals would lose approximately \$695.5 billion over a 10-year period.

### Corporate AMT

Section 2001 of the bill also would repeal the corporate AMT effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally could be utilized to the extent of the taxpayer's regular tax liability (as reduced by certain other credits). In addition, for tax years beginning in 2019, 2020, and 2021, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers would be refundable (a proration rule would apply with respect to short tax years). Any remaining AMT credits would be refundable in 2022.

The JCT has estimated that the repeal of the corporate AMT would reduce revenues by approximately \$40.3 billion over a 10-year period.

#### KPMG observation

##### *In general*

Repealing the corporate AMT would eliminate some of the complexity inherent in U.S. corporate taxation. For taxpayers with significant corporate AMT credit carryovers, the bill's generous rules would allow the full use of the credits to reduce or eliminate regular tax liability, and to obtain tax refunds to the extent the AMT credit carryovers exceed regular tax liability.

While the bill would repeal the AMT, it would also limit the NOL deduction for a given year to 90% of taxable income, adding a limitation that currently exists only in the AMT area.

##### *Natural resources*

The repeal of the corporate AMT also would eliminate the ability of taxpayers to use the

optional 10-year write-off contained in Code section 59(e) to minimize the disparity between certain AMT adjustments and preference items, which makes a taxpayer's regular income tax closer to the alternative minimum tax. This change would affect intangible drilling and development costs for oil, gas and geothermal wells (integrated oil corporations would still be required to capitalize 30% of their IDC allowable as a deduction ratably over the 60-month period beginning with the month in which the costs are paid or incurred) and the deduction for certain mine exploration and development expenditures. Under the AMT, mines were generally limited to cost depletion. However, for regular income tax purposes, depletion on mines would remain the higher of cost or percentage depletion for the tax year. Independent oil and gas producers could still claim the higher of cost depletion or percentage depletion under section 613A.

## Passthrough entities

### Income tax rate and employment tax changes

Section 1004 of the bill would change the maximum income tax rate applicable to some owners of passthrough entities (and sole proprietorships), the applicable self-employment tax rules, and the rate for certain dividends of real estate investment trusts and cooperatives.

#### Maximum rate on business income of individuals

Section 1004 of the bill would create a new 25% maximum rate for business income of individuals from sole proprietorships, partnerships, and S corporations. This new rate generally would apply to all net business income from passive business activities and to a percentage, the "capital percentage" (discussed below), of net business income from *active* business activities. Net business income is generally defined to include any wages, guaranteed payments or non-partner capacity payments.

The determination of whether income is from a passive business activity or an active business activity would turn upon the passive loss framework set forth in section 469. A "passive business activity" is a passive activity under section 469(c) (involving the conduct of a trade or business in which the taxpayer does not materially participate), except that the rule in that section treating working oil and gas interests as active is disregarded, and the provision deeming activities resulting in deductions under section 212 to be a trade or business is disregarded.

For income from active businesses, the capital percentage generally would be 30% unless an owner elects to use an alternate method to determine the capital percentage. The alternate method essentially would allow the 25% rate to apply to a deemed return (short-term AFR plus 7%) multiplied by the owner's share of the adjusted tax basis of any property described in section 1221(a)(2) which is used in connection with the business (determined without regard to section 168(k) and 179) (the "asset balance").



Once made, the election is binding on the owner for the year of the election and the following four years.

Service businesses, including, for example, law, accounting, consulting, financial service and brokerage firms and those who invest, trade or deal in certain securities (“specified service activities”) generally would not benefit from the 25% rate, because their deemed capital percentage would be zero. However, they also could elect annually to apply the alternate method, but only if the calculation above equals at least 10%. In either case, the amount the partner or shareholder receives in wages, guaranteed payments or non-partner capacity payments would reduce the applicable percentage in a manner that appears intended to effectively prevent wage income from being taxed at the lower rate.<sup>1</sup>

### **KPMG observation**

The 25% rate generally would apply to the net business income, over the sum of the net losses from such activities and carryover business loss from the preceding year. Interestingly, in calculating qualified business income, the bill would take into account only 30% of net business losses from active business activities (unless the zero capital percentage applies) even though the alternate method would allow businesses to use a higher capital percentage where appropriate. This appears to be unintended as the JCT description suggests that the alternate capital percentage would also apply to losses.

The bill introduces a new concept of a carryover business loss, which would be the excess of (1) the sum of the passive and active losses allowed, over (2) the sum of passive and active income. Apparently, losses from business activities subject to the lower rate could not offset income not subject to the reduced 25% rate, but could be used in the subsequent year if the active and passive income were insufficient to absorb business losses in the current year. Working interests in oil and gas property held directly or through an entity that does not limit the owner’s liability might qualify as a passive activity for purposes of the reduced rate, if the owner does not materially participate.<sup>2</sup> Passive investors in *natural resources* publicly traded partnerships would also benefit from the 25% rate.

Although under section 469(c), rental income is generally per se passive, a taxpayer that qualifies as a real estate professional under section 469(c)(7) may materially participate with respect to rental properties, making that income active. Further, a real estate professional may elect to treat all rental activities as a single activity for purposes of determining whether the real estate professional materially participates in the rental activity. The real estate professional’s election to group rentals applies only in years in which the taxpayer qualifies as a real estate professional and, once made, can be revoked

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<sup>1</sup> The JCT description indicates that if the net business income from an individual’s active business activity conducted through an S corporation is 100, including 75 of wages that the S corporation pays the individual, the otherwise applicable capital percentage is reduced from 30% to 25%.

<sup>2</sup> Under section 469, these oil and gas working interests are per se non-passive. The bill would eliminate that rule for purposes of the 25% rate.

only if there is a material change in facts and circumstances. For purposes of the new 25% rate, the real estate professional's election to treat all rental activities as a single activity may not necessarily be advantageous, as it would be more likely that the real estate professional would be active with respect to the combined activity. As a result, only the capital percentage of the income from the combined activity could qualify for the 25% rate.

Under the section 469 rules applicable to all taxpayers, partnerships, S corporations, trusts, estates and individuals may group activities together or treat each activity as separate (also a "grouping") for purposes of determining whether they materially participate in the activity. Generally, once grouped, a taxpayer may not change the grouping unless there is a material change in facts and circumstances or the original grouping was clearly inappropriate.

In this connection, it is also interesting that, while passive activity income is eligible for the reduced 25% rate, the additional 3.8% net investment income tax appears to apply to income from passive activities, making the "reduced" rate less advantageous. Determining the proper mix of passive, active, portfolio, plus income from services would be challenging under the new regime.

Although section 469 presumably was chosen as a "familiar standard" for purposes of the new provision, the uncertainties and complexities of section 469 (such as the grouping of activities, the determination of material participation, and the treatment of members of limited liability company members as limited or general partners) would be introduced by reference into the new rules and would require additional guidance.

With respect to the determination of the asset balance regarding any active business, the provision provides a look-through rule for partnerships and S corporations pursuant to which taxpayers would take into account their distributive or pro rata shares of the asset balance. It is unclear how such a determination would be made. For instance, should the computation of the partner's share of the asset balance be similar to the computation of previously taxed capital under section 743 and would a partner's section 743 adjustment attributable to the section 1221(a)(2) property of the partnership be taken into account?

### **Net earnings from self-employment**

Section 1004 of the bill also would make significant changes to the framework for net earnings from self-employment that are subject to the SECA tax. Net earnings from self-employment would be determined based upon the "labor percentage" of both the gross income and the gross deductions from that trade or business, and would include the "labor percentage" of both an individual's distributive share from a partnership interest and pro rata share of income from an S corporation. The labor percentage generally would be the inverse of the capital percentage applicable to that income or loss. The bill also would eliminate the exception from SECA for rental income.

### **KPMG observation**

The bill's inclusion of a shareholder's pro rata share of trade or business income from an S corporation and the elimination of the limited partner exclusion from liability for the SECA tax are important changes that, if enacted, would affect the structuring of many business arrangements. The bill also provides that proper adjustments would be made for wages paid to a shareholder of an S corporation (which are subject to employment taxes or FICA) so that the same income stream is subject to only FICA or SECA but not both.

### **REIT dividends**

See discussion in real estate investment trust section of this report for a discussion of the bill's proposed 25% rate for certain dividends of real estate investment trusts and cooperatives.

### **Revenue estimate and effective date**

The JCT estimated that the 25% passthrough rate provision would lose approximately \$448 billion over a 10-year period.

The changes made by section 1004 generally would apply to tax years beginning after December 31, 2017, but a transition rule would apply for years that include December 31, 2017. The transition rule would effectively prorate, and reduce the amount reduced for the lower rate, based on the number of days prior to January 1, 2018.

### **Repeal of technical termination rules**

Section 3313 of the bill would repeal the "technical termination" rules contained in current section 708(b)(1)(B). As a practical matter, although technical terminations sometimes can have favorable results, they also can result in unfavorable tax consequences and additional compliance burdens. Thus, some partnerships may view repealing the technical termination rules as a favorable development.

The JCT has estimated that this provision would raise approximately \$1.7 billion over 10 years.

This provision would apply to partnership tax years beginning after December 31, 2017.

## **Other general business tax reforms**

### **Corporate tax rate reduction**

**Reduction of maximum corporate tax rate to 20%.** A provision of the bill (section 3001) would eliminate the progressive corporate tax rate structure, currently imposing a maximum U.S. corporate tax rate of 35%, and replace it with a flat tax rate of 20% (and make various corresponding changes throughout the Code). Further, the U.S. corporate

tax rate on personal service corporations would be reduced to 25%, resulting in a 10 percentage point reduction from the current rate of 35%. The new rates would be effective for tax years beginning after 2017.

The bill would also repeal the alternative corporate tax on net capital gain (Code section 1201).

The JCT estimates that this provision will decrease revenues by \$1.462 trillion over 10 years.

### **KPMG observation**

This reduction is intended to make the U.S. corporate tax rate more competitive with the rates imposed by other countries. Consistent with the overall theme of the bill, this provision lowers tax rates in exchange for the elimination of certain tax benefits.

The corporate rate reduction proposed by the bill could affect choice-of-entity decisions for some business entities. The proposed flat 20% corporate tax rate would be lower than the proposed 25% tax rate for qualified business income of individuals earned through pass-through entities. As described in the passthrough entity description above, certain income earned through active business activities of passthrough entities may still be taxed at the individual rates, for which the bill would maintain a maximum tax rate of 39.6%.

The bill does not distinguish between investment income and active business income earned by corporations for purposes of applying the 20% tax rate. In addition, the bill does not integrate the corporate and individual income taxes, meaning that corporate income subject to a 20% rate could be subject to a further tax in the hands of shareholders when distributed to them as dividends. Thus, taxpayers should be concerned with the impact of other changes to the Code proposed under the bill, and choice-of-entity decisions would still be affected by individual facts and circumstances.

The bill's conforming change to the personal service corporation rate aligns with the prior position of both Treasury and the IRS to eliminate some of the tax advantages of operating in corporate form in situations in which professional service corporations offer little aside from the services of the professionals who own the corporation. Generally, a professional service corporation is a type of C corporation where substantially all of the activities of a corporation involve the performance of services in fields such as accounting, health, law, etc., and substantially all of the corporation's stock, by value, is held directly or indirectly by the employees performing services for the corporation in the identified fields. As such, the imposition of a 25% flat rate of tax on professional service corporations appears to purposefully correspond with the general 25% business tax rate associated with passthrough income.

The bill's proposed flat 20% corporate tax rate is higher than the 15% rate proposed by President Trump's tax plan, but corresponds with the 20% rate proposed in the House Blueprint released in June 2016.

## Cost recovery

### *Increase expensing*

Under section 3101 of the bill, the additional first-year depreciation deduction (bonus depreciation) would be increased and expanded.

According to the bill, generally, the bonus depreciation percentage would be increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before 2023 (with an additional year for certain qualified property with a longer production period).

The proposed statutory language would expand the definition of qualified property to include used property, provided it is the taxpayer's first use of the property. Under current law, bonus depreciation is available only for property, the original use of which begins with the taxpayer.

The definition of qualified property would be modified to exclude any property used in any real property trade or business (as defined in section 469(c)(7)(C)) or any property used in providing certain utility services if the rates for furnishing such services is subject to ratemaking by a government entity or instrumentality or by a public utility commission.

Under the proposed statutory language, a provision that allowed corporate taxpayers to treat AMT credits as refundable in lieu of claiming bonus depreciation, would be repealed, effective for tax years after 2017.

In the case of the taxpayer's first tax year ending after September 27, 2017, the taxpayer could elect to apply section 168 without regard to the amendments made by the proposed statutory language.

The proposed statutory language further provides that in the case of any tax year which includes any portion of the period beginning September 28, 2017, and ending on December 31, 2017, the amount of any net operating loss that may be treated as a carryback is to be determined without regard to the amendments made by the proposed statutory language.

Special anti-abuse transition rules would apply to qualified property acquired by the taxpayer before September 28, 2017, and placed in service after September 27, 2017.

The JCT estimates that the provision (with the December 31, 2022, sunset date) would decrease revenues by \$25 billion over 10 years.

## **KPMG observation**

This provision could have an important effect on M&A transactions. It would increase the incentive for buyers to structure taxable acquisitions as actual or deemed (e.g., pursuant to section 338) asset purchases, rather than stock acquisitions, by enabling the purchasing entity in an asset acquisition to immediately deduct a significant component of the purchase price, and potentially to generate net operating losses in the year of acquisition that could be carried forward (with annual increases for an interest component) to shield future income.

## **Small Business Reforms**

### *Modify the section 179 expensing election*

Under the bill (section 3201 of the draft legislation), the section 179 election would be modified to increase the maximum amount that could be deducted to \$5 million (the “dollar limit”). The dollar limit would be reduced dollar-for-dollar as total cost of section 179 property exceeds \$20 million (the phase-out amount). These limits would be adjusted annually for inflation. The changes would be effective for tax years beginning after 2017 and before 2023.

For tax years beginning after 2022, the dollar limit and phase-out amount would revert to their prior levels—\$500,000 and \$2 million, respectively (and would be adjusted for inflation).

In addition, qualified energy efficient heating and air-conditioning property would be added to the list of eligible investments, effective for property acquired and placed in service after November 2, 2017.

The JCT estimates that the provision (with the December 31, 2022 sunset date) would decrease revenues by \$11.4 billion over 10 years.

### *Reform and simplify small business accounting methods*

#### **Increase threshold for cash method of accounting**

Under current law, with certain exceptions, a C corporation or partnership with a C corporation partner may use the cash method of accounting only if its average gross receipts do not exceed \$5 million for all prior years (\$1 million for farm corporations and partnerships with C corporation partners, or \$25 million for certain family farm corporations).

Under the bill, the threshold for C corporations and partnerships with a C corporation partner (including farm corporations) would be increased to \$25 million and the requirement that such businesses satisfy the requirement for all prior years would be repealed. Also, the average gross receipts test would be indexed for inflation.

## **Modify accounting for inventories**

Under current law, businesses that are required to use an inventory method must also use the accrual method of accounting for tax purposes. An exception from the accrual method of accounting is provided for certain small businesses with average annual gross receipts of not more than \$1 million, and a second exception is provided for businesses in certain industries whose average annual gross receipts do not exceed \$10 million.

The bill would allow additional businesses with inventories to use the cash method by increasing this threshold. Under the provision, businesses with average annual gross receipts of \$25 million or less would be permitted to use the cash method of accounting even if the business has inventories. Under the provision, a business with inventories that otherwise qualifies for and uses the cash method of accounting would be able to treat inventory as non-incidental materials and supplies, or account for its inventories using the method of accounting reflected on its financial statements or its books and records.

## **Increase exemption for capitalization and inclusion of certain expenses in inventory costs**

Under current law, a business with \$10 million or less of average annual gross receipts is not subject to the uniform capitalization (UNICAP) rules with respect to personal property acquired for resale.

Under the bill, businesses with average annual gross receipts of \$25 million or less would be fully exempt from the UNICAP rules. This exemption would apply to real and personal property for both resellers and manufacturers.

## **Increase exceptions for accounting for long-term contracts**

Under current law, the taxable income from a long-term contract generally is determined under the percentage-of-completion method. An exception to this requirement is provided for certain businesses with average annual gross receipts of \$10 million or less in the preceding three years. Under this exception, a business may use the completed contract method with respect to contracts that are expected to be completed within a two-year period.

Under the bill, the \$10 million average annual gross receipts exception to the percentage-of-completion method would be increased to \$25 million. Businesses that meet the increased average annual gross receipts test would be permitted to use the completed-contract method (or any other permissible exempt contract method).

## **JCT estimates**

JCT estimates that the combined effect of the provisions to reform and simplify small business accounting methods would reduce revenues by \$30 billion over 10 years.



### **KPMG observation**

Overall, these provisions would allow businesses greater access to the cash method of accounting, simplify UNICAP exemption rules, and provide flexibility and additional opportunity for use of the completed contract method. According to the staff explanation, the provision aligns the eligibility to benefits of each of these rules to a single average annual gross receipts test (\$25 million), which further simplifies these rules for businesses. This provision is effective for tax years beginning after December 31, 2017.

### **Reform of business-related exclusions, deductions, etc.**

#### *Limitation on the deduction of net business interest expense*

Section 3301 of the bill would amend section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income.

For this purpose, adjusted taxable income generally would be a business's taxable income (and could not be less than zero) computed without regard to (1) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) depreciation, amortization, and depletion. Business interest would be defined as any interest paid or accrued on indebtedness properly allocable to a trade or business.

The provision would apply to all businesses, regardless of form, and any disallowance or excess limitation would be determined at the filer level (e.g., at the partnership level instead of the partner level). Any business interest disallowed would be carried forward to the succeeding five tax years as an attribute of the business, even if the business is a passthrough entity.

The proposed legislation would amend sections 381 and 382 to treat the disallowed interest as a carryover pre-change loss in the case of a corporate ownership change.

The proposed legislation would both prevent partners (or shareholders of an S corporation) from double counting adjusted taxable income of a partnership (or S corporation) for determining a partner's or shareholder's business interest limitation, and allow a partner or shareholder to use its distributive share of any excess amount of unused adjusted taxable income limitation of the partnership or S corporation in computing the partner's or shareholder's business interest limitation.

The adjusted taxable income of each partner (or shareholder) would be determined without regard to such partner's (or shareholder's) distributive share of the non-separately stated taxable income or loss of the partnership (or S corporation) to the extent the adjusted taxable income limitation is used by the partnership (or S corporation). Each

partner or shareholder would receive its distributive share of any excess amount of the partnership's (or S corporation's) unused adjusted taxable income limitation.

The JCT description illustrates the double counting rule with the following example. Assume partnership has \$200 adjusted taxable income and thus is able to fully deduct its \$60 of business interest expense. A 50% partner's distributive share of the partnership's ordinary business income would be \$70. In the absence of the limit on double counting, the 50% partner could deduct an additional \$21 ( $30\% \times \$70$ ) of business interest, assuming the fifty-percent partner had additional business interest. Thus, the 50% partner's business interest limit is based on its adjusted taxable income without regard to its \$70 distributive share of ordinary business income from the partnership.

The JCT description illustrates the excess amount distributive share mechanics with the following example. Assume the partnership described above had only \$40 of business interest and another \$20 of other deductible expenses. In that case, the 50% partner's distributive share of the excess amount (of unused adjusted taxable income limitation of the partnership) would be \$10. Thus, if the 50% partner had more than \$10 of its own business interest and no other adjusted taxable income, the 50% partner could deduct up to \$10 of its own business interest.

Under section 3203 of the proposed legislation, the net interest disallowance rules would not apply to small businesses—generally defined as businesses with average gross receipts of \$25 million or less.

The provision also would not apply to real property trades or businesses (defined as real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage) and certain regulated public utilities. Full expensing, under section 3101 of the bill, would not be available to a real property business or regulated utility not subject to the net interest disallowance provisions.

The proposal coordinates with the rules under section 4302 of the proposed legislation (proposed new section 163(n)), which would disallow interest expense for certain domestic corporations that are members of an international financial reporting group. The bill language would disallow interest deductions pursuant to whichever provision (proposed section 163(j) or (n)) would deny a greater amount of interest deductions.

The provision would be effective for tax years beginning after 2017.

The JCT estimates the provision would increase revenues by approximately \$172 billion over 10 years (after accounting for the small business exception provided in section 3203 of the proposed legislation).

### KPMG observation

The summary indicates that the proposed legislation is intended to reduce the tax favorability of debt financing as compared to equity financing. Consistent with this purpose, the proposed legislation would not be limited to interest paid to certain related persons by highly leveraged corporations and would apply to the business interest of any taxpayer and any disallowance would be determined without regard to the identity of the payee. If enacted, the proposed legislation, therefore, would represent a significant expansion in the scope of section 163(j).

The proposed legislation would apply at the filer level rather than the taxpayer level. Thus, the determination would be made at the partnership rather than the partner level. This would affect not only the determination of any interest disallowance, but also any excess amount (i.e., interest expense capacity) passed through from a partnership (or S corporation) to its partners (or in the case of an S corporation, its shareholders).

Special rules would apply to allow a pass-through entity's unused interest limitation for the year to be used by its owners and to ensure that net income from the passthrough entity would not be double counted at the partner level. Significantly, the proposed rule appears to disallow business interest expense at the partnership level. It would be helpful if this result were confirmed and illustrated with an example. If disallowance were at the partnership level, additional guidance would be needed to coordinate the treatment by partners and partnerships of any carryforward of disallowed business interest. For example, would the disallowance of interest at the partnership level create differences between the partnership's inside basis in its assets and the partner's basis in its partnership interest and what would happen to such disallowed interest in the event of transfers of partnership interests or upon the termination of the partnership?

The proposed legislation would apply only to *business* interest expense of the taxpayer. Nonbusiness interest, such as investment interest expense, would continue to be subject to the limitation on investment interest.

The proposed legislation includes only taxable interest income in the computation of net business interest expense. Thus, investments in tax-free municipal bonds would not increase a taxpayer's interest expense capacity.

It is unclear how the proposed rule interacts with other interest disallowance and deferral provisions other than section 4302 of the proposed legislation. Because business interest is defined as any interest paid or accrued, it is unclear if the business interest amount would be computed taking into account interest the deduction for which is deferred or disallowed under some other provision of the Code. For example, if a corporation issues an applicable high yield discount obligation, the deduction for some or all of the original issue discount may be disallowed or deferred under section 163(e)(5). Other provisions that limit the deduction for interest paid or accrued on certain debt instruments include sections 163(f), 163(l), 163(m), and 279.

In addition, there appear to be no special rules for financial services entities. As a result, the determination of net business interest expense is unclear for a company like an insurer that generates significant interest income related to investments as an integral part of its active insurance business.

Finally, it should be noted that interest expense can occur as a result of repurchasing one's debt instrument at a premium. Under Reg. sections 1.163-7(c), if a borrower were to repurchase its debt instrument for an amount in excess of its adjusted issue price, the repurchase premium is deductible as interest for the tax year in which the repurchase occurs, unless the deduction for the repurchase premium is disallowed under section 249 or the repurchase premium was the result of certain debt-for-debt exchanges.

### *Modify net operating loss (NOL) deduction*

Section 3302 of the bill would provide for the indefinite carryforward of an NOL (as opposed to the current 20-year carryforward). The proposed statutory language would also limit the NOL deduction for a given year to 90% of taxable income. This limitation is similar to the current limitation of NOLs in the alternative minimum tax regime (which would be repealed under the bill). Additionally, the proposed statutory language would repeal NOL carrybacks, although it would also permit a new one-year carryback for certain casualty and disaster losses for small businesses. Current law generally provides a two-year carryback for net operating losses, as well as certain carryback rules for specific categories of losses (e.g., "specified liability losses" may be carried back 10 years).

The repeal of the existing carryback provisions would include the repeal of the carryback limitations applicable to corporate equity reduction transactions (CERTs). The CERT rules are intended to prevent corporations from financing leveraged acquisitions or distributions with tax refunds generated by the carryback of interest deductions resulting from the added leverage. If applicable, the CERT rules can limit the amount of a NOL that can be carried to tax years preceding the year of the CERT.

The bill would also increase NOLs that are being carried forward by an amount equal to (i) the amount of the NOL, multiplied by (ii) the sum of (a) the annual federal short-term rate for the last month ending before the beginning of the year to which the NOL is carried and (b) four percentage points. The staff explanation describes this change as increasing NOL carryforwards by an interest factor to preserve their value. This provision is consistent with the House Blueprint, which intended that NOL carryforwards would be increased by an interest factor that compensates for inflation and a real return on capital.

The carryover provisions described above generally would be effective for NOLs arising in tax years beginning after December 31, 2017, the 90% limitation generally would apply to tax years beginning after that date, and the annual increase provision generally would apply to NOLs arising in and carried over to tax years beginning after that date.

The JCT has estimated that the proposal would raise approximately \$156 billion over 10 years.

### **KPMG observation**

Although the staff explanation states that this proposal would “generally repeal all carrybacks,” the bill does not appear to limit the three-year capital loss carryback allowed for corporations or impose a limitation on the utilization of capital loss carryovers.

The bill would require corporations to track NOLs arising in tax years beginning (1) before December 31, 2017, and (2) after December 31, 2017, separately, as only the latter category of NOLs would be eligible for the indefinite carryover and the annual percentage increase described above.

A separate section of the bill (section 3101) would allow increased expensing for certain property acquired and placed in service after September 27, 2017. The proposed statutory language provides that for any NOL attributable to a tax year which includes any portion of the period beginning September 28, 2017, and ending on December 31, 2017, the amount of such NOL that may be treated as a carryback is to be determined without regard to the amendments made by section 3101 of the bill.

The changes to the NOL carryover provisions could have a significant effect on the financial statement treatment of loss carryovers incurred in future tax years, given that unused loss carryovers would be increased annually and the carryovers would not expire.

The NOL changes would also remove the counter-cyclical effect of loss carrybacks, in that corporations generating losses due to a business downturn or due to large environmental or product liability payments would no longer be able to carry back losses to obtain refunds of taxes paid in prior years.

### *Limits on like-kind exchange rules*

Section 3303 of the bill would limit the like-kind exchange rules under Code section 1031 to exchanges of real property. The proposed statutory language continues to provide, however, that real property located in the United States is not like-kind to real property located outside the United States. In addition, deferral under section 1031 would not be allowed for an exchange of real property held primarily for sale.

The new section 1031 rules are proposed to apply to exchanges completed after December 31, 2017. A transition rule is included under which the new section 1031 rules would not apply to any exchange in which the taxpayer disposed of relinquished property, or received replacement property, on or before December 31, 2017.

The JCT has estimated that the proposal would raise revenue by \$30.5 billion over a 10-year period.

### KPMG observation

The proposed limitation on the like-kind exchange rules would eliminate deferral under section 1031 for exchanges of tangible personal property and intangible property. For tangible personal property, the proposed allowance for full expensing may offset the negative impact of eliminating the gain deferral under section 1031. However, for personal property not subject to full expensing and intangible property, the proposed limitation to section 1031 would have an adverse impact.

Economic interests in unsevered oil and gas, minerals and timber are real property that would remain eligible for like kind exchange treatment (e.g., poolings and unitizations). Moreover, a partnership that has made a valid election under Code section 761(a) to be excluded from subchapter K would continue to be treated as an interest in the assets of the partnership and not as an interest in a partnership.

### *Revisions of treatment of capital contributions*

*Repeal contribution-to-capital rules.* Section 3304 of the bill would repeal Code section 118 (which currently provides that a corporation does not recognize income on its receipt of a capital contribution) and add a new section—section 76.

New section 76 would provide that gross income includes any contribution to the capital of a corporation, other than a contribution of money or property made in exchange for stock of such corporation; however, the exception for contributions in exchange for stock would apply only to the extent that the fair market value of the money or other property does not exceed the fair market value of the stock received in the exchange at the time of contribution. Similar rules would apply to entities other than corporations.

The bill would make a conforming change under section 362(a) with respect to the rules for determining the basis of certain property acquired by corporations in certain tax-free transactions, providing that the corporation would take a carryover basis in property contributed only when stock of the corporation is issued in the exchange.

The bill also would amend Code section 362(c) to provide that, if property other than money is transferred to a corporation as a contribution to capital within the meaning of section 76, the basis of such property in the hands of the corporation will be the greater of: (1) the basis of the property in the hands of the transferor, increased by the amount of gain recognized to the transferor on the transfer; or (2) the amount included in gross income by the corporation under section 76.

The bill also would repeal section 108(e)(6). Currently, section 108(e)(6) provides that, for purposes of determining cancellation of indebtedness income, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital, section 118 does not apply, but the corporation is treated as having satisfied the debt with an amount of money equal to the shareholder's basis in the debt.



The bill would be effective for contributions made and transactions entered into after the date of the enactment.

JCT has estimated that the provision would increase revenues by approximately \$7.4 billion over 10 years.

#### **KPMG observation**

Under current section 118, corporations do not recognize income on receipt of a contribution to capital from a shareholder or non-shareholder. A number of cases describe the characteristics of a non-shareholder contribution to capital, although the scope of these rules is not always entirely clear. The paradigm case for a non-shareholder contribution to capital is a grant to a corporate taxpayer from a governmental instrumentality to encourage the taxpayer to make certain investments in a physical facility or favored technology within the contributor's jurisdiction. In repealing section 118, the proposal would require corporate taxpayers to treat their receipt of such grants as taxable income. This is consistent with the staff explanation, which states that the provision is intended to eliminate a federal tax subsidy for such state and local incentives and concessions. The proposal would, however, go beyond this stated purpose by requiring recognition of income from the receipt of federal, in addition to state and local, incentives, as well as on the receipt of incentives from nongovernmental parties.

The proposal also goes beyond the stated purpose by applying to capital contributions by shareholders (or holders of partnership equity), and it presents significant issues in this context. In particular, the rule does not by its terms address whether the meaningless gesture doctrine applies in determining whether stock is issued in exchange for a contribution of property. Under the meaningless gesture doctrine, stock may be deemed issued (or the requirement of issuing stock deemed satisfied) when a sole shareholder transfers property to a corporation or when each of a corporation's shareholders transfers property to a corporation in proportion to the shareholder's ownership of the corporation. If the meaningless gesture were to apply to a capital contribution by a shareholder to deem an issuance of stock in the corporation equal to the value of the contributed property, it could prevent the recipient corporation from recognizing income under proposed section 76. If, however, the meaningless gesture doctrine did not apply, it would be important to actually issue stock of equivalent value in all capital contribution transactions, including cases in which a sole shareholder contributes property to its wholly-owned corporation, and possibly to secure a third-party valuation of the stock issued in the exchange. Although neither the summary nor the JCT explanation addresses this issue, the drafters may believe that the meaningless gesture will apply in these cases, but it would be helpful if this point could be confirmed. In addition, there are instances in which Treasury regulations create deemed contributions, such as when a shareholder transfers property to an employee of a corporation as compensation for services performed for the corporation, or when a subsidiary corporation uses stock of a parent corporation to acquire property. Should the proposal be enacted, a number of conforming regulatory changes may be required to avoid unintended consequences.



The proposed rule may also have adverse consequences in transactions involving distressed entities. In the case of an insolvent corporation, an inability to issue stock with equivalent value to contributed cash or property may result in the corporation recognizing income from a transaction intended to rehabilitate it. For example, assume that a parent corporation owns 100% of the outstanding stock of a subsidiary corporation. The subsidiary has assets with a value of \$60 and has debt outstanding of \$100. In order to rehabilitate the subsidiary, the parent transfers assets to the subsidiary with a value of \$200. In that transfer, parent could only receive stock (or be deemed to receive stock) with a value of \$160, and under the provision the corporation would recognize \$40 of taxable income. The repeal of section 108(e)(6) could raise similar issues, including whether stock is deemed issued and the resulting consequences, when a corporation's debt is contributed to capital. In addition, a shareholder holding less than all of the stock of an ailing but solvent corporation may make a contribution to the capital of the corporation without receiving stock in order to bolster the corporation's financial position and protect the value of the shareholder's existing stock investment. The proposal would tax the corporation on the receipt of such a non-pro-rata shareholder contribution.

REITs and S corporations, as corporate entities, would presumably be subject to new Code section 76 as well. The classification of this income for purposes of the gross income tests applicable to REITs would require additional guidance.

New Code section 76 would provide that rules similar to the above would apply to entities other than corporations, such as, significantly, partnerships. Thus, the proposed rule could require a partnership to recognize gross income if there were a contribution of money or other property to a partnership to the extent the fair market value of the money or other property exceeded the value of the partnership interest issued. This could create issues, potentially, in many situations, including those in which: the partnership interest is discounted for lack of control or marketability, the terms of the partnership agreement create potential shifts in equity upon certain events post contribution, a partner may be satisfying a deficit restoration obligation, or a capital call commitment must be satisfied to retire leverage originally incurred to acquire assets that have since dropped in value. Current Code section 118 is not applicable to partnerships. Furthermore, the contributions made by partners to partnerships are already addressed in subchapter K which governs the tax consequences of contributions to the partnership. If new Code section 76 is to apply to partnerships, revisions may be needed to coordinate its application with subchapter K and potentially provide additional guidance regarding the basis of the partnership in contributed property, similar to the rules provided for corporations.

### *Repeal deduction for local lobbying activities*

Under section 3305 of the bill, the deduction for lobbying expenses with respect to legislation before local government bodies would be disallowed. The provision would be effective for amounts paid or incurred after December 31, 2017.

The JCT estimates this provision would increase revenue by approximately \$800 million over 10 years.

### **KPMG observation**

Under the proposal, only expenses associated with influencing legislation before local government bodies would be disallowed. Expenses associated with other common government affairs activities, such as monitoring legislation, attempts to influence rules and regulations, relationship building and reputational lobbying at the local government level, would be considered deductible as ordinary and necessary business expenses.

### *Repeal deduction for income attributable to domestic production activities*

Under section 3306 of the bill, the deduction for domestic production activities provided under section 199 would be repealed for tax years beginning after December 31, 2017.

A separate provision of the bill would extend the section 199 deduction for income attributable to qualifying activities performed in Puerto Rico for tax years before January 1, 2018 (a one-year extension),

JCT has estimated that repealing section 199 would increase revenues by approximately \$95.2 billion from 2018-2027. The one-year extension related to Puerto Rico would decrease revenues by approximately \$800 million over the same 10-year period.

### **KPMG observation**

The original intent of the section 199 deduction was to provide a targeted corporate rate reduction that would allow U.S. companies to compete against international tax systems, while also drawing international companies to the United States and its tax structure. While this proposed provision would eliminate the rate reduction created by section 199, a separate provision of the bill proposes an overall corporate rate reduction, as discussed above. While accelerating income to or deferring deductions from the final year in which section 199 is available may provide a permanent increase in the amount of the domestic production activities deduction that is available, such potential planning must be balanced against the benefits of more traditional planning (deferral of income and acceleration of deductions) in the context of tax rate reform.

### *Entertainment expenses and certain fringe benefits*

Section 3307 of the bill would provide that there would be no deduction for entertainment, amusement or recreation activities, facilities or membership dues relating to activities or social purposes. Also, the bill provides no deduction for transportation fringe benefits, 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 involving property or services not directly related to the employer's trade or business, except to the extent that such benefits are treated as taxable compensation to an employee. The current 50% limitation would apply only to expenses for food or beverages and to qualifying business meals with no deduction allowed for other entertainment expenses. The bill would disallow any deduction for reimbursed entertainment expenses paid as part of a

reimbursement arrangement to a tax-indifferent party, such as a foreign person or tax-exempt entity.

The effective date would be for amounts paid or incurred after 2017.

JCT estimates that this provision would increase revenues by \$33.8 billion for 10 years.

#### **KPMG observation**

The bill would eliminate or reduce the amount of allowable deduction for items that are currently allowed for being directly related to a trade or business. The provision would more closely tie the deduction of certain benefits to whether the amount was included in an employee's taxable compensation.

#### *Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction is disallowed*

Section 3308 of the bill would modify the definition of unrelated business taxable income (UBTI) to include the value of certain transportation fringe benefits (i.e., any qualified transportation fringe defined in section 132(f) and any parking facility used in connection with qualified parking defined in section 132(f)(5)(C)) and on-premises athletic facilities (defined in section 132(j)(4)(B)) if such benefits would be nondeductible (under section 274) if provided by taxable employers. The modification would not apply to the extent the amount paid or incurred is directly connected to an unrelated trade or business regularly carried on by the organization. These changes would apply to benefits provided in tax years beginning after December 31, 2017.

The JCT estimate of the effects of this provision on revenue is included in the estimate above for entertainment expenses and certain fringe benefits.

#### **KPMG observation**

According to the staff explanation, the proposed legislation is necessary to create parity between tax-exempt and taxable entities with regard to recruiting and retaining employees. This provision is dependent upon the provision proposed by section 3307, which would disallow deductions for these types of fringe benefits to taxable organizations.

#### *Deduction limits for FDIC premiums*

A proposed provision (section 3309 of the draft legislation) would amend section 162 to limit the amount certain "large" financial institutions could deduct for premiums paid pursuant to an assessment by the Federal Deposit Insurance Corporation (FDIC) to support the deposit insurance fund. The proposed limitation would apply only if the "total consolidated assets" of a financial institution (determined as of the close of the relevant tax year) exceed \$10 billion. A special aggregation rule would apply for purposes of

calculating “total consolidated assets” within an “expanded affiliated group” of related entities.

Under the proposed rule, the limitation would be equal to the ratio (not to exceed 100%) that (1) “total consolidated assets” in excess of \$10 billion bears to (2) \$40 billion. As a result, for financial institutions with “total consolidated assets” in excess of \$50 billion, no deduction for such premiums could be claimed.

The provision would be effective for tax years beginning after December 31, 2017, and the JCT estimates the limitation on deduction for FDIC premiums would increase revenues by \$13.7 billion over 10 years.

#### *Repeal of rollover of publicly traded securities gain into specialized small business investment companies*

In certain circumstances, section 1044 currently allows a taxpayer to defer capital gain income on the sale of publicly traded securities by “rolling over” the proceeds of such sale to purchase interests in a “specialized small business investment corporation” (SSBIC). An SSBIC is a type of investment fund licensed by the U.S. Small Business Administration. While the program was repealed in 1996, certain grandfathered SSBICs still exist.

Section 3310 of the bill would repeal this provision, effective for sales after 2017.

JCT estimates the limitation would increase revenues by \$1.7 billion over 10 years.

#### **KPMG observation**

The sale of shares in an SSBIC may qualify for the gross income exclusion for certain sales of small business stock contained in section 1202 (the bill proposes no change to section 1202). However, generally any gain deferred under section 1044 that is realized on the sale of the SSBIC shares is not eligible for the gross income exclusion under section 1202.

#### *Modify tax treatment of patents and certain self-created property*

Section 3311 of the bill provides that gain or loss arising from the sale, exchange, or other disposition of a self-created patent, invention, model or design, secret formula or process, would be treated as ordinary income. Also, this provision would repeal the election under section 1221(b)(3) to treat musical compositions and copyrights in musical works as a capital asset.

Under section 3312 of the bill, Code section 1235 (sale or exchange of patents) would be repealed. This would disallow long-term capital gain treatment on the transfer of a patent prior to its commercial exploitation.

Both provisions would apply to dispositions after December 31, 2017.

JCT estimates these modifications would increase revenues by \$500 million over 10 years.

### **KPMG observation**

The proposed ordinary income treatment represents a paradigm shift from the definition of “capital asset” and various rules for timing and character of income for certain self-created works. Taxpayers who currently apply the special character rules to these types of self-created property would find their gains and losses characterized as ordinary under the proposed statutory language. Under the proposed statutory language, gain or loss on the disposition of other self-created intangibles, such as personal goodwill, client lists, customer contracts, etc., would still be eligible for capital gain treatment.

Under current law, an individual who creates a patent and an unrelated individual who acquires a patent from its creator prior to the actual commercial use of the patent may treat any gains on the transfer of the patent as long-term capital gains. To qualify, a transfer must be of substantially all rights to the patent (or an undivided interest therein) and cannot be by gift, inheritance, or devise. The proposed provision would eliminate the potential for long-term capital gain treatment on the disposition of such patents held for more than one year.

### **Reform of business credits**

#### *Repeal of credit for clinical testing expenses for certain drugs for rare diseases or conditions*

Section 3401 of the bill would repeal the “orphan drug tax credit,” effective for amounts paid or incurred in tax years beginning after 2017.

### **KPMG observation**

Qualifying clinical testing expenses that would have otherwise qualified under the orphan drug credit may be eligible as qualifying research expenses under the research credit.

The orphan drug credit has been allowed for some clinical testing expenses outside the United States, if there is an insufficient testing population in the United States. These foreign expenses would not qualify under the research credit.

The JCT estimated that the provision would increase revenue by \$54 billion over 10 years.

#### *Repeal of work opportunity tax credit*

Section 3404 of the bill would repeal the work opportunity tax credit and would be effective for wages paid or incurred to individuals who begin work after 2017.

The JCT estimated that the provision would increase revenue by \$3.6 billion over 10 years.

#### *Repeal of rehabilitation tax credit*

Section 3403 of the bill would repeal the rehabilitation tax credit, generally for amounts paid or incurred after 2017.

A transition rule would allow the credit for qualified rehabilitation expenditures on buildings owned or leased at all times after 2017, if the expenditures are paid or incurred during a 24-month period selected by the taxpayer and that begins not later than the end of the 180 day period beginning on the date of the enactment of the legislation.

The JCT estimated that the provision would increase revenue by \$9.3 billion over 10 years.

#### *Repeal of new markets tax credit*

Section 3406 of the bill would prohibit new allocations of new markets tax credits (NMTC) after 2017 and no unused allocations of new markets tax credits would be allowed to be carried over into a succeeding calendar year after 2022.

The proposed statutory language preserves the pending 2017 new markets tax credit allocation of \$3.5 million.

The JCT estimated that the provision would increase revenue by \$1.7 billion over 10 years.

#### *Repeal of plug-in vehicle credit*

The proposed statutory language (section 1102 of the draft legislation) would repeal the credit for the purchase of new plug-in electric drive motor vehicles, effective for vehicles placed in service in tax years beginning after 2017.

The JCT estimated that the provision would increase revenue by \$200 million over 10 years.

#### *Repeal of employer provided child care credit*

The proposed statutory language (section 3402 of the draft legislation) would repeal the employer-provided child care credit, effective for tax years beginning after 2017.

The JCT estimated that the provision would increase revenue by \$200 million over 10 years.



### *Repeal of the credit for expenditures to provide access to disabled individuals*

The proposed statutory language (section 3407 of the draft legislation) would repeal the credit for expenditures to provide access to disabled individuals, effective for tax years beginning after 2017.

The JCT estimated that the provision would increase revenue by \$300 million over 10 years.

### *Repeal of deduction for certain unused business credits*

The proposed statutory language (section 3405 of the draft legislation) would repeal the deduction for unused business credits, effective for tax years beginning after 2017.

### **KPMG observation**

Many of the general business credits subject to the deduction have either expired under current law or would be repealed under the draft legislation.

The JCT estimated that the provision would have a negligible revenue effect over 10 years.

### *Modification of credit for portion of employer social security taxes paid with respect to employee tips*

Section 3408 of the bill would modify the tip credit to reflect current minimum wage (versus the \$5.15 rate applied) and the credit would be available for tips reported above the current minimum wage, thereby reducing the available credit. The bill provides that all restaurants claiming the credit would be required to report to the IRS tip allocations among tipped employees.

The effective date would be for tax years beginning after December 31, 2017.

The JCT estimated that the provision would increase revenue by \$3.9 billion over 10 years.

## **Energy credits**

### *Modify the credit for electricity produced from certain renewable resources*

Section 3501 of the bill would make two modifications to the credit for electricity produced from certain renewable resources.

First, it would reduce the production tax credit rate for facilities that begin construction after the date of the enactment of the legislation. The rate would be reduced from its current rate of 2.4 cents per kilowatt hour (as adjusted annually for inflation) for wind energy to 1.5 cents, and the rate would no longer be adjusted for inflation.



Second, the proposed statutory language would add a new statutory requirement that a taxpayer must demonstrate that the construction of any facility may not be treated as beginning before any date unless there is a continuous program of construction that begins before such date and ends on the date that such property is placed in service. This provision would apply to tax years beginning before, on or after date of enactment.

#### **KPMG observation**

This new statutory requirement would apply retroactively to facilities that have already begun construction. However, IRS guidance includes a similar continuous construction requirement, so it is not immediately clear what effect this new statutory requirement is intended to have.

The JCT estimated that the provision would increase revenue by \$12.3 billion over 10 years.

#### *Modify the Code section 48 energy investment tax credit*

Section 3502 of the bill would retroactively reinstate the energy investment tax credit for certain energy property that expired at the end of 2016 and extend the availability of the credit if construction of the property begins prior to 2022.

The energy investment tax credit for the following energy property would be reinstated:

- Equipment using fiber-optic distributed sunlight
- Qualified fuel cell property
- Qualified microturbine property
- Combined heat and power system property
- Qualified small wind energy property and
- Qualifying geothermal property

For qualified small wind energy property and qualified fuel cell property there would be a phase out of the credit rate if construction of the property begins after 2019 and before 2022; further, regardless of the date construction begins, if such property is not placed in service prior to 2024, the credit rate would be 10%.

The current-law phase-down of the credit for solar energy property would remain the same. However, the permanent 10% credit for solar energy property—currently available after the phase-down is complete—would be repealed if the construction of the property begins after 2027.

The permanent 10% credit available for geothermal energy property would be repealed if the construction of the property begins after 2027.

Finally, the proposed statutory language would add a new statutory requirement that a taxpayer must demonstrate that the construction of any facility may not be treated as beginning before any date unless there is a continuous program of construction that

begins before such date and ends on the date that such property is placed in service. This provision would be retroactive, applying to tax years beginning before, on or after date of enactment.

The JCT estimated that the provision would reduce revenue by \$1.2 billion over 10 years.

#### *Extension and phaseout of residential energy efficiency property credit*

Section 3503 of the bill would retroactively extend the credit for certain residential energy efficiency property—specifically, fuel cell property, qualified small wind energy property and qualified geothermal property. Under the proposed statutory language, the credit would be 30% for property placed in service before 2020, 26% for property placed in service in 2020, and 22% for property placed in service in 2021. The credit would not be available for property placed in service after 2021. The provision would be effective for property placed in service after 2016.

The JCT estimated that the provision would reduce revenue by \$1.1 billion over 10 years.

#### *Repeal of enhanced oil recovery credit*

The proposed statutory language (section 3504 of the draft legislation) would repeal the enhanced oil recovery credit, effective for tax years beginning after 2017.

The JCT estimated that the provision would increase revenue by \$200 million over 10 years.

#### *Repeal of credit for producing oil and gas from marginal wells*

The proposed statutory language (section 3505 of the draft legislation) would repeal the credit for producing oil and gas from marginal wells, effective for tax years beginning after 2017.

The JCT estimated that the provision would have no revenue effect.

#### *Modify credit for production from advanced nuclear power facilities*

Section 3506 of the bill would amend the credit allocation process for the credit for production from advanced nuclear power facilities and would allow a transfer of the credit by certain public entities.

Beginning after 2021, any allocated national megawatt capacity that remains unused would be re-allocated in the following order: first, to such facilities that did not receive an allocation equal to their full capacity; and second, to facilities placed in service thereafter in the order in which such facilities are placed in service. The proposed statutory language also would allow certain public entities to elect to transfer the credit to specified project participants (e.g., participants in design and construction, providers of nuclear steam supply systems or nuclear fuel, partners, and co-owners).

The clarification to the credit allocation process would be effective on the date of enactment, and the election for credit transfers would be effective for tax years beginning after the date of enactment.

The JCT estimated that the provision would reduce revenue by \$400 million over 10 years.

#### **KPMG observation**

As originally enacted, in order to claim the credit, the facility must have been allocated a national megawatt capacity limitation by the IRS and placed in service before 2021. As this allocation occurred before the facility was actually placed in service, some facilities, once placed in service, may not reach the allocated amount of the national megawatt capacity, or construction may not be completed by the deadline. The proposed statutory language ensures that all allocated national megawatt capacity is fully utilized through a re-allocation process.

Additionally, the proposed statutory language brings relief to public entities that are owners (or co-owners) of certain nuclear power facilities to which the IRS allocated the national megawatt capacity limitation for purposes of claiming the credit. The public entities are not subject to federal income tax, therefore such owners would have been unable to claim the benefit of the credit.

### **Bond reform**

#### *Termination of private activity bonds*

Under section 3601 of the bill, interest on any private activity bond (PAB) issued after December 31, 2017, would be included in gross income and subject to tax. As noted in the summary, the proposal would remove the federal government's subsidy of the borrowing costs for certain private businesses that are able to pay lower interest rates than competitors with similar creditworthiness but are unable to avail themselves of PABs and thereby paying a higher interest rate on the debt they issue.

The JCT estimates the termination of PABs would increase revenues by \$38.9 billion over 10 years.

#### **KPMG observation**

PABs issued on or before December 31, 2017, are not affected by these changes. State and local governments are not prevented from issuing PABs after 2017, but interest with respect to such bonds will no longer be exempt from tax.

#### *Repeal of advance refunding bonds*

Section 3602 of the bill would subject to tax the interest on advance refunding bonds issued after December 31, 2017. Advance refunding bonds are those refunding bonds

that are issued *more* than 90 days before the redemption of the refunded bonds. The summary indicates that the proposal is to remove incentives for state and local governments to subsidize the same activity with two sets of separately-issued federally subsidized debt.

The JCT estimates the repeal of advance refunding bonds would increase revenues by \$17.3 billion over 10 years.

#### **KPMG observation**

Advance refunding bonds issued on or before December 31, 2017, are not affected by these changes. Interest on refunding bonds issued *within* 90 days of the redemption of the refunded bond would remain tax exempt.

#### *Repeal of tax credit bonds*

Section 3603 of the bill would repeal the rules related to tax credit bonds. The statutes that would be repealed include:

- Clean renewable energy bonds
- New clean renewable energy bonds
- Qualified zone academy bonds
- Qualified forestry conservation bonds
- Qualified energy conservation bonds
- Qualified school construction bonds
- Build America Bonds

This provision would also repeal the election under Code section 6431, allowing issuers of tax credit bonds to receive a payment in lieu of the holder receiving a credit.

The provision would be effective for bonds issued after December 31, 2017, but the repeal would not affect the tax treatment of existing obligations. The JCT estimates this provision would reduce revenues by \$0.5 billion over 10 years.

#### **KPMG observation**

The federal government no longer provides new allocations for many of the bonds that would be repealed through this provision. Therefore, it may have minimal impact on the current municipal bond market. However, the provision would end recent discussions requesting the federal government to reintroduce certain bonds (such as Build America Bonds, which expired on January 1, 2011). The provision may also have a significant negative effect on participants that still receive the benefit from newly issued tax credit bonds, including public schools financed through qualified zone academy bonds and power providers that issue new clean renewable energy bonds.

### *Prohibition on using tax-exempt bonds for professional stadiums*

Section 3604 of the bill would amend section 103 by adding an exception for professional stadium bonds to the general exclusion from income of interest on state and local bonds under section 103. Interest on any professional stadium bond issued after November 2, 2017, would be subject to income tax.

Under the proposed statutory language, a professional stadium bond would mean any bond used to finance or refinance a facility that is “used as a stadium or arena for professional sports exhibitions, games, or training,” during at least five days in any calendar year.

The provision would be effective for bonds issued after November 2, 2017. The JCT estimates the provision would increase revenues by \$0.2 billion over 10 years.

### **KPMG observation**

Professional stadium bonds issued on or before November 2, 2017, are not affected by these changes, and interest on such bonds would remain exempt as public purpose bonds.

### **Insurance**

The discussion draft proposes changes that would affect the taxation of the insurance industry.

### *Modify operations loss deductions of insurance companies*

A proposed provision (section 3701 of the draft legislation) would alter the operations loss carryover and carryback periods for life insurance companies (currently carried back three years and forward 15) by striking Code sections 810 and 844 and conforming these periods to those of other corporations.

The draft also modifies the carryover and carryback rules for all corporations. Section 3302 repeals all net operating loss carrybacks (except for a special one-year carryback for small businesses and farms in the event of certain casualty and disaster losses) and allows taxpayers to carry operating losses forward indefinitely. Under the proposed provision, taxpayers’ ability to deduct a net operating loss carryover (or carryback, under the aforementioned casualty loss provision) would be limited to 90% of the taxpayer’s taxable income for the year.

These provisions would be effective for losses arising in tax years beginning after 2017.

The revenue effect of section 3701 is included in the JCT estimate provided for section 3302.

**KPMG observation**

This proposal would put life insurance companies on the same loss carryback and carryforward schedule as other corporations. The repeal of nearly all carrybacks could have a substantial impact on a life company's deferred tax asset admissibility computation for statutory accounting purposes. The first part of the admissibility test under SSAP 101 would no longer be applicable since it allows insurance companies to use a reversal period that corresponds to the tax loss carryback provisions of the Code.

The limitation of an insurance company's operating loss deduction to 90% of the company's taxable income would conform to current law regarding the utilization of losses to compute alternative minimum tax.

*Repeal small life insurance company deduction*

Code section 806 allows life insurance companies to currently deduct 60% of their first \$3 million of life insurance-related income. The deduction is phased out for companies with income between \$3 million and \$15 million. In addition, the deduction is not available to life insurance companies with assets of at least \$500 million.

A proposed provision (section 3702 of the draft legislation) would repeal the Code section 806 special deduction for small life insurance companies.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would raise \$0.2 billion over 10 years.

**KPMG observation**

This proposal is described as eliminating special treatment for a segment of the insurance industry in which "the risk distribution benefits of risk pooling are the weakest." The proposal would not eliminate a similar benefit for small property and casualty insurers.

*Computation of life insurance tax reserves*

Code section 807(d)(1) provides that the deduction allowed for life insurance reserves for a contract is the greater of the net surrender value or the Federally Prescribed Reserve. Code section 807(d) currently provides that the interest rate used in computing the Federally Prescribed Reserve for a contract is the greater of the prevailing state interest rate or the 60-month rolling average of the applicable federal mid-term rate. The prevailing state assumed interest rate is equal to the highest assumed interest rate permitted to be used in at least 26 States in computing regulatory life insurance reserves. The discount rate used by property & casualty (P&C) insurance companies for reserves is the applicable federal mid-term rate over the 60 months ending before the beginning of the calendar year for which the determination is made.



A proposed provision (section 3703 of the discussion draft legislation) would allow life insurance companies to take into account a specific percentage, 76.5%, of the increase or decrease in reserves for future un-accrued claims (as reported on the insurer's regulatory annual statement and on tax Schedule M-3) in computing taxable income. Deficiency reserves, asset adequacy reserves or other types of reserves would not be included.

The draft appears to eliminate the section 807 floor that stipulates tax reserves cannot be less than the contract's cash surrender value. As a result, certain contracts, such as certain deferred annuities, could have tax reserves that are significantly less than the contract's cash surrender value.

In addition, these provisions could result in a significant impact on surplus in light of the statutory accounting limitations on admissibility of deferred tax assets.

The provision would generally be effective for tax years beginning after 2017. The effect of the provision on computing reserves for contracts issued before the effective date would be taken into account ratably over the succeeding eight tax years.

The JCT has estimated that the provision would raise \$14.9 billion over 10 years.

#### **KPMG observation**

The provision is proposing to reduce the amount of reserves that may be deducted and to simplify the complex section 807 reserve calculation. The proposal supports the change by explaining that insurance regulators have been changing how life insurance companies must calculate and maintain reserves. The current rules in the Tax Code do not explicitly provide how reserves measured in the new manner (i.e., principle-based reserves) should be taken into account for tax purposes. The provision would replace the current-law prescribed rules with rules taking into account reserves on an economically neutral basis. The current-law rule that uses a regulatory-based measurement generally understates income.

In its efforts to reduce the complexity surrounding computation of the federally prescribed reserve under current law, the proposal could impact the financial stability of some life insurance companies in certain ways. First, the 23.5% haircut of statutory reserves may lead to a reduction of currently deductible life insurance company reserves. Some life insurance companies may not have sufficient surplus to absorb this increased tax liability. Second, the proposed provision disallows reserve deductions for asset adequacy reserves, contingency reserves, unearned premium reserves, or any other amount not constituting reserves for future unaccrued claims. It is unclear how the IRS will identify such non-deductible reserves. Third, the proposal removes the cash surrender value floor for tax reserves. Thus it is possible that tax deductible reserves could be lower than a contract's cash surrender amount.



*Repeal Code section 807(f) spread—Adjustment for change in computing reserves*

Under 807(f), taxpayers are currently required to make adjustments to taxable income when they change a tax accounting method, so that the accounting method change does not result in an omission or duplication of income or expense. For taxpayers other than life insurance companies, an adjustment that reduces taxable income generally is taken into account in the tax year during which the accounting method change occurs, while an adjustment that increases taxable income may be taken into account over the course of four tax years, beginning with the tax year during which the accounting method change occurs.

A proposed provision (section 3704 of the draft legislation) would repeal the special 10-year period for adjustments to take into account changes in a life insurance company's basis for computing reserves. The general rule for tax accounting method adjustments would apply to changes in computing reserves by life insurance companies.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would raise \$1.2 billion over 10 years.

**KPMG observation**

This proposal would put life reserve computation changes on the one-year or four-year spread rules applicable to general changes in methods of accounting. The proposal appears to provide that changes in life insurance reserve basis would continue to be an automatic adjustment and not require prior approval for such changes.

*Modify rules for life insurance proration for purposes of determining the dividends received deduction (DRD)*

Under current law deductions are limited or disallowed in certain circumstances if they are related to the receipt of exempt income. Under the "pro-ration" rules, life insurance companies are required to reduce deductions, including DRD deductions and reserve deductions, to account for the fact that a portion of dividends and tax-exempt interest received is used to fund tax-deductible reserves for the companies' obligations to policyholders. This portion is determined by a formula that computes the respective shares of net investment income that belong to the company and to the policyholders.

A proposed provision (section 3705 of the draft legislation) would change the life insurance company proration rules for the DRD in Code section 805(a)(4) by changing the company share to 40%.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would raise \$1.1 billion over 10 years.

**KPMG observation**

The current rules are complex and based on an archaic system of life insurance company taxation. The JCT description states that the provision sets the company share percentage to a fixed amount based on current industry average of the company share.

*Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts*

Previous rules enacted in 1959 included a rule that half of a life insurer's operating income was taxed only when the company distributed it, and a "policyholders surplus account" kept track of the untaxed income. In 1984, this deferral of taxable income was repealed, although existing policyholders' surplus account balances remained untaxed until they were distributed. Legislation enacted in 2004 provided a two-year holiday that permitted tax-free distributions of these balances during 2005 and 2006. During this period, most companies eliminated or significantly reduced their balances.

A proposed provision (section 3706 of the draft legislation) would repeal the rules for distributions from pre-1984 policyholders' surplus accounts.

The provision would generally be effective for tax years beginning after 2017, and any remaining balances would be subject to tax payable in eight annual installments.

The JCT has estimated that the provision would raise less than \$50 million over 10 years.

*Modify proration rules for property and casualty (P&C) insurance companies*

Under current law nonlife insurance companies are currently required to reduce the exclusion from income for tax-exempt interest income by 15% of the income. The adjustment is accomplished by a reduction in the deduction allowed for unpaid losses.

A proposed provision (section 3707 of the draft legislation) would replace the fixed 15% reduction in the reserve deduction for P&C insurance companies with a fixed 26.25% reduction in the reserve deduction.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would raise \$2.1 billion over 10 years.

**KPMG observation**

The JCT description states that the increase in the fixed haircut within the provision would keep the reduction in the reserve deduction consistent with current law by adjusting the rate proportionally to the decrease in the corporate tax rate. That rationale may not be consistent with the purpose under current law to measure the amount of tax-exempt income credited to reserves (estimated at 15%) in order to eliminate a double benefit.

Although the reduction is significant, a fixed rate may still be preferable overall to many insurers. The fixed rate facilitates predictability of after-tax rates of return on tax-exempt bonds and compare those rates to other investments.

### *Modify discounting rules for property and casualty (P&C) insurance companies*

Pursuant to Code section 846, a P&C company may deduct unpaid losses that are discounted using mid-term applicable federal rates and based on a loss payment pattern. The loss payment pattern for each line of insurance business is determined by reference to the industry-wide historical loss payment pattern applicable to such line of business, although companies may elect to use their own particular historical loss payment patterns. In the case of long-tail lines of business, a special rule extends the loss payment pattern period, so that the amount of losses which would have been treated as paid in the tenth year after the accident year is treated as paid in the tenth year and in each subsequent year (up to five years) in an amount equal to the amount of the losses treated as paid in the ninth year after the accident year.

A proposed provision (section 3708 of the draft legislation) would require P&C insurance companies to use a higher rate—the corporate bond yield curve (as specified by Treasury)—to discount their unpaid losses under Code section 846. In addition, the special rule that extends the loss payment pattern period for all long-tail lines of business would be applied similarly to all lines of business. The provision would also repeal the election to use company-specific, rather than industry wide, historical loss payment patterns.

In addition, the special rule that extends the loss payment pattern period for long-tail lines of business would be applied similarly to all lines of business (but with the five-year limitation on the extended period increased to 15 years) so that:

- In general, the amount of losses that would have been treated as paid in the third year after the accident year would be treated as paid in the third year and in each subsequent year in an amount equal to the average of the amount of the losses treated as paid in the first and second years after the accident year; and
- In the case of lines of business relating to auto or other liability, medical malpractice, workers' compensation, multiple peril lines, international coverage, and reinsurance, the amount of losses which would have been treated as paid in the tenth year after the accident year would be treated as paid in the tenth year and in each subsequent year in an amount equal to the average of the amount of the losses treated as paid in the seventh, eighth and ninth years after the accident year.
- The provision also would repeal the election in section 846(e) to use company-specific, rather than industry-wide, historical loss payment patterns.

The provision generally would be effective for tax years beginning after 2017, with a transition rule that would spread adjustments relating to pre-effective date losses and expenses over such tax year and the succeeding seven tax years.

The JCT has estimated that the provision would raise \$13.2 billion over 10 years.

#### **KPMG observation**

This proposal is scored as a large insurance tax revenue-raiser at \$13.2 billion over 10 years and could materially affect the computation of P&C loss reserves. The stated rationale for modifying the discount rate to a corporate bond-based rate is to provide a “more accurate measurement of income.”

The change in loss payment patterns may provide simplification, but will shorten or lengthen the pattern for different lines of business, which may or may not correspond more closely with actual loss payment patterns in the industry.

Elimination of the section 846(e) election will provide simplification, and will affect some insurers more significantly than others.

#### *Repeal elective deduction and related special estimated tax payment rules*

Under current law, insurance companies may elect to claim a deduction equal to the difference between the amount of reserves computed on a discounted basis and the amount computed on an undiscounted basis. Companies which make this election are required to make a special estimated tax payment equal to the tax benefit attributable to the deduction.

A proposed provision (section 3709 of the draft legislation) would repeal the Code section 847 elective deduction and related special estimated tax payment rules.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would raise less than \$50 million over 10 years.

#### **KPMG observation**

Code section 847 was originally enacted to provide for the admissibility of deferred tax assets associated with loss reserve discounting under the recognition rules of FAS 96.

FAS 109 liberalized these requirements, making section 847 largely unnecessary and administratively burdensome.

### *Capitalize certain policy acquisition expenses (DAC)*

A proposed provision (section 3710 of the draft legislation) would substantially increase the capitalization rates applicable to specified insurance contracts under Code section 848, and would replace the current three categories of contracts with only two categories. The current proxy rates applied to net premiums on “specified insurance contracts” are 1.75% for annuity contracts, 2.05% for group life insurance contracts and 7.7% for individual life insurance, group and individual health insurance, and other insurance contracts.

The proposed provision is as follows:

- Group contracts (4%)
- All other specified contracts (11%)

The 10-year spread would remain the same.

The provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would raise \$7 billion over 10 years.

#### **KPMG observation**

When section 848 was originally enacted, there was significant debate over the appropriate capitalization percentage and amortization period. The proposal would have the effect of increasing the amount of DAC capitalized. The proposed rules would further reduce current deductions for these expenses.

### **Compensation**

#### *Nonqualified deferred compensation*

The bill would create a new section 409B to provide that an employee is taxed on nonqualified deferred compensation as soon as there is no service-related substantial risk of forfeiture with respect to that compensation. The performance of future services would be considered a substantial risk of forfeiture, but a covenant not to compete or a condition related to the purpose of the compensation other than the performance of services would not be a substantial risk of forfeiture. The proposed legislation provides that the definition of “nonqualified deferred compensation plan” is very broad and would include any deferred compensation plan, except a qualified plan, a bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. The proposed statutory language specifically provides that a deferred compensation plan includes equity-based compensation such as units, stock appreciation rights, and stock options. However, the bill provides that a deferred compensation plan does not include a plan which provides for the transfer of property under section 83 (other than stock options) or a section 402(b) trust. The JCT description provides that 409B applies to all options and

SARs with no intended exceptions. However, the JCT description clarifies that statutory options would not be subject to section 409B.

The effective date the provisions would be for amounts attributable to services performed after 2017. The current rules related to deferred compensation would continue to apply to existing nonqualified deferred compensation arrangements related to services performed before 2018. Grandfathered amounts must be included in income the later of “(1) the last tax year beginning before 2026, or (2) the tax year in which there is no substantial risk of forfeiture of the rights to such compensation.” However, the bill provides that guidance would be issued to allow plans a limited time to amend to conform with new distribution requirements.

JCT estimated this provision would increase revenues by \$16.2 billion over 10 years.

#### **KPMG observation**

The bill would be a significant change to the deferred compensation rules. Section 409B only permits compensation to remain tax deferred until there is no substantial risk of forfeiture related to services. Sections 409A, 457(b) for tax-exempt entities, 457(f), and 457A would no longer apply to amounts deferred which are attributable to services performed after December 31, 2017. The statutory language broadly covers compensation except for section 83 property. Therefore, this provision could have a major impact on the future of employee compensation. Common equity arrangements, such as stock options and stock appreciation rights, could have a more limited use since their ability to defer compensation after vesting would be eliminated.

#### *Modification of limitation on excessive employee remuneration*

Section 3802 of the bill proposes repeal of the exceptions to the \$1 million deduction limitation for commissions and performance-based compensation. The bill would clarify that the definition of “covered employee” includes the principal executive officer, principal financial officer, and the three other highest paid employees. The bill would provide that once an employee is treated as a covered employee, the individual remains a covered employee as long as the individual receives remuneration from the corporation. Further, the bill would expand the definition of a “publicly held corporation”. The JCT description provides that the definition would be expanded to include foreign companies publicly traded through ADRs, and may include some corporations that are “not publicly traded, such as large private C or S corporations.”

The effective date would be effective for tax years beginning after 2017.

JCT estimated the provision would increase revenues by \$9.3 billion over 10 years.

#### **KPMG observation**

The proposed elimination of the exception of performance-based compensation from the \$1 million deduction limitation is a substantial change to the current rules. The



performance-based exception while complex is an often-used exception to link compensation to performance and provide a greater deduction to a publicly traded corporation. The proposed change to expand the definition of covered employee to include the principal financial officer in alignment with the definition used by the SEC has been a long discussed change because the differences in definitions generate some confusion. Expanding the definition to apply even after officers retire is also a major change. It is not completely clear how the deduction would work after a change in control.

### *Excise tax on excess tax-exempt organization executive compensation*

Section 3803 of the bill would impose a 20% excise tax on remuneration in excess of \$1 million and on excess parachute payments paid by an organization exempt from tax under section 501(a), an exempt farmer's cooperative (section 521(b)(1)), a political organization (section 527), or a federal, state, or local governmental entity with excludable income (section 115(1)), to any of its current or prior (beginning after December 31, 2016) five highest-paid employees.

Remuneration would include cash and other benefits paid in a medium other than cash. However, it would not include any designated Roth contribution (section 402A(c)) or amounts that are excludable from gross income. Remuneration would also include payments from certain related organizations, including organizations that control, or are controlled by, the tax-exempt organization. However, remuneration that is not deductible by reason of the \$1 million limit on deductible compensation (section 162(m)) is not taken into account for purposes of the proposal.

A "parachute payment" generally is defined as a payment contingent upon an employee's separation from employment if the aggregate present value of such payment equals or exceeds three times the employee's base amount. Parachute payments do not include payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity (section 403(b)), or an eligible deferred compensation plan of a state or local government employer (section 457(b)). The 20% excise tax would be applied to the excess of the parachute payment over the portion of the base amount allocated to the payment.

The proposed legislation would apply to remuneration and parachute payments paid in tax years beginning after December 31, 2017.

JCT estimated the provision would increase revenues by \$3.6 billion over 10 years.

### **KPMG observation**

The proposed legislation provides rules for tax-exempt entities that are similar to section 162(m) limits on the deductibility of compensation paid by publicly traded corporations and section 280G rules on excess parachute payments that may be applicable to taxable corporations. The proposed legislation related to "excess parachute payments" relies upon section 280G guidance for determining the "base amount" calculation.



The provision would impose the excise tax on the employer and related organizations, each sharing the liability in proportion to the compensation paid. As a result of the proposal's broad definition of related organizations, it appears that a taxable organization could be subject to the excise tax.

The proposal would add an additional layer of complexity to the rules governing compensation paid by tax-exempt organizations. Currently, sections 4941 and 4958 impose excise taxes on the recipients of unreasonable or excess compensation paid by certain tax-exempt organizations. In addition, the inurement prohibition that applies to most tax-exempt organizations and the violation of which may result in loss of tax-exempt status, guards against the payment of unreasonable compensation. Although the summary indicates that the provision is consistent with the limitation on the deductibility of executive compensation paid by taxable publicly traded corporations, it appears to not take into account some of the existing rules.

## International provisions

In the context of international tax, H.R. 1 quite arguably goes beyond the Tax Reform Act of 1986 and, if enacted, would represent the most significant changes in the area since the Foreign Investors Tax Act of 1966. Altogether gone is any element of deferred taxation on foreign income within a US-parented multinational group—the income is taxed as earned or is permanently exempt from U.S. taxation. This change would not come without costs, however—not only would existing deferred earnings be subjected to immediate taxation (at reduced rates), but subpart F would be retained to provide full and immediate taxation of the classes of income that are captured by current law, and a new, very broad, class of income “foreign high return income” would be subject to immediate taxation at a reduced rate.

H.R. 1 also contains a number of anti-base erosion proposals, which would have significant impacts on both foreign- and U.S.-parented large multinational groups. Net interest expense would be limited not only by the 30% of [EBITDA] rule applicable to purely domestic entities, but also would be capped at 110% of a U.S. consolidated group's share of world-wide interest expense. A new proposal would impose an excise tax, or in lieu of that, an elective alternative net basis tax regime, on payments from US persons to related foreign persons if the payments give rise directly (or indirectly, for example through COGS) to deductions in the US.

Taken together all of these rules would represent a significant expansion of the base of cross-border income to which current US taxation would apply.

## Establishment of participation exemption system for taxation of foreign income

### *Add U.S. participation exemption*

Section 4001 of the bill would add new section 245A to the Code, which entitles a domestic corporation that is a U.S. shareholder (as defined in section 951(b)) of a foreign

corporation to a 100% dividends received deduction (DRD) for the foreign-source portion of dividends received from the foreign corporation (the “245A DRD”).

The foreign-source portion of a dividend would be equal to the same proportion of the dividend as the foreign corporation’s foreign earnings bears to its total undistributed earnings. A foreign corporation’s undistributed foreign earnings would consist of all undistributed earnings except for income effectively connected with the conduct of a trade or business in the United States, and dividend income received from an 80% owned domestic corporation. Total undistributed earnings include all earnings without reduction for any dividends distributed during the tax year. For the purpose of computing both foreign and total undistributed earnings, new section 245A would also treat a foreign corporation’s pre-1987 earnings in the same manner as its post-1986 earnings, thereby effectively eliminating any of the distinctions found in section 902(c).

Nimble dividends (i.e., dividends paid out of current year earnings when there is an overall accumulated deficit at year end) are also eligible for the 245A DRD, equal to the ratio of current year foreign earnings to total current year earnings.

A corporate U.S. shareholder may not claim a foreign tax credit (FTC) or deduction for foreign taxes paid or accrued (including withholding taxes) with respect to any dividend allowed a 245A DRD. Additionally, for purposes of calculating a corporate U.S. shareholder’s Code section 904(a) FTC limitation, the shareholder’s foreign source income would not include: (i) the entire foreign source portion of the dividend, and (ii) any deductions allocable to a 245A DRD (or stock that gives rise to a 245A DRD).

In addition to owning 10% of the voting power of the foreign corporation, a domestic corporation would need to satisfy a holding period requirement and an anti-conduit provision to benefit from the 245A DRD.

- The domestic corporation would have to be a U.S. shareholder of the foreign corporation for more than 180 days during the 361-day period beginning 180 days before the dividend is paid, and
- A 245A DRD would not be permitted to the extent that the domestic corporation that owns the shares with respect to which the dividend is paid is under an obligation to make related payments with respect to positions in substantially similar or related property.

Several conforming amendments would be made to coordinate the 245A DRD with existing Code provisions, including:

- A 245A DRD would not be available for any dividend from a corporation exempt from tax under Code sections 501 or 521.
- Section 1059, under which a corporate shareholder’s basis in stock is reduced by the non-taxed portion of extraordinary dividends received, would be coordinated with new

section 245A so that a corporation that receives an extraordinary dividend in respect of stock that the corporation has not held for more than two years before the dividend announcement date would be required to reduce its basis in the stock by the amount of the 245A DRD.

New section 245A would apply to distributions made after (and deductions with respect to tax years ending after) December 31, 2017.

#### **KPMG observation**

The 100% participation exemption system would move the United States away from a worldwide tax system and closer to a territorial tax system for earnings of foreign corporations but only to the extent those earnings are neither subpart F income, nor subject to the minimum tax rule discussed below. The participation exemption proposal largely follows the participation exemption proposal found in the Tax Reform Act of 2014 (2014 reform proposal), except that the 2014 reform proposal provides only a 95% DRD. For corporations earning only foreign source income, the mechanics of new section 245A are largely irrelevant and the full DRD will be available with respect to all dividends received by a corporate U.S. shareholder whether out of current or accumulated earnings and profits.

#### *Repeal section 956 for corporate shareholders*

Section 4002 of the draft legislation would amend Code section 956 to exclude U.S. corporate shareholders of controlled foreign corporations (CFCs) from having a current income inclusion with respect to investments in U.S. property made by a CFC. The proposal also would provide the Secretary with authority to issue regulations addressing U.S. shareholders that are partnerships with corporate partners. Code section 956 would continue to apply to individual U.S. shareholders.

The provision would be effective for tax years of foreign corporations beginning after December 31, 2017.

#### **KPMG observation**

Under current law, an investment in U.S. property by a CFC may give rise to a current income inclusion to a U.S. shareholder to the extent the investment was made with untaxed earnings. Congress originally enacted Code section 956 because it believed that a CFC's investment of untaxed earnings in U.S. property represented a constructive dividend to the U.S. shareholders that should be currently taxed to the U.S. shareholders as if the CFC actually distributed a dividend. Because actual distributions of untaxed earnings to U.S. corporate shareholders would not be subject to U.S. taxation under the participation exemption system discussed above, there would be no tax-avoidance reason for U.S. corporate shareholders to be subject to taxation by reason of a CFC's investment in U.S. property.

### *Limit losses with respect to specified 10% owned foreign corporation*

Section 4003 of the draft legislation would provide two loss limitation rules.

First, the bill would amend Code section 961 to provide that if U.S. shareholder that is domestic corporation receives a dividend from a foreign corporation that is allowed a 245A DRD, solely for the purposes of determining the domestic corporation's loss on the sale of stock of the foreign corporation, the domestic corporation would reduce its basis in the stock of the foreign corporation by an amount equal to the 245A DRD.

Second, section 4003(b)(1) of the bill would add Code section 91, which would require domestic corporations to recapture foreign branch losses in certain foreign branch transfer transactions. Under section 91, if a domestic corporation transfers substantially all the assets of a foreign branch (within the meaning of section 367(a)(3)(C)) to a 10% owned foreign corporation of which it is a United States shareholder, the domestic corporation would have to include in gross income the "transferred loss amount" (TLA) with respect to such transfer.

The TLA is defined as the excess (if any) of:

- The sum of losses incurred by the foreign branch and allowed as a deduction to the domestic corporation after December 31, 2017, and before the transfer, over
- The sum of (1) any taxable income of such branch for a tax year after the tax year in which the loss was incurred, through the tax year of the transfer, and (2) any amount recognized under the section 904(f)(3) "overall foreign loss recapture" (OFLR) provisions on account of the transfer.

The amount of the domestic corporation's income inclusion under this proposal would be subject to limitations.

Section 4003(b)(2) of the bill also changes the source of "branch loss recapture" (BLR) income from foreign source to U.S. source.

The proposal requiring basis adjustments to a foreign corporation's stock would be effective for dividends received after December 31, 2017.

The proposal relating to TLA inclusions applies to transfers occurring after December 31, 2017.

### **KPMG observation**

The 2014 reform proposal contained a similar loss limitation provision that required taxpayers also to carry forward and include in future income the portion of the TLA that was subject to a limitation and thus not included in gross income in the year of transfer. Section 91 as proposed by the Bill does not include this carry forward requirement.

Section 91 dovetails TLA inclusions with the OFLR provisions and BLR provisions to avoid double inclusions and to provide ordering rules when there are overlapping applications of section 91 and one or both of these provisions. As a general matter, it appears that section 91 is intended to ensure that *all* recognized losses attributable to applicable foreign branches that are subsequently transferred outbound are recaptured; the BLR rules are limited to certain outbound non-recognition transactions, and both the BLR and OFLR are capped at foreign branch built-in gain. Section 91 would apply to both recognition and non-recognition transactions and would not be limited to foreign branch built-in gain. Section 91, however, does not provide a coordination rule with the “dual consolidated loss recapture” (DCLR) provisions, creating uncertainty in situations in which section 91 and DCLR overlap. While section 91 and DCLR are not coterminous, the DCLR provisions apply both to recognition and non-recognition transactions and in many situations require recapture of amounts in excess of foreign branch built-in gain. Thus, the DCLR provisions in many situations already achieve the apparent desired result of section 91.

### *Mandatory repatriation*

Section 965 is revised to provide for a transition rule to effect the participation exemption regime added by section 245A. This transition rule provides that the subpart F income of a deferred foreign income corporation (DFIC) for its last tax year beginning before January 1, 2018 is increased to include its accumulated post-1986 deferred foreign income (deferred income) as of November 2, 2017, or December 31, 2017, whichever is greater. A taxpayer generally includes in its gross income its pro rata share of the deferred income of each DFIC with respect to which the taxpayer is a U.S. shareholder. This inclusion, however, is reduced (but not below zero) by an allocable portion of the taxpayer’s aggregate foreign E&P deficit and the taxpayer’s share of its affiliated group’s aggregate unused E&P deficit.

Section 965 includes a participation exemption, the net effect of which is to tax a U.S. shareholder’s income inclusion at a 12% rate to the extent it is attributable to the shareholder’s foreign cash position and at a 5% rate otherwise. A U.S. shareholder can claim a foreign tax credit (FTC) for a portion of the foreign income taxes associated with its income inclusion.

### **KPMG observation**

Section 965 is conceptually based on the mandatory repatriation provision included in the 2014 reform proposal. However, unlike the 2014 reform proposal, section 965 provides two testing dates at which a foreign corporation’s deferred income must be measured. These dates add considerable complexity to section 965. First, the November 2 date requires foreign corporations to compute their E&P on a date that is not likely to coincide with regular reporting cycles. Section 965 does not provide the method that foreign corporations must use to determine their E&P as of November 2 (e.g., closing of the books). Second, the testing date for each foreign corporation is independently determined

and, because the inclusion is based upon the greater of the deferred income on November 2, 2017, or December 31, 2017, these foreign corporations will be required to calculate their E&P on both dates.

Taxpayers that have been in the process of planning to reduce E&P in anticipation of a mandatory repatriation by filing accounting method changes should still be able to file a Form 3115 to be effective for 2017 and the E&P would include the full section 481(a) adjustment determined as of the beginning of 2017, as well as transactions affecting the new method through November 2, 2017.

### *U.S. shareholder and DFIC definitions*

The current definition of “U.S. shareholder” applies for purposes of section 965. Thus, a U.S. shareholder is, with respect to a foreign corporation, any U.S. person that owns directly, indirectly, or constructively under section 958 at least 10% of the foreign corporation’s voting power.

A DFIC, with respect to a U.S. shareholder, is a specified foreign corporation of the shareholder with positive deferred income. A “specified foreign corporation” is: (i) any controlled foreign corporation, and (ii) any other foreign corporation that is not a passive foreign investment company and that has at least one domestic corporate U.S. shareholder (for these purposes determined without regard to section 958(b)(4)). A DFIC that is not a controlled foreign corporation is treated as such solely for purposes of taking into account its deferred income and determining each of its U.S. shareholder’s pro rata share of such income.

### **KPMG observation**

The definition of “U.S. shareholder” includes not only domestic corporate shareholders in foreign corporations, but also domestic partnerships, trusts, estates, and individuals that directly, indirectly, or constructively own 10% or more of a DFIC’s voting power. As a result, such non-corporate shareholders may be exposed to inclusions under section 965 even though the going forward exemption regime for dividends from foreign subsidiaries under section 245A will only apply to corporate shareholders. Because section 245A will only apply to corporate shareholders of specified 10% owned foreign corporations and section 965 only applies to post-1986 E&P, it appears that corporate shareholders of foreign corporations that are not specified 10% owned foreign corporations and non-corporate shareholders of all foreign corporations will be subject to tax on distributions of pre-1987 E&P from foreign corporations.

Section 965 defines “specified foreign corporation” by turning off the application of section 958(b)(4) for purposes of determining whether a domestic corporation is a U.S. shareholder of a non-CFC foreign corporation. Section 958(b)(4) prevents stock attribution from a foreign person to a U.S. person for certain subpart F rules, including the rules regarding whether a U.S. person is a U.S. shareholder or a foreign corporation is a CFC. As a result, the section 965 mandatory repatriation regime may apply to domestic corporations that own less than 10% of the voting power of non-CFC foreign affiliates.



Moreover, a domestic corporation that owns less than 10% of the voting power of a non-CFC foreign affiliate will not be entitled to claim FTCs with respect to its income inclusion. This aspect of section 965 makes it much broader than the 2014 reform proposal's mandatory repatriation provisions, which only applied to CFCs and 10/50 corporations.

The Chairman's mark amends section 958(b) by striking paragraph (4) for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. Thus, it appears that section 958(b)(4) applies to determine whether a U.S. person is a U.S. shareholder for tax years prior to the amendment's effective date, notwithstanding the definition of specified foreign corporation. For example, if a domestic corporation owns 9% of a foreign affiliate, the remaining 91% of which is owned by the domestic corporation's foreign parent, the foreign affiliate is a specified foreign corporation with respect to the domestic corporation, but the domestic corporation is not a U.S. shareholder of the affiliate. Therefore, the domestic corporation does not have to include its pro rata share of the foreign affiliate's deferred income.

### *Deferred income and E&P deficits*

Deferred income is a DFIC's E&P accumulated in tax years beginning after December 31, 1986, determined as of the applicable testing date (i.e., November 2, 2017, or December 31, 2017) that is not attributable to effectively connected income or amounts previously included in income under section 959. For these purposes, a DFIC's post-1986 E&P is not reduced for dividends distributed during the tax year that includes the applicable testing date, and is increased by any qualified deficit arising before January 1, 2018, that continues to be treated as such after December 31, 2017. The JCT description states that the Secretary may also prescribe rules that are appropriate to implement the intent of section 965 and use of November 2, 2017, as one of the measurement dates to establish a floor for determining deferred income. These rules may address the extent to which retroactive "check-the-box" elections will be permitted.

A U.S. shareholder can reduce, but not below zero, its pro rata share of a DFIC's deferred income by an allocable portion of its aggregate foreign E&P deficit. A U.S. shareholder's "aggregate foreign E&P deficit" is the sum of its pro rata share of the post-1986 E&P deficit of each of its specified foreign corporations, determined as of the applicable testing date. A U.S. shareholder's aggregate foreign E&P deficit is allocated to each of its DFICs based on their relative amount of deferred income.

After taking into account the allocable portion of its aggregate foreign E&P deficit, a U.S. shareholder can reduce, but not below zero, its remaining pro rata share of a DFIC's deferred income by its share of its affiliated group's "aggregate unused E&P deficit," which is the sum of each group member's unused E&P deficit. An affiliated group member's "unused E&P deficit" is the amount by which its aggregate foreign E&P deficit exceeds the amount of its income inclusion, determined without regard to the E&P deficit allocation rules. An affiliated group's aggregate unused E&P deficit is allocated to each group member based on the relative amount of its deferred income, determined after taking into



account the member's aggregate foreign E&P deficit. Section 965 includes rules that adjust the application of these affiliated group "netting" rules to group members that are not wholly owned within the group.

### **KPMG observation**

Section 965, similar to the 2014 reform proposal, computes deferred E&P without regard to current year dividends. The "add-back" may reduce the expected U.S. federal income tax benefits of commonly used E&P and FTC-planning techniques that were recently completed in anticipation of tax reform. As such, taxpayers would be well-advised to reassess the treatment of the transactions associated with these techniques in light of section 965.

The E&P deficit provisions included in section 965 are also similar to the 2014 reform proposal because they allow a U.S. shareholder to benefit from its share of deferred E&P deficits. Although section 965 is itself somewhat unclear, the JCT description indicates that hovering E&P deficits are taken into account for this purpose.

The affiliated group E&P deficit sharing rules included in section 965 were not included in the 2014 reform proposal. These rules generally should be favorable to taxpayers. However, because an affiliated group can only include "includible corporations" that meet strict ownership requirements, these rules will not apply to all related domestic corporations. For example, members of two separate U.S. consolidated groups commonly owned by a partnership or foreign corporation are not members of the same affiliated group.

### *Participation exemption*

Under the section 965 participation exemption, a U.S. shareholder is taxed at reduced rates on its income inclusion. The portion of the inclusion attributable to the U.S. shareholder's foreign cash position is taxed at 12% and the remaining portion is taxed at 5%. The participation exemption uses a deduction to achieve these reduced rates. The amount of a U.S. shareholder's section 965 deduction is the sum of the amounts necessary to tax its deferred income attributable to its foreign cash position at 12% and all other deferred income at 5%, in each case, based upon the highest marginal corporate tax rate in effect for the year of the inclusion. Adjustments are also made for corporate rate changes that apply for only a portion of the U.S. shareholder's tax year.

A U.S. shareholder's foreign cash position generally is one-third of the sum of its pro rata share of the cash position of each of its specified foreign corporations, determined as of November 2, 2017, and the close of each of their last two tax years ending before November 2, 2017. If a specified foreign corporation did not exist on either of the two latter dates, its cash position is determined solely by reference to its position as of November 2, 2017. A specified foreign corporation's "cash position" is the sum of its: (i) cash; (ii) net accounts receivable; (iii) and the fair market value of personal property actively traded on an established financial market, commercial paper, certificates of

deposit, government obligations, foreign currency, short-term obligations, and any economically equivalent asset identified by Treasury. Cash positions of a specified foreign corporation that could not be distributed on the testing dates noted above because of foreign law restrictions are excluded and cash position of a non-corporate foreign entity owned by a specified foreign corporation may be included. Section 965 includes rules to prevent double counting accounts receivable and short-term loans between specified foreign corporations and a specified foreign corporation's equity investments in another specified foreign corporation. Section 965 also includes an anti-abuse rule that will disregard a transaction for purposes of the section 965 deduction rules if the Secretary determines that the principal purpose of the transaction was to reduce a U.S. shareholder's foreign cash position.

#### **KPMG observation**

The section 965 deduction is modeled after the 2014 reform proposal, but is less taxpayer-friendly. The 2014 reform proposal provided a similar deduction that resulted in deferred E&P attributable to liquid assets being taxed at an 8.75% tax rate and all other deferred E&P being taxed at a 3.5% rate. Section 965 raises these rates substantially, presumably to generate additional revenue for budgetary purposes. Also, the section 965 deduction is determined solely by reference to the corporate income tax rate, even though section 965 applies to corporate and non-corporate U.S. shareholders.

#### **Foreign tax credits**

A portion of the foreign income taxes paid by a DFIC and deemed paid by a U.S. corporate shareholder are allowed to be taken as an FTC by the shareholder with respect to its income inclusion. Foreign income taxes carried forward may also be claimed as an FTC with respect to the income inclusion without limitation. The amount of foreign income taxes associated with a U.S. shareholder's income inclusion that are disallowed as an FTC are those taxes associated with the amount of the income inclusion offset by the section 965 deduction. These disallowed taxes may not be deducted and the section 78 gross-up does not apply to these taxes. Allowed foreign income taxes associated with a U.S. shareholder's income inclusion and not claimed as an FTC may be carried forward for 20 years.

#### **KPMG observation**

Section 965(g)(2) "haircuts" the FTCs associated with the U.S. shareholder's income inclusion by 65.7% for foreign income taxes associated with the portion of the inclusion attributable to the shareholder's foreign cash position and 85.7% for foreign income taxes associated with the other portion of the inclusion. These percentages are equal to the amount of the U.S. shareholder's income inclusion that is offset by the section 965 deduction that is calculated using a corporate tax rate of 35%. As noted above, the amount of the section 965 deduction may be reduced to the extent that the corporate tax rate is 20% for the tax year of the income inclusion; however, the amount of disallowed FTCs does not appear to be similarly adjusted.

## **Overall foreign loss recapture**

A U.S. shareholder's overall foreign loss (OFL) recapture amount is unaffected by its income inclusion under section 965, but it is not clear whether the separate limitation loss recapture provisions are similarly unaffected.

## **Payment**

The tax assessed on a U.S. shareholder's income inclusion generally is payable in the same manner as its other U.S. federal income taxes. A U.S. shareholder may, however, elect to pay the increase in U.S. federal income tax liability as a result of the application of revised section 965 in equal installments over an eight-year period. This tax liability may be accelerated upon the occurrence of certain "triggering events," which include an addition to tax for failure to timely pay any installment due, a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 case), or a cessation of business by the taxpayer. Acceleration can be avoided upon the sale of substantially all the assets of the taxpayer if the buyer enters into an agreement with the Secretary to assume the liability for the remaining installments due.

## **S Corporations**

If an S corporation is a U.S. shareholder of a DFIC, each shareholder of the S corporation may elect to defer paying its net tax liability under section 965 with respect to the DFIC until its tax year that includes a "triggering event" with respect to the liability. A net tax liability that is deferred under this election is assessed as an addition to tax in the electing shareholder's tax year that includes the triggering event. If an S corporation shareholder elects to defer paying its net tax liability, the S corporation is jointly and severally liable for the liability and any penalty, addition to tax, or additional amount attributable thereto.

A "triggering event" for purposes of the section 965 S corporation provisions includes the general section 965 triggering events, a corporation ceasing to be an S corporation, an S corporation ceasing to exist, and the taxpayer's transfer of S corporation stock. If a taxpayer transfers some, but not all, of its S corporation stock, the transfer is only a triggering event with respect to the net tax liability properly allocable to the transferred stock. The transfer of S corporation stock is not treated as a triggering event if the transferee enters into an agreement with the Secretary to assume the transferor's net tax liability with respect to the transferred stock.

An S corporation shareholder that elects to defer paying its net tax liability under section 965 may also elect to pay this liability in equal installments over an eight-year period. The first installment must be paid by the due date (without extensions) of the shareholder's U.S. federal income tax return for the year that includes the triggering event.

## KPMG observation

Section 965 provides a favorable deferral regime for S corporation shareholders because the shareholders can elect to defer paying their net tax liability until there is a triggering event. Moreover, when a triggering event occurs with respect to an electing S shareholder, the shareholder can elect to pay its net tax liability on an installment basis.

## Modifications related to foreign tax credit system

### *Repeal section 902 indirect foreign tax credits; determination of section 960 credit on a current-year basis*

A provision of the proposal (section 4101 of the draft legislation) would repeal the deemed paid foreign tax credit under section 902 of the Code and retain but modify the deemed paid foreign tax credit under section 960 of the Code.

Section 902 of the Code deems a U.S. corporate shareholder of a 10% owned foreign corporation to have paid a portion of the foreign corporation's taxes when it receives or is deemed to receive a dividend from that foreign corporation. Section 960 of the Code provides a deemed paid credit for subpart F inclusions. Under the proposal, the allowable credit under section 960 of the Code is based on current-year taxes rather than the section 902 "pooling" approach.

To the extent foreign taxes attributable to a subpart F inclusion are not claimed as credits in the year of the subpart F inclusion—for example, because they arise on a distribution of previously taxed income (PTI) from a lower-tier to an upper-tier CFC—these foreign taxes would be allowed as credits under section 960 in the year the PTI is distributed. The section 960 credit, as under current law, would be computed separately for each separate category of income under Code section 904(d). The proposal would make conforming amendments to other Code provisions to reflect the repeal of Code section 902, including:

- Amending Code section 78 to treat the "gross-up" for deemed paid taxes as an additional section 951(a) inclusion rather than a dividend
- Amending Code section 909 to apply to direct foreign taxes and foreign taxes that would be deemed paid under Code section 960

The amendments are proposed to be effective for tax years of foreign corporations beginning after 2017.

## KPMG observation

These revisions to the foreign tax rules are essentially identical to the proposals in the "2014 tax reform proposal." The repeal of section 902 of the Code would have significant consequences for section 902 corporations (referred to as "10/50 corporations" in the

draft legislation) because no taxes paid or accrued by such corporations could be claimed as FTCs.

#### *Determine source of income from sales of inventory solely on basis of production activities*

A provision of the proposal (section 4102 of the draft legislation) would revise the current general rule under Code section 863(b), which sources income from inventory property produced in one jurisdiction and sold in another jurisdiction by allocating 50% of sales income to the place of production and 50% to the place of sale (determined based on title passage). Under the proposed change, income from inventory sales would be sourced entirely based on the place of production. Thus, if inventory property is produced in the United States and sold outside the United States, sales income would be 100% U.S. source. If inventory property is produced partly within and partly without the United States, income from the sales would be partly U.S. source and partly foreign source.

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

#### **KPMG observation**

The proposed change, which is identical to the proposal in the 2014 tax reform proposal eliminates the easily manipulable title passage rule with a rule that is meant to reflect solely the economics of production. It is unknown, though, whether it could have the unintended result of encouraging companies to expand foreign production.

#### *Limit foreign tax credits for high returns*

In addition, the proposal (section 4301(b) of the draft legislation) would add a new FTC basket for taxes associated with “foreign high return” income as provided in new section 951A. For more details regarding those rules see the discussion of section 4301(b) in the “Prevention of Base Erosion” section, below.

#### **Rules related to passive and mobile income**

##### *Repeal section 955 of the Code—no inclusion based on withdrawal of previously excluded subpart F income from qualified investment*

A provision (section 4201 of the bill) would repeal section 955 of the Code. As a result, there would no longer be current U.S. tax imposed on previously excluded foreign shipping income of a foreign subsidiary if there was a net decrease in qualified shipping investments.

The amendment in section 4201 would apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this provision would reduce revenues by less than \$50 million over 10 years.

### *Repeal section 954(g) of the Code—no inclusion based on foreign oil-related income*

A provision (section 4202 of the bill) would repeal section 954(g) of the Code. As a result, there would no longer be full U.S. tax currently imposed with respect to foreign oil-related income of a foreign subsidiary.

#### **KPMG observation**

While the repeal of section 954(g) of the Code would exclude foreign oil related income from subpart F income, such income may be subject to current U.S. taxation under new Code section 951A, which effectively imposes a minimum tax based, in part, on a CFC's gross income, subject to certain exceptions. Under one exception, income derived from the disposition of commodities produced or extracted by a CFC is not subject to the new minimum tax. Taxpayers should analyze the transactions that generate foreign oil related income to determine whether the income qualifies for this exception.

The amendment in section 4202 would be effective for tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this provision would reduce revenues by \$3.9 billion over 10 years.

### *Inflation adjustment of the de minimis exception for foreign base company income*

A provision (section 4203 of the bill) would amend section 954 of the Code to require an inflation adjustment to the \$1 million de minimis threshold, with all increases rounded to the nearest multiple of \$50,000.

The amendment in section 4203 would be effective for tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this provision would reduce revenues by \$.4 billion over 10 years.

### *Permanently extend look-through rule for related CFCs in section 954(c)(6) of the Code*

A provision (section 4204 of the bill) would make permanent the exclusion from the definition of foreign personal holding company income the receipt of certain dividends, interest, rents, and royalties from related parties under section 954(c)(6) of the Code. As currently enacted, the temporary exclusion in section 954(c)(6) of the Code expires on December 31, 2019.

The amendment in section 4204 would apply to tax years of foreign corporations beginning after December 31, 2019, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.



According to JCT, this provision would reduce revenues by \$11.8 billion over 10 years.

#### **KPMG observation**

While the amendment of section 954(c)(6) of the Code would exclude from the definition of foreign personal holding company income the receipt of certain dividends, interest, rents, and royalties from related parties, taxpayers need to carefully analyze existing transaction flows to determine whether these types of related-party payments generate CFC “tested income” that could be included in the “foreign high return amount” subject to current taxation. Under the new minimum tax provision, amounts excluded from a CFC’s subpart F income under Code section 954(c)(6) are not taken into account for purposes of determining its U.S. shareholder’s “foreign high return amount” to the extent that the payment of the amount does not reduce the “foreign high return amount” of a payor U.S. shareholder. The provision also grants authority to the IRS to issue regulations that revise this rule.

#### *Modify the constructive stock ownership rules in section 958(b) of the Code to allow downward attribution of foreign-owned stock*

A provision (section 4205 of the bill) would eliminate a constructive ownership rule in section 958(b)(4) of the Code that prevents downward attribution of stock owned by a foreign person to a U.S. person. As a result, for example, stock owned by a foreign corporation would be treated as constructively owned by its wholly owned domestic subsidiary for purposes of determining the U.S. shareholder status of the subsidiary and the CFC status of the foreign corporation.

The amendment in section 4205 would apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this provision, along with section 4001 of the bill, would reduce revenues by \$205.1 billion over 10 years. Nonetheless, this provision likely would increase revenues as a result of expanding the scope of taxpayers subject to the subpart F rules.

#### **KPMG observation**

A primary impact of this proposal would be to cause minority US owners of foreign subsidiaries in an inverted group to be as treated US shareholders of CFCs as a result of attribution from the majority foreign owner. These residual owners would become subject to the subpart F rules, including the new Code section 951A minimum tax rules.

#### *Eliminate the 30-day rule under section 951(a) of the Code for current income inclusions*

A provision (section 4206 of the bill) would eliminate the requirement in section 951(a) of the Code for a foreign corporation to constitute a CFC for an uninterrupted period of at



least 30 days in order for a U.S. shareholder to have a current income inclusion. As a result, for example, a U.S. shareholder could have a current subpart F inclusion when a CFC generates subpart F income during a short tax year of less than 30 days.

The amendment in section 4206 would apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, this provision would increase revenues by \$.4 billion over 10 years.

## Prevention of base erosion

### *Tax the “foreign high-return amount” of controlled foreign corporations*

One of the most important provisions of the bill would impose a tax on a U.S. shareholder’s pro rata share of a CFC’s foreign high-return amount (the “Foreign High-Return Amount”). The tax would be imposed on 50% of the U.S. shareholder’s share of the CFC’s foreign high-return amount (at the statutory rate of 20% and thus at an effective rate of 10%). The foreign high-return amount, similar to amounts calculated under subpart F, must be included in a U.S. shareholder’s income each year without regard to whether that amount is in fact distributed by the CFC to the U.S. shareholder.

Although lowering the U.S. statutory rate from 35% to 20% presumably would reduce the incentives to erode the U.S. tax base by shifting profits outside the United States, there was a concern (especially among revenue scorers) that shifting to a territorial tax system would exacerbate the incentives since any shifted profits would be potentially permanently exempt from U.S. tax. The inclusion of the foreign high-return amount in a U.S. shareholder’s income is intended to reduce those incentives further by ensuring that CFC earnings that are considered to be “non-routine” are subject to a minimum effective tax rate of at least 10%.

### **KPMG observation**

Both the reduction in the corporate tax rate and the exemption of dividends from CFCs (see discussion of section 4002 of the bill, above) are described as increasing the competitiveness of U.S. corporations and levelling the playing field with foreign multinationals. In this context it is worth noting that an immediate 10% tax on non-routine returns of CFCs will be comparatively unfavorable to the CFC rules of most of the major trading partners of the United States, which typically tax CFC earnings in much more limited circumstances.

In general terms, the foreign high-return amount is calculated as the excess of

- The aggregate net income of all CFCs (net of any net losses of CFCs) other than income that is subpart F, U.S. effectively connected, active financing, insurance, derived from certain commodities transactions or from certain payments between related CFCs (net tested income)

over

- (x) a routine return (which would fluctuate with interest rates, but currently would be approximately 8%) on the aggregate amount of the U.S. tax bases of all CFCs in depreciable tangible property (routine return)

less

- (y) the aggregate interest expense paid or accrued by the CFCs that reduced net tested income (allocable interest expense)

#### **KPMG observation**

Notwithstanding the complexity of this calculation, the routine return will often be negligible, because (i) the CFC's primary value-driver is intangible assets, and, notably, no relief is given for a return on such assets even when a taxpayer has purchase basis (for example, because the taxpayer purchased a patent); (ii) the tangible property is substantially depreciated; or (iii) in the case of highly-leveraged CFCs, the allocable interest expense substantially reduces or eliminates the routine return. As such, the tax base on which the tax is imposed will in many cases be a U.S. shareholder's ratable share of net tested income without reduction for any sort of routine return.

Commodities income, for purposes of the aforementioned exclusion from the definition of tested income, includes the "gross income of such corporation from the disposition of commodities which are produced or extracted by such corporation." Since extraction income is often subject to a high-rate of effective tax, the exclusion may be an attempt to eliminate opportunities to credit those high effective rate taxes against other low-tax tested income.

In general, accruals or payments between related CFCs (other than dividends, which are generally excluded from income) would generally be deductible by the payor CFC (and would reduce net tested income to the extent the deduction is allocable to that income) and be includible in the gross income of the payee CFC (and generally would increase the payee's net tested income).

#### **KPMG observation**

Under current law (which the bill would not change) accruals of an item that are owed by one CFC to a related CFC are generally deductible before the tax year of payment only if the item of income is includable in the gross income of a U.S. shareholder who directly or indirectly owns the recipient CFC. As such, accrued non-subpart F items between CFCs could create net tested income in the recipient CFC without reducing the payor's net tested income. Thus, if the bill is enacted as proposed, it might be necessary for CFCs to pay accrued items between related CFCs before the end of the CFC's tax year to ensure that they are deductible and there is no double-counting of net tested income.

The rules for determining whether a U.S. shareholder is required to include the foreign high-return amount in its income and the U.S. shareholder's pro rata share of that amount are similar to the U.S. subpart F rules.

In general, if a U.S. person is (i) a 10% U.S. shareholder of a CFC (taking into account the broad constructive ownership rules applicable in subpart F) on any day during the CFC's tax year during which the foreign corporation is a CFC and (ii) the U.S. person owns a direct or indirect interest in the CFC on the last day of the tax year of the foreign corporation on which it is a CFC (without regard to whether the US person is a 10% shareholder on that day), then the U.S. person must include in its own income its pro rata share of the foreign high-return amount of the CFC for the CFC's tax year that ends with or within its own tax year.

A provision of the proposal (section 4301(b) of the draft legislation) would add new section 960(d) to the Code to provide a limited deemed credit for **80%** of the foreign income taxes with respect to foreign high-return income that is includible in a U.S. corporate shareholder's income. Under the proposal, the foreign taxes deemed paid by the domestic corporation would equal 80% of

- Such domestic corporation's "foreign high return percentage", multiplied by
- The aggregate "tested foreign income taxes" paid or accrued by all CFCs of which the domestic corporation is a U.S. shareholder with respect to their tested income (as discussed above, tested income consists of the CFC's gross income other than income that is subpart F, U.S. effectively connected, active financing, derived from certain commodities transactions or from certain payments between related CFCs).

The foreign high return percentage equals the ratio of the CFC's aggregate pro rata share of foreign high-return amount divided by the CFC's aggregate pro rata share of tested income. This ratio presumably is intended to compare the amount included in the U.S. shareholder's income and subject to tax in the United States, the foreign high-return amount, to the amount with respect to which the relevant foreign taxes are imposed, the tested income, to determine the relevant percentage of foreign taxes that should be viewed as deemed paid for purposes of the credit.

The proposal (in new Code section 960(d)) also would modify the Code section 78 gross-up to treat the deemed paid taxes as an increase in the foreign high-return amount included under new Code section 951A. However, the proposal would compute the section 78 gross-up by reference to **100%** of the related taxes, rather than by reference to the 80% that are allowable as a credit.

The proposal also would amend Code section 904(d) to create a separate basket for these deemed paid taxes to prevent them from being credited against U.S. tax imposed on other foreign-source income. Code section 904(c) would be amended to provide that

any deemed paid taxes under new Code section 960(d) cannot be carried back or forward to other tax years.

#### **KPMG observation**

New Code section 951A would impose current tax on 50% of a domestic corporation's foreign high-return amount, but new Code section 960(d) would allow a deemed paid foreign tax credit of 80% of the foreign taxes attributable to the foreign high-return amount.

In general, because of the deemed paid foreign tax credit, a U.S. shareholder generally would be indifferent to the new Code section 951A tax when the effective tax rate on the underlying income is at least 12.5% (ignoring base and timing differences).

Consistent with netting gains and losses between different CFCs in computing the amount of income included in a domestic corporation's foreign high-return amount, the JCT report provides that any taxes paid by a CFC in a net income as well as a net loss position are taken into account in computing the section 960(d) deemed paid foreign tax credit. Nonetheless, taxpayers would not obtain the full benefit of these taxes when there is a loss CFC because the "foreign high return percentage" reduces the creditable amount whenever there is at least one loss CFC. It is unclear whether the result is intended in this context.

Finally, because there is no carryforward or other provision to mitigate the consequences of timing differences between U.S. and foreign income tax laws, it is possible that U.S. shareholders whose CFCs generally are subject to significant foreign taxes may nonetheless owe residual U.S. tax in a particular year if significant income is recognized in that year for U.S. tax purposes but not for foreign tax purposes. For large multinationals this issue may be mitigated by the ability to average across CFCs, but cyclical businesses nevertheless could be especially susceptible to this problem. Moreover, some taxpayers may be better off deducting rather than crediting the foreign taxes they are deemed to pay under the proposal.

The provision would be applicable commencing in tax years of foreign corporations beginning after December 31, 2017.

#### **KPMG observation**

To mitigate the impact of this provision in 2018, U.S. shareholders with a calendar year should consider electing a November 30 year-end for their CFCs, in which case the income of their CFCs will not be subject to the tax until December 1, 2018. In the case of a U.S. shareholder with a fiscal year, that U.S. shareholder generally would be exempt from the tax until the first day of the CFC's fiscal year beginning in 2018 (e.g., a CFC with a September 30 year-end would become subject to the tax beginning October 1, 2018).

*Limit deduction of interest by domestic corporations which are members of an international financial reporting group*

Section 4302 of H.R. 1 would amend section 163 of the Code to add a new Code section 163(n), to potentially limit the amount of deductible interest expense of a U.S. corporation that is a member of any “international financial reporting group.” This limitation on deductions for interest expense would apply *in addition to* the new general disallowance of certain interest expense under section 3301 of H.R. 1 (which would amend current Code section 163(j)). Whichever provision (section 4302 of H.R. 1 (new Code section 163(n)) or section 3301 of H.R. 1 (new amended Code section 163(j))) would deny the greater amount of interest deductions would apply to the affected U.S. corporation.

New Code section 163(n) would limit a current deduction for net interest expense to the extent the U.S. corporation’s share of the group’s global net interest expense exceeds 110% of the U.S. corporation’s share of the group’s global earnings before interest, taxes, depreciation, and amortization (EBITDA). Disregarded entities are included for this purpose.

Disallowed interest expense under either section 4302 of H.R. 1 or section 3301 of H.R. 1 may be carried forward for up to five tax years, and carryforwards would be used on a first-in, first-out (FIFO) basis.

The required “international reporting group” is defined as any group of *entities* that in the current year:

- Includes at least one foreign corporation that is engaged in a trade or business in the United States, *or* at least one domestic (U.S.) corporation and one foreign corporation;
- Prepares consolidated financial statements; and
- Has (taking into account in the aggregate all entities in the group) annual global gross receipts of more than \$100 million for the three-reporting-year period ending with the current year.

A “consolidated financial statement” generally means for this purpose a statement made on the basis of generally accepted accounting principles (GAAP), international financial reporting standards (IFRS), or other comparable method of accounting and which is provided to the U.S. Securities and Exchange Commission), to shareholders or creditors, or to other governmental agencies for non-tax purposes.

Although the general rule created by section 4302 of H.R. 1 applies only to a U.S. corporation, that rule is later explicitly *extended* to apply to *partnerships* and *foreign corporations*, and applies to groups filing consolidated returns:

- A partnership is an entity which can be a member of an international reporting group, and section 4302 of H.R. 1 explicitly subjects partnerships to these interest

disallowance rules, under rules similar to those in Code section 163(j)(3), except as provided by regulations.

- This interest disallowance rule also may apply to limit the interest deduction of a foreign corporation that is engaged in a trade or business in the United States, except as provided by regulations.
- Members of an affiliated group of corporations that file (or are required to file) a consolidated income tax return shall be treated as a single corporation for purposes of applying this interest disallowance rule.

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

The JCT estimates that this provision would increase revenues by \$34.2 billion over 10 years.

#### **KPMG observation**

A somewhat similar proposal was included in a 2014 tax reform proposal released by the then Chairman of the House Committee on Ways and Means. Section 4302 of H.R. 1 focuses on excessive leverage, and interest deductions in the United States, and, like the 2014 proposal, allows the U.S. entity to have 10% more leverage than the worldwide group. However, the current proposal in section 4302 of H.R. 1 applies only to groups of entities having annual global gross receipts of more than \$100 million for the three-reporting-year period ending with the current year, and allows carryforwards of disallowed interest expense for up to five years instead of one year.

The prior proposal applied to a U.S. corporation that was a U.S. shareholder as defined in Code section 951(b). Section 4302 of H.R. 1 is not so limited in its application.

Neither the current proposal nor the prior proposal would apply to a group consisting only of domestic corporations.

*Add excise tax on certain payments from domestic corporations to related foreign corporations; election to treat such payments as effectively connected income*

The final sentence in the “Unified Framework” released by Republican leadership on September 27 was an opaque statement that “the committees will incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.” H.R. 1 includes several responses to this call to action, including the proposal discussed above to address perceived over-leveraging of the United States by both U.S- and foreign-parented multinationals. At center stage, however, is sec. 4303 of H.R. 1, which would impose a new excise tax on deductible payments by domestic corporations to related foreign corporations. The new tax is sweepingly broad in scope, applying to virtually every form of payment, other than



interest, that would give rise to a reduction in U.S. taxable income, and would apply to both U.S. and foreign-headquartered groups, thus including payments by U.S. multinationals to their CFCs.

The rate of the proposed excise tax (new Code Sec. 4491) would equal the highest corporate tax rate (20% after enactment). The excise tax thus would effectively deny the benefit of a deduction for covered payments, *unless* the foreign recipient elects to treat the payment as income effectively connected with a U.S. trade or business (ECI) and as income attributable to a permanent establishment for tax treaty purposes, as discussed in further detail below. If the election is not made and the excise tax is paid, it is not deductible from the domestic corporation's taxable income.

## Scope

The targeted payments (referred to as "specified amounts") are amounts paid or incurred by domestic corporations to foreign corporations that are part of the same international financial reporting group (IFRG). An IFRG is a group of entities that prepare consolidated financial statements (as defined in new Code section 163(n), described above), provided that the specified amounts paid or incurred by domestic members of the IFRG exceed \$100,000,000 annually, using a three-year averaging test. Foreign corporations that have a U.S. trade or business or permanent establishment (other than a deemed U.S. trade or business pursuant to the new election) are considered domestic corporations with respect to the U.S. business-connected payments they make or receive, including deemed payments by the branch to its owner.

Specified amounts include most items that are allowable as a deduction or includible in COGS, inventory, or the basis of a depreciable or amortizable asset. The only exceptions are for: (i) interest, (ii) payments for actively traded commodities and related hedges; (iii) "FDAP" payments subject to U.S. withholding tax, to the extent of the proportion that the rate of tax imposed bears to 30% (similar to the scaling ratio used in the definition of "disqualified interest" in current section 163(j)); and (iv) payments for services that are charged at cost (i.e., no markup) under the services cost method in Reg. section 1.482-9(b). Payments to and from partnerships that are part of the IFRG are subject to the rules on a look-through basis, based on the partners' distributive shares of the income, gain, deduction, or loss to which such amounts relate.

## KPMG observation

The exclusion of interest from the scope of covered payments is noteworthy, given the focus in recent years on the benefit of intercompany interest expense deductions for "inverted" and foreign-owned U.S. multinationals. The House drafters likely concluded that the proposed curbs on business interest expense generally (section 3301) and, more importantly, the new worldwide group interest ratio (section 4302) are sufficient to limit the base erosion potential from intercompany interest.



### The “section 882(g) election”

Section 4303 of the bill also would add new Code section 882(g), under which a foreign corporation that receives specified amounts can make an election (the “section 882(g) election”) to treat the specified amounts as ECI and as income attributable to a permanent establishment. A specified amount that is subject to the election is not subject to the excise tax.

Significantly, the ordinary rules for allocation and apportionment of deductions do not apply for purposes of determining the U.S. taxable income from specified amounts subject to a section 882(g) election. Instead, an electing foreign corporation can take into account only its “deemed expenses” with respect to a specified amount. “Deemed expenses” are the amount of expenses necessary to ensure that the “net income ratio” of the foreign corporation with respect to the specified amount is equal to the net income ratio of the IFRG for that year with respect to the “product line” to which the specified amount relates. The net income ratio is the ratio of net income (determined without regard to interest income, interest expense, or income taxes) to revenues, determined “on the basis of the consolidated financial statements” of the IFRG (rather than under U.S. federal income tax principles).

The provision contemplates that regulations may “provide for the proper determination of product lines.”

### KPMG observation

In contrast to segment reporting, product line is not an accounting term of art. Although the proposal would grant regulatory authority to provide guidance on the proper delineation of product lines, taxpayers likely would have some flexibility in this regard.

The proposal appears intended to drive taxpayers to elect ECI treatment, with the result that all global operating profits from sales by foreign affiliates through U.S. affiliates are subject to U.S. taxation. However, because payments to unrelated parties are not subject to the provision, it does not appear to impact foreign companies that sell into the United States without a U.S. taxable presence (either a U.S. subsidiary or taxable branch), either because they use third-party distributors or because they sell directly to U.S. consumers without creating an income tax nexus. Note, however, that there is an express grant of regulatory authority to “prevent the avoidance of the purposes of this subsection through the use of conduit transactions or by other means.

The proposal could have a material impact on segments of certain industries. For example, one insurance industry segment includes off-shore reinsurance to an affiliated entity as an integral part of its business model. The proposal would have an economic impact on related party cross border reinsurance. In addition, because the provision is written to cover a broad range of payments, the application to specific types of reinsurance agreements raises questions regarding the scope of the paid or accrued specified amounts.

It is also interesting to note that H.R. 1 would assert these new destination-based taxing rights while at the same time retaining our origin-based jurisdiction to tax with respect to U.S. based production activities. In fact, section 4102 of the bill would strengthen origin-based taxation by providing that the source of income from sales of inventory produced in the United States is determined based solely on the place of production activities.

The section 882(g) election does not put the electing foreign corporation into U.S. trade or business status with respect to other income, nor does it subject the electing foreign corporation's own payments to foreign related parties to the new regime.

### **KPMG observation**

By deeming deductions based on global profit levels, the section 882(g) election avoids the need for iterative application of the rules applicable to specified amounts. Note, however that the foreign corporation would be subject to branch profits tax under Code section 884 with respect to the effectively connected net income determined under the NIR formula.

### **KPMG observation**

The summary prepared by the Ways and Means Committee states that this new regime would “reaffirm the arm’s length principle by reinforcing the significance of accurately pricing related-party transactions to avoid subjecting amounts that are in excess of arm’s-length prices to U.S. taxation.” The structure of the deemed ECI computation, however, appears aimed at requiring that all profits from a U.S. sale (albeit based on “rough justice,” by reference to global average profits for the product line) are subject to U.S. tax, in sharp contrast to the traditional notion of the arm’s length principle, which would instead allocate such profits to taxing jurisdictions based on where value is created, by reference to the location of relevant functions, assets, and risks. The “rough justice” nature of the inquiry may be particularly stark in cases where the expenses paid to unrelated third-parties by the U.S. taxpayer are lower (in proportion to revenue) than those paid on a worldwide group basis; in such cases it appears that the deemed ECI computation (when taken together with profits reported by the U.S. taxpayer) may end up subjecting more than 100% of the group-wide profits to U.S. taxation. Incongruities will also arise when U.S. pricing differs significantly from global pricing due to differing market conditions.

### **Reporting and payment**

Along with the substantive rules, section 4303 sets forth a new set of recordkeeping and reporting obligations relating to the excise tax and the section 882(g) election.

Lastly, from a tax collection and enforcement perspective, all domestic corporations within the IFRG of the foreign corporation making the Section 882(g) election are treated jointly and severally liable for the deemed ECI tax.

## Effective date and revenue effect

The provision applies to payments made on or after December 31, 2018, thereby affording taxpayers at least a one-year transition period.

The provision is estimated to increase revenues by \$154.5 billion over 10 years.

## KPMG observation

Although no explicit statement is made about the intent to override tax treaties, the provision presumably would not have the desired effect unless the 20% gross-basis tax applied notwithstanding limitations that otherwise would be imposed by tax treaties (and unless profits attributable to a permanent establishment pursuant to a section 882(g) election were calculated using the deemed expense approach rather than the accepted treaty approach). Framing this tax as an excise tax imposed on domestic companies likely indicates an intent for the tax to be outside the scope of tax treaties, which generally apply only to income taxes. Such an approach, similar to the approach taken by the United Kingdom in its diverted profits tax, would mean that the tax could be applied in full notwithstanding U.S. treaty obligations.

Regardless of the merits of the approach, it is likely to be viewed as having an effect similar to a treaty override by U.S. treaty partners, and may provoke a response. Where it applies, it effectively requires affiliated entities to choose between (a) paying a 20% gross-basis tax on payments that previously were exempt for U.S. income tax purposes (or subject to reduced tax) under the provisions of a treaty, or (b) deeming the existence of a permanent establishment for treaty purposes and calculating its profits using a method not authorized by the language of the tax treaty. There might also be questions regarding whether the tax is consistent with commitments under our trade agreements. The overall impact of the proposal will depend in part on the response of other countries. If other jurisdictions in the supply chain continued to apply conventional tax rules to the income that is taxed under this proposal, the proposal would result in some degree of double taxation. If other jurisdictions were to respond by adopting a similar tax, however, the result would be multiple taxation in the case of product lines with supply chains spanning multiple such countries.

Apart from the reaction of individual treaty partners, this proposal appears to reflect a substantial shift from the historic U.S. approach of pushing for lower taxation at source in favor of residence-based taxation. It is unclear what such a shift would mean for the future of U.S. tax treaty policy. At the least, the proposal is likely to have a significant impact on the U.S. position in discussions at the OECD regarding the tax challenges raised by the digitalization of the economy, which are focused explicitly on the question of how to balance residence-versus source-based taxation. In that context, a number of OECD countries have expressed a desire to expand market-based taxing rights. While the U.S. Treasury Department previously resisted addressing fundamental questions of residence- versus source-based taxing rights in the context of the OECD's project to

address base erosion and profit shifting (BEPS), it appears that the U.S. government is now prepared to actively engage in that conversation at the OECD.

## Provisions related to possessions of the United States

### *Extend deduction allowable with respect to income attributable to domestic production activities in Puerto Rico*

In conjunction with its general repeal of the deduction for domestic production activities under section 199, the bill would provide a narrow extension of the provision in the context of Puerto Rican activities. By its terms, the section 199 deduction (which had been available since 2006) had been available with respect to activities in Puerto Rico up through December 31, 2016. The bill would retroactively extend the benefits of that provision for an additional two years for gross receipts from Puerto Rico that are taxable under section 1 or 11 for such tax year.

Section 4401 of H.R. 1 would apply retroactively to tax years beginning after December 31, 2016, and before January 1, 2018.

This proposed amendment to Code section 199(d)(8)(C) is projected to reduce revenues by \$0.1 billion over 10 years.

### **KPMG observation**

The Protecting Americans from Tax Hikes (PATH) Act of 2015 (P.L. 114-113) extended the section 199 provision that includes Puerto Rico in the term “United States” for purposes of computing the domestic production activities deduction for tax years beginning before January 1, 2017. The proposed statutory language provides a retroactive one-year extension of the section 199 deduction for tax years beginning before January 1, 2018. This is consistent with the timing of the overall proposed repeal of section 199 provided in a separate provision of the bill.

Only wages paid by the taxpayer to a bona fide resident of Puerto Rico for qualifying activities performed in Puerto Rico are considered “wages” for purposes of computing the 50% W-2 wage limitation. Further, the gross receipts included in “domestic production gross receipts” for section 199 purposes must be subject to U.S. federal income tax. If finalized, for the states that conform to section 199, recognition of the proposed extension would depend on the individual state’s conformity date.

The extension of the section 199 deduction for activities in Puerto Rico may be a welcome provision for U.S. taxpayers currently conducting business in Puerto Rico. However, taxpayers should also bear in mind that because Puerto Rican corporations are generally treated as foreign persons, any transactions between a U.S. taxpayer and a Puerto Rican subsidiary would be subject to the new excise tax regime created in section 4403 applicable to certain payments from domestic corporations to related foreign corporations.

### *Extend temporary increase in limit on cover over of distilled spirits excise taxes to Puerto Rico and the Virgin Islands*

Section 4402 of the bill proposes to retroactively apply the \$13.25 per proof gallon distilled spirits excise tax cover-over amount paid to the treasuries of Puerto Rico and the U.S. Virgin Islands. The JCT has estimated that this proposal would lose \$0.8 billion of revenue over a 10-year period.

Under current law, a \$13.50 per proof gallon federal excise tax is imposed on distilled spirits produced or imported into the United States. For purposes of these taxes, the “United States” is the 50 states and the District of Columbia. Thus, distilled spirits, such as rum, produced in Puerto Rico or the U.S. Virgin Islands is considered to be imported product and subject to tax. However, section 7652(f) of the Code provides that a portion of the tax imposed on products produced in Puerto Rico and the U.S. Virgin Islands shall be covered over (i.e. “paid back”) to these U.S. territories. A cover over amount of \$13.25 per proof gallon of distilled spirits expired on December 31, 2016; the current amount of cover over with respect to distilled spirits is \$10.50.

The bill would retroactively reinstate the \$13.25 per proof gallon cover over for distilled spirits produced in Puerto Rico or the U.S. Virgin Islands effective January 1, 2017. This cover over amount would be extended through December 31, 2022.

#### **KPMG observation**

This provision would pay over to the U.S. Virgin Islands and Puerto Rico, which have been affected by recent hurricanes, an estimated \$800,000,000. This amount, however, is shared with the rum producers under longstanding agreements negotiated between the parties.

### *Extend American Samoa economic development credit*

H.R. 1 section 4403 retroactively extends the application of a tax credit available to certain domestic corporations with respect to their economic activity-based limitation with respect to American Samoa. This credit, which was introduced in section 119(d) of division A of the Tax Relief and Health Care Act of 2006, is not in the Code but is computed based on the rules of sections 30A and 936. The credit had been scheduled to phase out for tax years beginning after January 1, 2017; section 4403 retroactively extends the credit for an additional five years.

Section 4403 of H.R. 1 would apply retroactively to tax years beginning after December 31, 2016, and be extended to apply to tax years beginning before January 1, 2023.

This proposed provision is projected to reduce revenues by \$0.1 billion over 10 years.

### **KPMG observation**

The extension of the credit may be a welcome provision for certain domestic corporations operating in American Samoa. However, taxpayers should also bear in mind that because Samoan corporations generally are treated as foreign persons, any transactions between a U.S. taxpayer and a Samoan subsidiary would be subject to the new excise tax regime created in section 4403 applicable to certain payments from domestic corporations to related foreign corporations.

### **Restrict insurance business exception to passive foreign investment company rules**

H.R. 1 would expand the application of the passive foreign investment company (PFIC) rules, which deny U.S. investors the benefit of deferral of their U.S. tax on the PFIC's earnings, by limiting the exception from the rules for active insurance businesses.

Under section 4501 of H.R. 1, the current law exception from passive income for certain investment income derived from the active conduct of an insurance business would apply only to a foreign corporation that satisfies the new definition of a “qualifying insurance corporation.”

The new definition of a “qualifying insurance corporation” (whose investment income would not cause it to be a PFIC) is expanded by adding the requirement that its “applicable insurance liabilities constitute more than 25% of its total assets” based on “liabilities and assets as reported on the corporation’s applicable financial statement for the last year ending with or within the tax year.” Applicable liabilities include loss and loss adjustment expenses and certain reserves, but do not include deficiency, contingency, or unearned premium reserves.

The “applicable financial statement” generally must be a statement made on the basis of generally accepted accounting principles (GAAP), on the basis of international financial reporting standards (IFRS) if no GAAP statement is available, or, “except as otherwise provided by the Secretary in regulations,” on the basis of the annual statement required to be filed with the applicable insurance regulatory body, but only if neither a GAAP nor IFRS statement is available.

Section 4501 provides potential relief to a foreign corporation that cannot meet the new 25% test by giving the Secretary regulatory authority to allow a U.S. person owning stock of such a foreign corporation to elect to treat it as a qualifying insurance company if (1) its applicable liabilities equal at least 10% of its assets, and, (2) (a) the foreign corporation is predominantly engaged in an insurance business, and (b) the failure to satisfy the greater than 25% threshold is due solely to run-off-related or rating-related circumstances involving such insurance business.



## Effective date

Section 4501 of H.R. 1 would apply to tax years (presumably of foreign corporations being tested for PFIC status) beginning after December 31, 2017.

## Revenue Impact

The JCT has estimated that the provision would raise \$1.1 billion over 10 years.

### KPMG observation

This provision largely tracks prior legislative proposals that were described as addressing a perceived abuse whereby some insurance activities were used to shelter large investments. The change may also have impacts on non-U.S. insurance companies that insure long-tail and catastrophic risks.

U.S. persons owning stock of a corporation treated as a PFIC because it is ineligible for the active insurance exception in Code section 1297(b)(2)(B) would be required to begin filing Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, and to consider available PFIC-related elections.

Under current law (Code section 6501(c)(8)), a U.S. person that fails to file Form 8621 for a year generally would have the statute of limitations for its tax return for that year kept open until three years after the U.S. person furnishes the required information to the IRS.

Section 4501 of H.R. 1 also could require the Department of the Treasury to issue new regulations, and the IRS to amend Form 8621, for taxpayers to take advantage of the election it would provide to U.S. shareholders of certain affected foreign corporations that fail the 25% test.

## Exempt organizations

The bill includes a number of changes that would affect tax-exempt organizations. Unless otherwise stated, all provisions would be effective for tax years beginning after December 31, 2017.

### Clarification of unrelated business income tax treatment of entities treated as exempt from taxation under section 501(a)

Under section 5001 of the bill, the unrelated business income tax (UBIT) would apply to an organization exempt from tax under section 501(a)—even if the organization is also exempt or excludes amounts from gross income by reason of another provision.

JCT estimated this provision would increase revenues by \$1.1 billion over 10 years.

**KPMG observation**

According to the summary, current law is unclear as to whether certain state and local entities (e.g., public pension plans) that are tax-exempt under section 501(a) and exclude income by reason of section 115(1) (colloquially, “super” tax-exempts) are subject to UBIT. This provision would resolve this uncertainty and subject such governmental entities to UBIT. If adopted, this provision could have a significant impact on public pension plans and on the funds in which they invest their assets.

**Exclusion of research income limited to publicly available research**

Section 5002 of the bill would require organizations operated primarily for purposes of carrying on fundamental research to make such research freely available to the general public in order to exclude the income derived from such research from unrelated business taxable income (UBTI).

JCT estimated this provision would increase revenues by \$0.7 billion over 10 years.

**KPMG observation**

The proposed legislation does not alter the present exclusions from UBTI provided for by section 512(b)(7) (research performed for certain governmental entities) or section 512(b)(8) (research performed by a college, university or hospital). The provision would simply narrow the current exclusion from UBTI under section 512(b)(9).

**Simplification of excise tax on private foundation investment income**

Section 5101 of the bill would impose a single 1.4% excise tax rate on the net investment income of non-operating private foundations.

JCT estimated this provision would increase revenues by \$0.5 billion over 10 years.

**KPMG observation**

Currently, a non-operating private foundation is subject to either a 2% or 1% excise tax on its net investment income, depending upon the amount of disbursements for charitable purposes the foundation has made over the prior five years. The proposal would result in increasing the tax on some foundations while reducing the tax for others.

**Private operating foundation requirements relating to operation of art museum**

Under section 5102 of the bill, an art museum would not qualify as a private operating foundation unless it is open to the public during normal business hours for at least 1,000 hours per year.

JCT estimated this provision would increase revenues by less than \$50 million over 10 years.

### **Excise tax based on investment income of private colleges and universities**

Section 5103 of the bill would impose a 1.4% excise tax on the net investment income of private colleges and universities with at least 500 students and non-exempt use assets with a value at the close of the preceding year of at least \$100,000 per full-time student.

#### **KPMG observation**

The proposal would not apply to public colleges or universities even if similarly situated in asset size to their private counterparts.

### **Exception from private foundation excess business holding tax for independently-operated philanthropic business holdings**

Section 5104 of the bill would create an exception to the excise tax applicable to a private foundation's ownership (generally more than 20%) in a for-profit business. To meet the proposed exception, the private foundation must satisfy the following conditions:

- It owns 100% of the voting stock in the for-profit business;
- It acquired all of its interests in the for-profit business other than by purchase (e.g., by gift or bequest);
- The for-profit business distributes all of its net operating income in any given tax year to the private foundation; and
- No substantial contributor (or family member) of the private foundation is a director of, employed by, or contracts with the for-profit business, at least a majority of the private foundation's board of directors does not consist of directors or executives of the for-profit business or members of a substantial contributor's family, and there is no loan outstanding from the for-profit business to a substantial contributor (or family member).

JCT estimated this provision would increase revenues by less than \$50 million over 10 years.

#### **KPMG observation**

This proposal has bipartisan support and has been introduced separately in both the 114<sup>th</sup> and 115<sup>th</sup> Congress. It would permit foundations to continue to own a business enterprise that is unrelated to the exempt purposes of the foundation, if the business is independently operated and its profits are dedicated to tax-exempt purposes. The proposal would permit the business to retain a reasonable reserve for working capital and other business needs.

## **Churches permitted to make statements relating to political campaign in ordinary course of religious services and activities**

Section 5201 of the bill would provide that a church (or an integrated auxiliary of a church or a convention or association of churches) would not jeopardize its tax-exempt status solely as a result of statements related to political campaigns made during religious services and in the ordinary course of the organization's regular activities, provided that the associated expenses are de minimis. The proposal would permit such entities to continue to receive tax-deductible contributions for income, gift, and estate tax purposes and would except such entities from the excise tax on political expenditures (section 4955).

## **Additional reporting requirements for donor advised fund sponsoring organizations**

Section 5202 of the bill would require a sponsoring organization of donor advised funds to disclose annually on its Form 990 (1) the average amount of grants made from its donor advised funds (as a percentage of the value of assets held in donor advised funds at the beginning of the tax year) and (2) whether it has a policy relating to the frequency and minimum level of distributions from its donor advised funds. The proposal would require the organization to attach a copy of any such policy to its Form 990.

JCT estimated this provision, which would be effective for returns filed for tax years beginning after 2017, would have no revenue effect.

## **REITs**

### **KPMG observation**

The bill would reduce, for tax years beginning after 2017, the maximum tax rate on ordinary dividends paid by a REIT (specifically, dividends paid by the REIT that are neither capital gain dividends nor are eligible for treatment as "qualified dividend income") to 25% (not including the 3.8% Medicare tax).

This is important given the substantial decrease in the maximum corporate tax rate from 35% to 20%. Under current law, for U.S. taxpayers that are individuals, trusts, and estates, dividends paid by a non-REIT domestic C corporation generally are subject to an effective maximum federal income tax rate of slightly over 50% (including tax paid at the corporate level), while ordinary dividends from a REIT generally are subject to an effective maximum federal income tax rate of 43.4%.

The bill would reduce the rate on dividends paid by a domestic C corporation to approximately 39%. A reduction in the tax rate applicable to REIT ordinary dividends would preserve (and, in fact, increase) the disparity between the effective federal tax rate applicable to noncorporate domestic taxpayers for C corporation income and dividends,

on the one hand, and REIT ordinary income and dividends, on the other hand; the disparity for these taxpayers for distributions attributable to capital gain generally would be slightly more than 15% (approximately 39% for C corporations, and 23.8% for REITs).

### *Foreign income*

As described elsewhere, the changes proposed by the bill to the taxation of U.S. taxpayer's foreign income would be substantial, and would have an effect on REITs that invest overseas. Domestic corporate taxpayers (which would seem to include REITs) generally would be able to deduct the "foreign-source portion" of dividends from foreign corporations (other than certain passive foreign investment corporations) in which they are "United States shareholders" (they hold a 10%-or-greater voting interest, determined taking into account applicable attribution rules). Those dividends also would seem to continue to be qualifying income for purposes of the 95% gross income test applicable to REITs. Further, where a REIT would be required under the bill to include in income a portion of its "foreign high return amount" of a foreign corporation, the bill would treat the inclusion as qualifying income for both gross income tests applicable to REITs.

The bill also includes provisions treating the accumulated earnings of certain overseas corporations as being repatriated. Importantly, the bill does not explicitly treat the deferred foreign income treated as repatriated under the bill as qualifying income for purposes of either REIT gross income test. Instead, that income is treated as subpart F income, which is not explicitly treated as qualifying income for either gross income test under current law or under the bill. Moreover, it does not appear that a REIT's distribution requirement associated with a repatriation inclusion would be "staggered" so as to mirror the installment payment method permitted corporate taxpayers generally.

### *Miscellaneous*

Several other points are worth mentioning:

- First, REITs would in many cases appear to be exempt from the proposed limitation on the deductibility of net business interest expense (business interest expense in excess of business interest income) that exceeds 30% of the REIT's "adjusted taxable income." This is because many REITs (and partnerships in which they invest) are engaged in "real property trades or businesses" within the meaning of the passive-activity loss rules and, as such, are not covered by this new limitation.

For those REITs (or REIT-owned partnerships) that would be subject to the limitation, this calculation generally is determined at the partnership-level rather than the partner-level, though the partner's share of the partnership's "excess limitation" (i.e., the amount by which the partner's share of 30% of the partnership's adjusted taxable income exceeds the partnership's net business interest expense) can be used by the partner to absorb its directly incurred net business interest expense. Disallowed interest expense would be permitted to be carried to the next five tax years.

This provision would apply to tax years beginning after 2017. As a trade-off for not being subject to this interest limitation, the bill would not permit current expensing of the cost of any property acquired and used in real property trade or business. This new limitation on deductions for net business interest expense would replace the current earnings-stripping rules under Code section 163(j).

It is also worth noting, however, that while the bill would exempt many real estate businesses from these rules, the bill proposes a separate limitation on deductions for net interest expense of domestic, and certain foreign, corporations (including, presumably, REITs) that are members of “international financial reporting groups” (“IFRGs”). The bill also would subject domestic corporations (including REITs) to a 20% nondeductible excise tax on certain deductible and other payments, not including interest, made to a member of their IFRGs. This excise tax would appear generally to apply to REIT dividends, which ordinarily are deductible; specifically, it would apply to the product of the REIT dividend multiplied by the ratio of the rate of FDAP withholding tax on the dividend to 30%. Either provision might have the effect of reducing the efficiency of the structures used by some foreign investors to make investments in U.S. real estate and in real-estate lending businesses, though many investment structures will not include REITs that are members of IFRGs. Moreover, it is possible that these provisions might affect investors in the REIT that are not members of its IFRG, given that the excise tax applies at the REIT level and the denial of the interest deduction could have an effect on the timing and amounts of the REIT’s dividends (e.g., the REIT might need to pay additional dividends to satisfy its distribution requirement or even be subject to excise taxes under section 4981 or interest charges as a need to pay deficiency dividends). Minority investors might need to protect themselves against being disadvantaged by these rules as a result of other investors’ ownership.

- Second, the new limitation on the utilization of net operating loss (NOL) carryovers to 90% of a taxpayer’s taxable income would apply to REITs. For purposes of the 90% limitation, a REIT’s taxable income would be the REIT’s “REIT taxable income” without taking into account the dividends paid deduction (DPD). This seemingly would mean that a REIT could use an NOL carryover to offset all of its REIT taxable income after paying distributions to its shareholders, provided that the REIT distributed at least 10% of pre-DPD REIT taxable income.

As a REIT ordinarily determines its utilization of NOL carryovers after its DPD, this modification is necessary to avoid causing a REIT to fail the minimum distribution requirement, incurring a corporate-level tax, or forgoing the NOL carryovers.

The bill would also repeal the corporate AMT for tax years beginning after 2017; current law generally treats 10% of the amount offset by the utilization of an NOL carryover as a preference item subject to AMT.

- Third, the bill would make certain clarifying and “clean-up” changes to the statutory language relating to the rules for capital gain dividends paid by REITs.



- Fourth, the bill would keep the provisions relating to foreign investment in real property largely intact, beyond reducing the corporate income tax rate applicable to foreign corporations' effectively connected income (including, generally speaking, their income subject to FIRPTA). There had been some public speculation as to whether the rules under FIRPTA might be substantially relaxed or repealed entirely so as to incentivize foreign investment in U.S. real estate.

The bill would, however, reduce the rate of required withholding under FIRPTA on REIT distributions made after 2017 from 35% to 20%. This would apply even, apparently, to those REIT distributions that would be subject to FIRPTA under Code section 897(h)(1) but that would not be eligible for treatment as capital gain dividends (e.g., distributions attributable to short-term capital gain generated by sales of U.S. real estate). Those dividends might also be subject to withholding under withholding provisions applicable to "FDAP" income.

- Lastly, the bill would eliminate tax-free like-kind exchanges for all property other than real property, effective for exchanges completed after December 31, 2017. REITs often use like-kind exchanges to defer gain while disposing of their real property holdings. Like-kind exchange treatment would continue to be available for non-real property exchanges for which at least one "leg" of the exchange is completed prior to January 1, 2018.

## State and local taxes

### KPMG observation

#### *Background*

Nearly every state conforms its state corporate and personal income tax in some manner to the Code. Conformity between state and federal taxes simplifies tax filing and compliance for taxpayers, and at the same time, reduces the administrative burden facing state tax authorities.

States follow two patterns in conforming to the federal income tax. Rolling or current conformity states tie the state tax to the Code for the tax year in question, meaning they adopt all changes to the Code as passed by Congress unless the state passes legislation to decouple from specific provisions. Static or fixed-date conformity states tie to the Code as of a particular date (e.g., December 31, 2016), meaning the state legislature must act to incorporate subsequent federal changes into the state tax code. States are about evenly divided between rolling and static conformity. A small number of states, notably California, adopt selected Code provisions, rather than using the blanket approach used by most states.

### *Corporate overview*

For corporate income taxes, states generally begin the computation of state corporate taxable income with federal taxable income and therefore allow, for state tax purposes, many federal deductions. A majority of the states start with line 28 of federal Form 1120 (taxable income before net operating losses and special deductions), and the remainder start with line 30, which includes net operating losses and special deductions. States establish their own tax rates and do not, for the most part, conform to various federal tax credits aimed at promoting various types of activities, such as credits for alternative energy sources. The research and development credit is an exception, as a number of states allow a counterpart credit based largely on the contours of the federal credit.

As noted, states do tend to pick and choose the items to which they will conform, often choosing not to conform to items that have major revenue loss consequences. For example, many states have decoupled federal bonus depreciation and the domestic production activities deduction allowed under Code section 199.

### *Individual overview*

On the individual income tax side, most states conform to the federal definition of adjusted gross income (AGI), but some seven conform to federal taxable income (meaning they incorporate the federal standard deduction and personal exemption allowance in addition to the AGI provisions). States that allow itemized deductions also usually conform to the federal itemized deductions, with the most common model allowing all federal itemized deductions other than the deduction for state income taxes. There are 11 states that do not provide for itemized deductions.

As with the corporate tax, states establish their own tax rates and tend not to conform to a wide range of income tax credits. The earned income credit is the most common exception to this general rule. In addition, only a few states have an individual AMT.

Given these relationships between federal and state income taxes, enactment of federal tax changes that affect the computation of the tax base, by altering the income reflected or the deductions allowed would have an impact on state taxes. Changes to federal tax rates and tax credits would not, for the most part, have a direct impact on state taxes. With this as background, the state tax implications of certain of the changes proposed in the bill are reviewed below.

### *Individual provisions*

- **Tax rates:** The revision of tax rates and brackets (along with the 25% rate on business income of owners of passthrough entities) proposed in the bill would not directly affect state taxes as states establish their own tax rate structure.
- **Standard deduction, personal exemption allowance, and child credit:** The bill, if enacted, would effectively double the standard deduction for all tax filers, repeal the

personal exemption allowances, enhance the child tax credit, and adopt a new family tax credit. These changes would not automatically affect most state personal income taxes as the large majority of states with an individual income tax conform to AGI, which is computed before these factors come into play. There are, however, seven states that conform to the federal definition of taxable income for individual income tax purposes, meaning the changes in the standard deduction and personal exemptions would be incorporated into the state individual income tax.

- **Itemized deductions:** If enacted, the bill would repeal most federal itemized deductions, including deductions for state and local income and sales taxes, property taxes for other than real property, personal casualty losses, certain medical expenses, a variety of miscellaneous deductions, and the overall limit on itemized deductions. It would also modify the home mortgage interest deduction and limit the deduction for real property taxes to \$10,000 per return.

As noted, the large majority of individual income tax states that allow itemized deductions conform to the federal definitions of those deductions, meaning that most of the changes would affect those states. Importantly, however, the largest component of the revenue effect of the itemized deductions appears to be from the repeal of the state income tax deduction, which is not allowed in the vast majority of states that allow itemized deductions.

Although there is minimal direct state tax effect of repealing the income tax deduction, the indirect effect would be to increase the after-tax cost of state income tax for those taxpayers that itemize—estimated to be about 10% of all filers after the increase in the standard deduction. This may well affect the ability of states to respond to future revenue needs. In addition, state choices among revenue sources may be influenced in the future by the retention of limited deductibility for real property taxes; a number of states, however, have constitutional limits on property tax levels.

### *Business provisions*

- **Tax rates:** The marquee tax rate provisions of the bill—20% for corporations and 25% for the business income of passthrough entities—would not have a direct impact on state taxation of these entities as states establish their own rate structure. The reduction in federal rates may cause state corporate income taxes to be relatively more important versus the federal tax, and consequently, increase the attention paid to state tax rates if they remain unchanged.
- **Permanent expensing of certain assets:** The bill, as proposed, would allow 100% expensing of certain new and used assets for a five-year period other than for property used in a real property trade or business or by a public utility. It also would increase the availability of expensing for small businesses under Code section 179. These changes would flow through to the state tax base in rolling conformity states unless the state acts to decouple. There would be no impact in static conformity states unless the state acts to adopt the change.

As noted, most states (about 30) have chosen not to conform to the existing bonus depreciation regime, largely because of the negative revenue impact. The revenue implications of the new 100% expensing provisions may be substantial both for states that conform to bonus depreciation and especially for those that do not. A smaller number of states (about 15) do not conform to the current law limits on section 179, choosing instead to retain earlier, less generous provisions. The full expensing system is accomplished by rather straightforward amendments to the current bonus depreciation law, meaning that there are likely to be a minimum of compliance-related issues emanating from the change beyond those present currently in states that do not conform to bonus depreciation.

- **Interest deductibility:** The bill, if enacted, would disallow the deduction of net interest expense to the extent it exceeds 30% of a taxpayer's adjusted taxable income, with an exemption for taxpayers with less than \$25 million in gross receipts and entities engaged in a real property business. This limitation would flow through to the state tax base, if a state conformed to the change.

At the federal level, the limit on interest deductibility is generally viewed as a counterpart to the 100% expensing allowed for certain assets. Whether that policy carries over to states that choose not to conform to the expensing is an open question. If a state chooses to conform to the interest limitation, there would be certain complexities because of the different filing entities at the state and federal level. The federal limitation would be determined at the tax filer level, which would, in many cases, be different than at the state level where a taxpayer may elect or be required to file on a combined basis or a separate entity basis, both of which may differ from a federal consolidated group filing. In addition, over 20 states currently have rules that disallow the deduction of certain interest paid to related parties. Coordinating the state and federal rules in these states could also present complications.

- **Net operating loss limitations:** The bill proposes to limit the use of net operating loss deductions (NOLs) by eliminating the current law carryback provisions in many cases and limiting the deduction to 90% of the taxpayer's taxable income. States vary significantly in their conformity with the provisions of the Code that address the calculation and use of NOLs. Most states do not allow a carryback currently, and there are varying carryforward periods. In addition, several states have limitations (e.g., Louisiana and Pennsylvania) on the extent to which NOLs may offset taxable income, and a number of states require adjustments to federal NOLs and the computation of a state-specific NOL. States seem likely to continue to choose their own approach to NOLs, resulting in continued complexity.

- **Repeal of other deductions and credits:** The bill proposes to repeal or limit a variety of other business deductions and credits. To the extent a state currently conforms to a deduction, limiting or repealing the deduction would broaden the state tax base (assuming continued conformity). The most significant deduction proposed for repeal is the Code section 199 deduction to which about one-half of the states currently conform. The repeal or modification of the various credits proposed in the bill would not have a significant impact on state taxes as there is not a state analog for most of the credits.
- **Revision in the treatment of contributions to capital:** The bill proposes to revise the contributions to capital rules to include in gross income any contributions to capital in the form of money or property that exceed the fair market value of any stock that is issued in exchange for the money or property. As described in the bill summary, the proposal “would remove a federal tax subsidy for state and local governments to offer incentives and concessions to businesses that locate operations within their jurisdiction....”

The JCT estimates the provision would increase federal revenues by \$7.4 billion over 10 years. The JCT Explanation indicates that a municipal tax abatement designed to encourage a business to locate in that locality would not be considered a contribution to capital for purposes of this section. If enacted, the proposal would reduce the value of the incentive to the receiving entity. As a result, the provision may encourage states and localities to increase the incentives offered or to restructure the incentives offered. The bill also proposes restrictions on the issuance and use of certain types of state and local bonds that are used to promote investment and economic development.

- **Deduction for foreign-source dividends received:** As part of the move to a territorial system, the bill would, if enacted, allow a dividends received deduction (DRD) for 100% of the dividends received from a foreign entity in which the U.S. recipient owns more than 10%. A number of state issues would flow from this new federal DRD. Of critical importance is the limitation placed on states by the foreign commerce clause, which prohibits states from discriminating against foreign commerce in their corporate tax systems, even if the differential treatment is result of conforming to the federal income tax. [See *Kraft General Foods v. Iowa Department of Revenue*, 505 U.S. 71 (1992).]

In the context of a DRD, this has been held to mean that dividends from foreign subsidiaries may not be subjected to a higher tax than dividends from domestic corporations. Many states have addressed this limitation by applying their DRDs in the same manner to both foreign and domestic dividends; a number of states, but certainly not all, allow a 100% DRD for dividends from foreign corporations (e.g., California allows a 75% DRD for foreign dividends for water’s edge filers). Depending on how states conform to the new federal DRD for foreign dividends, consideration will need to be given to whether that conformity results in disparate treatment for foreign and domestic dividends.

- **Transition to a territorial system—repatriation:** To transition to the territorial system, the bill, if enacted, would require a deemed repatriation of post-1986 earnings and profits (E&P) and would subject those amounts to reduced tax rates depending on whether the E&P relates to cash and cash equivalents or other assets. This is accomplished by first treating the post-1986 E&P as subpart F income and then allowing a deduction of those included amounts to arrive at the applicable preferential tax rates. This approach may create significant issues at the state level.

First, most states currently provide an exclusion from state taxable income for subpart F income either in the form of a specific exclusion or a DRD that applies to subpart F income. Second, to the extent any income is recognized in a state as a result of this provision, it could implicate the foreign commerce clause if the foreign income (i.e., subpart F income) is treated less favorably than if the income was earned from a domestic source. In states that automatically conform to the Code, confusion could arise from the potential conflict between the deduction provided for in the bill and a state's DRD (or the subpart F exclusion that would otherwise apply).

- **Territorial system—base erosion:** Under the proposed bill, a U.S. parent of a foreign subsidiary would be subject to U.S. tax on 50% of the U.S. parent's foreign high return amount, measured by the excess of the foreign subsidiaries' aggregate net income over a "routine return" (as defined in the bill). This income inclusion would be required through the enactment of a new Code section.

While this provision would require this income to be treated as subpart F income for a number of purposes, it would not technically be subpart F income. This creates issues for state corporate income taxes because the exclusion from income in some states for subpart F income is specific to subpart F and may not encompass this new income amount, meaning it could be subject to tax in those states. That potentially raises the issue of a potential foreign commerce clause violation if taxation would result in less favorable treatment for foreign-source income.

The bill, if enacted, would also include an interest limitation for members of certain multinational groups. This limitation would work in conjunction with the generally applicable interest limitation discussed above. Whichever provision results in the greatest reduction to deductible interest would apply. The limitation specific to debt owed to a foreign affiliate could affect state taxable income in states that already limit the deductibility for interest paid between related parties. Many of those states have an exception to their interest addback provision that applies to interest paid to a related party in a foreign jurisdiction having a tax treaty with the United States. For states that conform to this new federal limitation on interest deductibility, that otherwise deductible interest may be limited, even though it otherwise qualifies for an exception to the state addback statute.



The proposed base erosion provisions also include a 20% excise tax on certain payments made to a foreign affiliate by a U.S. corporation. This excise tax would not apply if the foreign affiliate elected to treat the payments as effectively connected income (ECI). For corporations that pay the excise tax, it is possible there would be no state tax effect because the new excise tax would not cause a change to the taxable income of the corporation (i.e., it would be subject to a separate federal excise tax and not the corporate income tax). If the foreign affiliate elected to treat the income as ECI, the state tax results would vary by state.

For example, if the ECI exceeded the nexus thresholds for a particular state, the foreign affiliate could be subject to tax in that state. In a state that requires combined returns on a water's-edge basis and includes foreign affiliates to the extent of their ECI in the return, the election to treat the payments as ECI could result in a change in the composition of the water's-edge group.

### *Closing thoughts*

For the last 12 months, there has been much speculation in the state tax community as to the effect federal tax reform, if enacted, would have on the states and how states would react. Until now, the speculation has been based on vague plans and general concepts. With the release of H.R. 1, the Tax Cuts and Jobs Act, and the various iterations that will follow, it will likely be possible for states and state taxpayers to further delve into the state implications of these far-reaching potential changes. The interrelationships between state and federal income taxes are such that any federal changes will necessarily have implications for state taxes.

But, state taxpayers must keep a few fundamental principles in mind. First, the reaction to federal tax reform by individual states will be largely dictated by the fiscal impact of conformity to the revised federal code. State balanced budget requirements will have an out-sized influence on whether and to what extent states conform to the federal changes. Simply put, states do not have the ability to run a deficit under their typical one-or two-year state budget cycles.

Second, there will likely be indirect effects as a result federal tax reform that states will consider. Certain of the proposed changes, such as the repeal of the state and local income tax deduction for individuals, will increase the after-tax costs of state and local government at a time when federal resources are likely to be constrained and reduced federal assistance may be available.

Third, timing is everything. If federal tax reform is passed in late 2017 effective for the 2018 tax year, states will have a very limited time to assess the fiscal and tax effect of the federal changes by the time state legislatures convene in early 2018. Some states may—out of necessity—simply delay addressing the changes until the impacts can be analyzed fully. This could be accomplished by freezing conformity to a pre-tax reform year, a step that would likely lead to a significant disconnect between federal and state tax laws—at least in the short-term.

Finally, there is no “one size fits all” state or state taxpayer response to federal tax reform. The proposed changes in H.R. 1 would affect each state differently and would need to be carefully analyzed by state tax administrators and state legislators so that the state can formulate a response. The effect on individual taxpayers would also vary widely and would depend on the taxpayer’s particular situation, current state filing position, and industry.

## Impact of tax reform on accounting for income taxes

### Remeasurement of current and deferred taxes

Accounting Standards Codification (ASC) Topic 740 requires the determination of income tax expense (benefit), income taxes receivable (payable) and deferred tax assets (liabilities) to be based upon currently enacted tax laws and rates. The effects of changes in tax laws or rates are generally reflected for financial reporting under U.S. generally accepted accounting principles in the interim period that includes the date of enactment; in other words, for U.S. federal income tax purposes, the period the president signs legislation into law.

The tax effect of a change in tax laws or rates on income taxes receivable (payable) for the current year is recorded after the effective dates prescribed in the statutes and reflected in the computation of the estimated annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. In some instances, a change in tax laws or rates may have retroactive effect. In those instances, the effect of the change on income taxes receivable (payable) for a prior year is recognized as of the date of enactment.

Deferred tax assets (liabilities) are remeasured to reflect the effects of enacted changes in tax rates and other changes in tax law when the law is enacted, even though the changes may not be effective until future periods. Companies will need to consider the timing of reversal of temporary differences that exist as of the enactment date. If the enactment date is different from an entity’s normal closing cycle, a company should make reasonable efforts to estimate the temporary differences at the date of enactment.

In addition, although the existing proposed legislative text calls for an immediate and permanent corporate tax rate reduction, changes in the tax law may phase in or out over a period of time, or the change in tax laws or rates may sunset and revert to existing tax law or rates. Accordingly, companies may need to perform some level of scheduling of temporary differences to determine the appropriate tax laws and rates to measure deferred tax assets and liabilities. The existing tax laws and rates should continue to be used to measure deferred tax assets and liabilities for those temporary differences scheduled to reverse prior to the effective date, while the new tax laws and rates should be applied to temporary differences that are scheduled to reverse after the effective date. If new tax laws or rates included in the final enacted legislation sunset, then reversion to

the existing tax laws and rates would be applied to those temporary differences scheduled to reverse after the sunset date. Therefore, companies will need the systems and processes to understand what years the tax basis of its existing assets and liabilities will reverse and what years the related financial reporting carrying amounts are expected to reverse.

### **Potential changes in significant judgments**

Although remeasurement of deferred tax assets and liabilities may be prevalent, there are additional financial reporting impacts to consider with respect to changes in tax laws and rates. For instance, lower tax rates in the U.S. can reduce a company's tax liability before tax credits and impact the company's ability to utilize certain tax attributes such as foreign tax credit carryforwards and general business credit carryforwards. A company may need to reassess whether there will be sufficient taxable income of the appropriate character in a given period to realize the deferred tax assets associated with operating loss and tax credit carryforwards. To the extent that deferred tax assets are not more likely than not to be realized, the deferred tax assets should be reduced by a valuation allowance to the amount that is more likely than not of being realized. To the extent additional limitations are introduced as part of the change in tax law may result in a change to an entity's valuation allowance judgment. For instance, if an interest expense limitation is included in the final enacted legislation, entities may see a significant increase in taxable income that may result in the release of an existing valuation allowance on U.S. federal deferred tax assets. The reassessment of an entity's valuation allowance judgment should be performed as of the date of enactment in conjunction with the remeasurement of deferred tax assets and liabilities.

Lower U.S. federal tax rates and the potential mandatory taxation of foreign earnings may result in a change of an entity's intentions with respect to the application of the indefinite reinvestment of its investment in foreign subsidiaries. Deferred tax assets and liabilities, or income taxes receivable or payable, may need to be recorded in the period that includes enactment. If an entity has historically asserted that its investments are indefinitely reinvested, certain information required to measure deferred tax assets and liabilities or income taxes receivable or payable, including the balance of earnings and profits and tax pools, may not be readily available. Entities may also need to consider the remeasurement of existing deferred tax assets and liabilities on investments in subsidiaries based upon the provisions of the enacted tax law. As part of this assessment, entities must continue to apply the guidance that prohibits the recognition of a deferred tax asset unless it becomes apparent the temporary difference will reverse within the foreseeable future.

There may be elements of the new legislation where it is not entirely clear how a court would interpret the law. Accordingly, companies should also assess what impact the new law will have on the accounting for uncertainty in income taxes. If there are tax positions expected to be reported on a future tax return that are not more likely than not or are not highly certain to be sustained upon examination based on the technical merits, a company

should determine the appropriate amount of unrecognized tax benefits to record in the financial statements.

### **Intraperiod tax allocation**

The entire impact of changes in tax laws and rates is recorded as a component of income tax expense or benefit related to continuing operations in the interim period that includes enactment. If material, the effect of the changes in tax law or rates should be disclosed in the notes to the financial statements.

If enactment occurs subsequent to a period end, but prior to the issuance of the financial statements, and the impact is anticipated to be material, disclosure may be necessary if non-disclosure would be misleading to a reader of the financial statements, while the effects are not recorded until the interim period in which the enactment occurs.

### **Summary**

This discussion highlights some anticipated common areas of accounting for income taxes resulting from a change in tax law or rates, but it is not all inclusive. An entity's specific facts and circumstances should be assessed in determining the accounting for income taxes impact as additional insight into final legislation is obtained.

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For more information on any of the provisions discussed in this booklet, please contact a professional in KPMG's Washington National Tax office.

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